TRADE BRIEFING PAPER • TRADE BRIEFING PAPER • TRADE BRIEFING PAPER • TRADE BRIEFING PAPER

September 21, 2004 No. 21

CENTER FOR TRADE POLICY STUDIES

# *The Case for CAFTA*

## *Consolidating Central America's Freedom Revolution*

by Daniel Griswold and Daniel Ikenson

## Executive Summary

The next major trade agreement likely to come before Congress will be the Central American Free Trade Agreement. The agreement would eliminate almost all trade barriers between the United States, Costa Rica, El Salvador, Guatemala, Honduras, Nicaragua and also the Dominican Republic.

If approved, CAFTA would establish free trade with nearby countries that together make up the United States' 13th-largest trading partner and second-largest export market in Latin America, behind only Mexico. Upon implementation, goods in 98 percent of the product categories from which the CAFTA countries could export to the United States would enter duty-free. For U.S. companies, CAFTA would offer guaranteed reciprocal access for our most competitive exports, including agricultural products.

Two glaring exceptions to free trade in the agreement are sugar and apparel. CAFTA grudgingly expands the existing quota on sugar imports from the region, denying U.S. consumers and sugar-using industries the benefits of lower prices. Its apparel provisions contain restrictive "rules of origin" requiring use of U.S.-made textiles, which will add to the cost of production in the region and ultimately undermine demand for U.S. inputs. Nonetheless, CAFTA marks a major step toward liberalizing trade.

CAFTA would enhance important U.S. foreign policy goals by promoting freedom and democracy in a region that has been troubled in the recent past by wars and political oppression. Today, all six CAFTA partners are democracies pursuing political, economic, and trade reforms.

Objections that the agreement does not adequately protect environmental and labor standards are unwarranted. All six countries have adopted laws consistent with core labor standards as established through the International Labor Organization. All six have made measurable progress on a range of social indicators. Promoting trade and development through CAFTA would further that progress.

*Daniel Griswold is director of the Cato Institute's Center for Trade Policy Studies, and Daniel Ikenson is a trade policy analyst with the center.*

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**The CAFTA countries and the Dominican Republic make up the second-largest market for U.S. goods exports in Latin America, behind only Mexico.**

## Introduction

One of the most controversial trade agreements to come before Congress in several years will be the Central American Free Trade Agreement. Signed on May 28, 2004, the agreement would liberalize trade between the United States and five Central American countries—Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua. An agreement with the Dominican Republic was signed two months later, on August 5, and will be "docked" with CAFTA and presented to Congress as a package, perhaps by the end of 2004.

Four free-trade agreements have already sailed through this Congress. In July 2003 comfortable majorities in the House and the Senate approved free-trade agreements with Chile and Singapore, and in July 2004 even larger majorities approved such agreements with Australia and Morocco. But enactment of CAFTA will not be so easy.

Critics of trade liberalization offered only token opposition to the previous agreements, but they have drawn a line in the sand on CAFTA. The most commonly articulated criticism is that CAFTA as it currently stands does not adequately protect labor and environmental standards in the Central American countries. Democratic presidential nominee John Kerry has threatened to veto the current agreement if it is not renegotiated to include "stronger" labor and environmental standards.

The economic and foreign policy stakes in the CAFTA debate are high. Central America shares a border with Mexico, already a free-trade partner of the United States, making the proposed agreement a logical extension of the existing North American Free Trade Agreement. Economic, historical, and cultural ties are strong between the United States and the countries of Central America, many of which have sizable immigrant populations in the United States. The region was a thorn in the side of U.S. foreign policy during the 1980s, when it was plagued by civil strife, communist insurgencies, and human rights abuses. A free-trade agreement could be a powerful tool for promoting peace, stability, and democracy in the region.

As for trade, critics argue that the populations and incomes of our partners in the agreement are too low for them to buy U.S. products in any significant amount. Although none of the five CAFTA countries or the Dominican Republic is a sizable economic entity by itself, when combined they are surprisingly large as a U.S. economic partner. The total population of the six countries is 45 million and total GDP in 2003 at purchasing power parity was $204 billion.[1]

Because of proximity, U.S. trade with the region is already robust. In 2003 America's two-way trade in goods with the CAFTA countries and the Dominican Republic totaled $31.9 billion—an amount that would rank those countries together as our 13th-largest trading partner, ahead of Brazil, Singapore, and Australia. The CAFTA countries and the Dominican Republic make up the second-largest market for U.S. goods exports in Latin America, behind only Mexico.[2]

This study weighs the impact of the Central American Free Trade Agreement on the U.S. economy and on U.S. foreign policy. The study concludes that, despite its imperfections, CAFTA would promote freedom, development, and stability in a region vitally important to America's national interests.

## Trade Barriers Eliminated—With Two Glaring Exceptions

From economic stabilization to regional integration and security, there are many compelling reasons to adopt CAFTA. But the primary purpose of a free-trade agreement is to spur cross-border trade and investment by reducing and ultimately eliminating market barriers. CAFTA will undoubtedly advance those objectives.

Technically, for an agreement to truly warrant the "free-trade" modifier, all trade restrictions—tariffs, quotas, import licensing programs, and other discriminatory regulations—should disappear, and foreign and domestic companies in each market should enjoy the privileges of national treatment. Although CAFTA features significant market access improvements for most products, certain quantitative restrictions and long tariff phase-out schedules exist for a variety of products, and the agreement contains a labyrinth of technical provisions used to determine whether a product qualifies as originating in the region, which is a requirement of preferential treatment. Those "rules of origin" are particularly cumbersome in the textile and apparel sectors and are sure to impede the potential growth of trade in those sectors.

In that sense, CAFTA (like all of the other "free-trade agreements" of the United States) is not really a free-trade agreement. The tariff liberalization schedule is managed, quotas remain on several products, a safeguard trigger mechanism is specified, content requirements to confer local origin are mandated, compensation in lieu of market access for sugar is stipulated, and so on. The agreement is less ambitious than it could and should have been. But despite those shortcomings, CAFTA is an affirmative step toward the policy goal of free trade.

## Immediate and Reciprocal Access

By eliminating or at least reducing tariffs and increasing quota allowances, CAFTA is likely to lead to increased trade and to spur investment within the region. The lower costs of cross-border transactions will mean lower prices throughout the supply chain and the potential for a more optimal allocation of resources. Meanwhile, the reciprocal nature of liberalization will present U.S. exporters with greater sales opportunities, a dynamic that is likely to accelerate as Central Americans and Dominicans earn more foreign exchange, raise their own incomes and living standards, and ultimately purchase more U.S. products.

Contrary to what some of CAFTA's detractors have been saying, trade between the United States and the six CAFTA partners is significant. In aggregate, America's CAFTA partners purchased $15.1 billion worth of U.S. exports in 2003, an increase of 11 percent from 2000, making the region the 13th largest market for U.S. exporters and four times larger than Chile, with whom the U.S. signed a free-trade agreement in 2003.[3] Meanwhile, U.S. imports from the region totaled $16.8 billion in 2003, up 4 percent from 2000, making it the 15th-largest supplier to U.S. consumers and businesses.[4]

Opponents of the agreement suggest that Central Americans cannot afford U.S. products and that "surrendering" access to the U.S. market without complete reciprocity will exacerbate the trade deficit. The reality, however, is that each of the six CAFTA partners already has duty-free access to the U.S. market under the Caribbean Basin Trade Partnership Act program. In fact, most of the products on which U.S. tariffs go to zero immediately under CAFTA are already afforded duty-free access under the provisions of the CBTPA. Under CAFTA, however, there will be fewer restrictions and lower compliance costs associated with qualifying for preferential access.

**The reciprocal nature of liberalization will present U.S. exporters with greater sales opportunities, a dynamic that is likely to accelerate.**

For those who are inclined to keep score from only the perspective of market access abroad (an accounting method that discounts entirely the benefits of imports), the difference between the CBTPA and CAFTA is that CAFTA is reciprocal. It will grant U.S. companies duty-free access to the Central American market for a variety of products, which are at present subject to tariffs.

CAFTA would reinforce and accelerate the trend in the region toward more open markets. All of the trade-agreement partners have moved decisively to open their economies to trade in the past decade, lowering tariffs and other trade barriers to imports from each other and the rest of the world. The result has been a visible increase in import competition. In every one of the CAFTA countries, imports of goods and services as a share of GDP have risen sharply in the past decade. Between 1991 and 2001 the average ratio of imports to GDP for the six countries rose from 33 percent to 49 percent.[5] A free-trade agreement would build upon that progress by expanding and solidifying gains in market access.

With certain industry exceptions, tariff elimination under CAFTA is actually quite liberal.

**Table 1**
**Tariff Liberalization Schedule of CAFTA (number and percentage of product categories liberalized by stage)**

| Stage | Description | United States | | Costa Rica | |
|---|---|---|---|---|---|
| A | Duties removed immediately (some products retroactive to 1/1/04) | 6,404 | 60.2% | 4,400 | 69.9% |
| B | Duties removed in 5 equal annual stages, year 1 through year 5 | 6 | 0.1% | 287 | 4.6% |
| C | Duties removed in 10 equal annual stages, year 1 through year 10 | 8 | 0.1% | 592 | 9.4% |
| D | Duties removed in 15 equal annual stages, year 1 through year 15 | 13 | 0.1% | 216 | 3.4% |
| E | Staggered duty reduction begins in year 7; duty-free in year 15 | 0 | 0.0% | 0 | 0.0% |
| F | Duties removed in 10 equal annual stages, year 11 through year 20 | 0 | 0.0% | 5 | 0.1% |
| G | Goods continue to receive duty-free treatment | 3,261 | 30.7% | 115 | 1.8% |
| H | Goods continue to receive most-favored-nation treatment | 0 | 0.0% | 0 | 0.0% |
| I | Staggered duty reduction begins in year 1; duty-free in year 10 | 18 | 0.2% | 0 | 0.0% |
| J | Duties removed immediately in accordance with WTO commitments | 730 | 6.9% | 0 | 0.0% |
| K | Duties removed as of January 1 of year 1. | 17 | 0.2% | 0 | 0.0% |
| L | Duties apply according to special provisions; duty-free in year 10 | 1 | 0.0% | 0 | 0.0% |
| M | Staggered duty reduction begins in year 1; duty-free in year 10 | 0 | 0.0% | 602 | 9.6% |
| N | Duties removed in 12 equal annual stages, year 1 through year 12 | 0 | 0.0% | 34 | 0.5% |
| O | Staggered duty reduction begins in year 7; duty-free in year 15 | 0 | 0.0% | 0 | 0.0% |
| P | Staggered duty reduction begins in year 11; duty-free in year 18 | 0 | 0.0% | 0 | 0.0% |
| Q | Duties at 15% in year 1; staggered reduction begins in year 4; duty-free in year 15 | 0 | 0.0% | 0 | 0.0% |
| R | Duties removed in 9 equal annual stages, year 7 through year 15 | 0 | 0.0% | 0 | 0.0% |
| S | Staggered duty reduction begins in year 6; duty-free in year 15 | 0 | 0.0% | 9 | 0.1% |
| T | Staggered duty reduction begins in year 5; duty-free in year 15 | 0 | 0.0% | 4 | 0.1% |
| U | Staggered duty reduction begins in year 11; duty-free in year 17 | 0 | 0.0% | 0 | 0.0% |
| V | Staggered duty reduction begins in year 11; duty-free in year 20 | 0 | 0.0% | 0 | 0.0% |
| W | Duties removed in 4 equal annual stages, year 1 through year 4 | 0 | 0.0% | 0 | 0.0% |
| X | Duties removed in 4 equal annual stages, year 2 through year 5 | 0 | 0.0% | 0 | 0.0% |
| Y | Staggered duty reduction begins in year 1; duty-free in year 10 | 0 | 0.0% | 0 | 0.0% |
| | Subject to tariff-rate quotas | 178 | 1.7% | 35 | 0.6% |
| | Total tariff provisions | 10,636 | | 6,299 | |

Note: Product categories are shorthand for eight-digit harmonized tariff schedule provisions.

**The overwhelming majority of products will become or will continue to be duty-free right away.**

Although the agreement articulates a broad range of tariff elimination schedules, from an immediate to a 20-year phase-out, the overwhelming majority of products will become or will continue to be duty-free right away.

Table 1 provides the particulars of each liberalization stage and identifies the number of tariff provisions falling within each stage for each country. For the United States, 60 percent of its tariff schedule provisions will become duty-free upon enactment of the agreement (Stage A). This has potential to translate immediately into real cost savings, given that almost 75 percent of the value of U.S. imports from the region in 2003 fell under these zero-tariff provisions and that most of those imports fell within a few dozen clothing provisions.[6] This portends not only new investment in apparel production facilities in the region but investment in industries in which potential growth may have been retarded by the existence of a tariff, complicated rules for duty-free treatment, or uncertainty about the future of the CBTPA program.

Together, the 31 percent of tariff schedule provisions that are already duty-free (Stage G), the 7 percent that will become duty-free in accordance with World Trade Organization commitments (Stage J), and the few provisions in Stage K will allow fully 98 percent of products that could actually or theoretically be exported from the CAFTA countries to enter the United States without tariffs or quantitative restrictions

| El Salvador | | Guatemala | | Nicaragua | | Honduras | | Dom. Rep. | |
|---|---|---|---|---|---|---|---|---|---|
| 1,971 | 31.3% | 2,101 | 33.3% | 1,664 | 25.1% | 1,733 | 27.6% | 4,318 | 63.3% |
| 426 | 6.8% | 237 | 3.8% | 551 | 8.3% | 397 | 6.3% | 386 | 5.7% |
| 665 | 10.6% | 789 | 12.5% | 928 | 14.0% | 941 | 15.0% | 706 | 10.4% |
| 89 | 1.4% | 93 | 1.5% | 139 | 2.1% | 137 | 2.2% | 130 | 1.9% |
| 0 | 0.0% | 0 | 0.0% | 1 | 0.0% | 0 | 0.0% | 0 | 0.0% |
| 0 | 0.0% | 4 | 0.1% | 11 | 0.2% | 7 | 0.1% | 8 | 0.1% |
| 2,924 | 46.5% | 2,924 | 46.4% | 3,068 | 46.3% | 2,940 | 46.8% | 888 | 13.0% |
| 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% |
| 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% |
| 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% |
| 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% |
| 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% |
| 152 | 2.4% | 114 | 1.8% | 184 | 2.8% | 78 | 1.2% | 316 | 4.6% |
| 17 | 0.3% | 4 | 0.1% | 27 | 0.4% | 10 | 0.2% | 30 | 0.4% |
| 0 | 0.0% | 1 | 0.0% | 0 | 0.0% | 4 | 0.1% | 6 | 0.1% |
| 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% |
| | | | | | | | | | |
| 0 | 0.0% | 0 | 0.0% | 10 | 0.2% | 0 | 0.0% | 0 | 0.0% |
| 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% |
| 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% |
| 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% |
| 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 5 | 0.1% |
| 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 5 | 0.1% |
| 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 2 | 0.0% |
| 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 21 | 0.3% |
| 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 0 | 0.0% | 2 | 0.0% |
| 44 | 0.7% | 40 | 0.6% | 39 | 0.6% | 33 | 0.5% | 0 | 0.0% |
| 6,288 | | 6,307 | | 6,622 | | 6,280 | | 6,818 | |

upon implementation of the agreement. That bodes well for U.S. consumers, consuming industries, and prospects for economic growth.

But what about the other 2 percent of products that will remain protected? Among those that will continue to be protected by long tariff phase-outs are olives, cotton, tobacco, certain footwear, wool, pillows and bedding, cashmere, milk and cream, tuna fish, and even hairnets. (Who knew that the U.S. hairnet industry was so vital as to warrant such exemption?) In addition, the agreement provides for tariff rate quotas on 178—mostly agricultural—U.S. tariff provisions, including beef, butter, cheese, ethyl alcohol, ice cream, milk powder, milk, cream, sour cream, other dairy products, peanut butter, peanuts, and sugar. Although CAFTA expands preexisting quotas for those products, for most products the expansion is modest and imports in excess of the quota are subject to the same—often prohibitive—tariffs that apply more broadly to our general trade partners.

## No Break for Sugar Consumers

The maintenance of quotas is difficult to justify in a "free-trade agreement," and the quotas are particularly onerous with respect to sugar. According to the Office of the United States Trade Representative:

> Increased sugar market access for Central American countries in the first year under

**The quotas are particularly onerous with respect to sugar.**

> CAFTA amounts to about *one day's* production of the U.S. sugar industry. . . . This will grow very slowly over fifteen years to about 1.7% of production and 1.6% of consumption by year 15. Sugar imports have declined by about one-third since the mid-nineties. CAFTA would not even come close to returning U.S. imports to those levels. Tariffs on sugar would *not be changed* under CAFTA. The U.S. above-quota tariff is prohibitive at *well over 100 percent*, one of the highest tariffs in the U.S. schedule.[7]

**The prohibitively high above-quota tariff on sugar will preclude any noticeable decrease in U.S. sugar prices, an ironic outcome of a free-trade agreement with a sugar-producing region.**

It demonstrates the political muscle of the U.S. sugar industry that such a statement would come from the office of the most important U.S. trade official. The Dominican Republic and Central America are important sugar producers that have been denied full access to the U.S. market under a long-standing U.S. sugar import quota system. By providing only modest market access improvements, CAFTA effectively takes off the table one of the most significant commodities currently produced in that region, denying those countries access to a potentially lucrative market and denying U.S. sugar-using industries an opportunity to reduce their costs of production. A true free-trade agreement would remove the barriers that prevent the Central American region from capitalizing on the advantages it has in sugar production so that America's food processors, beverage producers, and confectionaries could capitalize fully on their own advantages.

The prohibitively high above-quota tariff on sugar will preclude any noticeable decrease in U.S. sugar prices, an ironic outcome of a free-trade agreement with a sugar-producing region. This provision is in effect a double whammy for certain U.S. food processors and candy producers, which have been adversely affected over the years by artificially inflated sugar prices, because in response to the U.S. position, the CAFTA partners insisted on a 15-year tariff phase-out for candy and certain processed food items. U.S. sugar-consuming industries will face free-market competition from abroad for their final products and continue to pay a protected monopoly price at home for their most important input.

While maintaining its own protected domestic market, the U.S. sugar industry managed to secure a "compensation mechanism" in the agreement, which provides for cash payments to CAFTA sugar exporters in lieu of U.S. market access. Article 3.16 stipulates:

> In any year, the United States may, at its option, apply a mechanism that results in compensation to a Party's exporters of sugar goods in lieu of according duty-free treatment to some or all of the duty-free quantity of sugar goods established for that Party in Appendix I to the Schedule of the United States to Annex 3.3. Such compensation shall be equivalent to the estimated economic rents that the Party's exporters would have obtained on exports to the United States of any such amounts of sugar goods and shall be provided within 30 days after the United States exercises this option.[8]

This provision runs counter to the whole concept of a free-trade agreement. Rather than encourage trade, under the agreement the United States can instead pay its CAFTA partners not to trade. One of the primary purposes of trade is to gain access to products and services at lower prices. This compensation mechanism is anathema to that objective: it means paying something for nothing.

At present, it is unclear how and under what circumstances such a compensation mechanism would be invoked or where the money would come from and even whether the scheme would pass muster in dispute resolution if a case were brought before the WTO. What is clear, however, is that the influence of U.S. sugar producers weighed heavily in the ultimate composition of CAFTA, undermining other important exporting interests and ultimately preventing the agreement from being as liberalizing as it could have been.

## Restrictive Rules for Apparel and Textiles

The U.S. textile industry also made its presence felt by watering down some of the potential regionwide benefits of CAFTA. Clothing made up about 55 percent of U.S. imports from the CAFTA-plus region in 2003. Without exception, all apparel products will be duty-free upon implementation of the agreement. However, compromising the potential gains of the agreement is the inclusion of some fairly rigid stipulations that must be met as a requirement of duty-free treatment.

The U.S. textile industry lobbied hard for what are known as "yarn forward" rules of origin. Under those rules, a textile or apparel product manufactured in Central America or the Dominican Republic must be produced from regional textile components in order for the final product to be considered "originating" in the region and, ultimately, to receive duty-free treatment.[9] What renders those rules particularly restrictive is that there is no significant regional textile industry outside the United States. Thus, in order to receive duty-free treatment, a shirt or a pair of pants exported from Central America or the Dominican Republic to the United States must contain U.S. textile components.

Such rules undermine the potential benefits of the agreement by forcing Central American apparel producers into less-efficient cost structures. Requiring them to purchase U.S. components forces them to pay higher prices and to have fewer design and production options. Accordingly, those companies will be limited in the types of garments they can produce and will be less flexible in responding to their customers' requirements than their competitors in Asia and elsewhere.

While duty-free access will be a relative benefit to Central American and Dominican producers—particularly in light of the persistence of high U.S. tariffs on clothing generally—the cost of securing that access will entail paying higher prices for inputs, having less flexibility with respect to the products manufactured, and incurring significant compliance and record-keeping costs to demonstrate to U.S. Customs authorities the authenticity of their origin claims.

The purpose of forcing those demands on the Central Americans is to secure a customer base for U.S. textile producers. But just as protecting a domestic market through tariffs and quotas has proven time and again to be a losing long-term strategy for the "protected" industry, exporting protectionism through rigid rules of origin may ultimately kill one of the U.S. textile industry's best export markets.

Central American and Dominican garment producers are long-standing and natural customers of the U.S. textile industry by virtue of proximity. The region has potential to be a vertically integrated production platform—with the United States supplying yarns and fabrics and the CAFTA partners producing clothing. Such a scenario would presumably please U.S. textile producers.

But attaching stipulations that ultimately raise the costs of producing clothing for export to the United States will make apparel producers less inclined to invest in production capacity in the region than they would be if there were more liberal rules of origin. A recent survey of major apparel retailers by the National Retail Federation[10] found a unanimous view among respondents that a yarn forward rule of origin is not cost-effective and results in a net increase in the cost of apparel production, even when the savings from elimination of tariffs and quotas are factored in. All retailers participating in the survey reported that yarn forward rules accelerated the shift in apparel production away from preferential trading partners that are subject to this rule, like Mexico, to large Asian suppliers who could provide the full package from thread to apparel.

The fear, of course, among U.S. textile producers is that, if given a choice, apparel producers in the region would source from China, India, Pakistan, and elsewhere. Although that may be true to some extent—particularly in cases in which U.S. textile producers are unwilling or unable to produce inputs to their customers' specifications—the reality is that there is a premium to timeliness. And timeliness is enhanced by tightening the supply chain, which is often a function of the proximity of each point in the supply chain. And given the proximity of U.S. textile producers to Central American and Dominican garment producers, there is an advantage to cultivating

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this relationship, as opposed to sourcing textile components in Asia for garment production in Latin America.

As a whole, access to the U.S. market is enhanced substantially under CAFTA. Its limitations are concentrated within a few, long-time protectionist industries. Unfortunately, it is precisely those industries in which our CAFTA partners operate with comparative advantage, and as a result the full benefits and potential of a real free-trade agreement are not likely to be realized.

### Open Doors for U.S. Exporters

CAFTA will deliver real benefits to U.S. exporters by reducing and eliminating tariffs on a wide range of products. On average, 75 percent of the tariff product categories will be duty-free for U.S. exports to the region upon enactment of the agreement (see Table 1). Although the CAFTA partners have specified a greater number of products for longer tariff phase-out schedules, they each have fewer products subject to quota. Most of the 32 advisory committees appointed to convey industry-specific and issue-specific feedback to the U.S. Trade Representative on the perceived impact and propriety of trade agreements offered unanimous endorsements of CAFTA.

The Agricultural Technical Advisory Committee (ATAC) for Animals and Animal Products issued the following statement in its report to the trade representative concerning market access for poultry. "As a result of this agreement, U.S poultry producers and exporters will have a much greater opportunity to expand markets in Central America."[11] On dairy access, it reported, "We believe this agreement will further promote reciprocal trade within the hemisphere."[12] And the committee's pork producers and a majority of its beef producers wrote, "The U.S. Trade Representative is to be commended for immediately securing market access for U.S. high quality beef cuts (beef grading 'prime' and 'choice') and for phasing out tariffs and tariff-rate quotas for other beef and pork over a 15-year period."[13]

Likewise, the ATAC for Fruits and Vegetables was quite pleased, noting, "The U.S.-CAFTA is considered by many on the committee to be an excellent agreement that will provide immediate economic benefits to their specialty crop commodities."[14] And the ATAC for Processed Foods, urging quick congressional approval, wrote, "The Committee is especially pleased that the Agreement covers all agricultural products, and notes that more than half of current U.S. agricultural exports to Central America will become duty-free when the Agreement takes effect, including a number of processed food items."[15]

Those endorsements are representative of the vast majority of opinions presented by the advisory committees for capital goods, consumer goods, and almost every specific manufacturing industry. The Industry Sector Advisory Committee (ISAC) for Capital Goods agreed that CAFTA will increase export opportunities for U.S. capital goods; the ISAC for Consumer Goods believes the agreement will deliver important benefits to consumer goods firms in terms of market access, regulatory transparency, and customs procedures; the Chemical and Allied Products ISAC believes CAFTA promotes U.S. economic interests and provides for equity and reciprocity; and so on. With very few exceptions, the sentiment of U.S. business groups regarding market access under CAFTA is positive.

### Liberalizing Services and Investment

As an economy that employs most of its workers in the services sectors, the United States will benefit significantly from historic liberalization of Central American and Dominican regulations and prohibitions affecting cross-border provision of professional services, telecommunications, financial services, electronic commerce, and investment.

The agreement stipulates new and improved rules governing the provision of the following services: accounting, advertising, architecture, asset management, audiovisual, computer and related, education, electronic commerce, energy, engineering, express delivery, financial, health care, insurance, legal, telecommunications, and vessel repair. It also removes certain onerous restrictions on the distribution of imported products in Central America. Under so-called dealer protection regimes, distribution of U.S. exports to the region is hampered by inefficient, exclusive, and effectively permanent relationships with local distributors, regardless of the local company's performance. The new rules will afford U.S. companies greater latitude in picking distributors and negotiating the terms of the relationship.

With the exception of a few country-specific objections, the opinion of the ISAC for Services is that CAFTA makes significant strides toward liberalization and is likely to promote growth in services exports to and investment in the CAFTA region.

Spurring investment in the region would be one of the principal benefits of CAFTA. At the end of 2003 American companies owned a total of $4.3 billion in direct investments in the five CAFTA countries and the Dominican Republic. More than 80 percent of those investments are concentrated in Costa Rica, El Salvador, and the Dominican Republic, with a much smaller stock of investment in Guatemala, Honduras, and Nicaragua.[16] A free-trade agreement could be expected to encourage more long-term investment in the region by creating a more stable investment climate and institutionalizing trade reforms and investor protections. And by increasing incomes and improving working conditions in those societies, increased foreign direct investment would, in turn, spur even more U.S. exports to the region.

## Promoting Peace and Democracy in Our Hemisphere

Central America is one of the bright spots for U.S. foreign policy. Two decades ago that region was one of the major trouble spots in our hemisphere and was one of the most contentious aspects of U.S. foreign policy. Several Central American countries were beset to one degree or another during that period with civil wars, human rights violations, economic dysfunction, and the internal dislocations of populations.

In Nicaragua, the leftist Sandinistas held power throughout the 1980s after toppling the regime of the late dictator Anastasio Somoza in 1979. Their time in power was marked by economic mismanagement, growing control over the economy and daily life, and armed opposition from the U.S.-backed Contra insurgency. The Sandinistas were supported by "technical assistance" from Cuba and loans from the Soviet Union. They lost power in 1990 in internationally monitored elections and have failed to win a majority in free and open elections since then.

In El Salvador, the communist-leaning Farabundo Martí Front for National Liberation waged a costly and bloody war against the government during the 1980s, and anti-communist "death squads" struck back at alleged FMLN sympathizers. After long negotiations between elected governments and the FMLN, a peace treaty was signed in 1991 and formalized in 1992. In elections since then, including earlier in 2004, Salvadoran voters rejected communist-leaning candidates in favor of more pro-market parties. El Salvador has even adopted the U.S. dollar as its official currency.

In Guatemala in the early 1980s, an unelected military government fought a coalition of guerrilla groups known as the Guatemalan National Revolutionary Unity. Against a backdrop of civil war and human rights abuses, Guatemalans elected a civilian president in 1985 under a new constitution. Subsequent elected governments pursued negotiations with the armed opposition, resulting in a final peace agreement signed in December 1996 by the democratically elected president Alvaro Arzu Irogoyen.

Today, each of the CAFTA-plus countries is at peace internally and with its neighbors. Each is a functioning, multiparty democracy with an elected government. According to the human rights think tank Freedom House, three of the six countries are rated "Free"—civil and political freedoms are largely or fully protected. Those rights, including freedom of speech, assembly, worship, and participation in free elections, are the most fully protected in Costa Rica, the Dominican Republic, and El

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Salvador. Freedom House rates Guatemala, Honduras, and Nicaragua as “Partly Free” because of lingering political violence and other problems.[17] But every one of the Central American countries that struggled in the 1980s has made significant progress since then in expanding economic freedom and political and civil liberties.

A free-trade agreement with the United States would solidify those positive trends. By encouraging private-sector growth, trade expansion would create a larger, more educated, and politically aware middle class, which has traditionally formed the backbone of democratic systems. Expanding trade increases travel and contact with other people in free societies and spreads availability of the tools of communication—cell phones, Internet access, satellite dishes, international phone service, and so forth. Economic liberalization diminishes centralized control of the government over the economy, reducing the power of the government to dominate daily economic and political life.

Economic and trade reform has proven to be the companion of political reform in other countries and regions. A recent study by the Cato Institute found that countries relatively open to trade were significantly more likely to respect the civil and political liberties of their citizens than countries that are relatively closed. Nations that have pursued economic and trade liberalization were also significantly more likely to have pursued political liberalization.[18] Examples include South Korea, Taiwan, several countries in eastern and central Europe, and Chile and Mexico among other Latin American countries.

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Mexico is an especially relevant case for Central America. Within seven years after enactment of the North American Free Trade Agreement, Mexicans were able to elect Vicente Fox in 2000 as president, the first opposition-party candidate elected after more than seven decades of one-party rule. The economic and trade reforms institutionalized by NAFTA helped to break the hold the ruling party exercised over its citizens. In the same way, CAFTA would strengthen the foundation of representative government and respect for human rights in the region.

During a visit to Washington in July 2004, Nicaragua's minister of development, industry, and commerce, Mario Arana, connected the dots of trade, development, and democracy. In a speech at the Inter-American Development Bank, he noted:

> It is also an historical fact that expanded commercial relations between the United States and our countries have played a pivotal role in the democratization process of the region. The system of trade preferences granted by the Caribbean Basin Initiative (CBI) and other related programs has been essential to support economic growth and development in our countries at a critical time in our histories, and has helped to consolidate democratic institutions and the rule of law. As we all know, the creation of new jobs and more economic opportunities is one of the most effective tools to fight war and social unrest.[19]

Enactment of a free-trade agreement between the United States and the countries of Central America and the Dominican Republic would reward and consolidate the region's remarkable transformation—a development profoundly in America's foreign policy interest.

## A “Race to the Top” on Labor and Environmental Standards

The chief argument being made against the agreement signed in May is that it does not adequately protect the environment and labor rights in the region. If governments in the region are not required to maintain and raise their domestic standards, the argument goes, workers in those countries will be exploited and workers in the United States will be exposed to unfair competition. If low standards in the CAFTA countries attract investment from U.S. companies seeking to cut costs, it could put pressure on U.S. lawmakers to reduce standards here in a destructive “race to the bottom.” But a careful examination of each of those concerns reveals that they are without foundation.

### CAFTA Countries Making Progress

As in most developing nations, labor and environmental standards in CAFTA countries are not what citizens in more advanced economies expect and demand. Those countries are still relatively poor compared with the United States, with per capita GDPs (in terms of local purchasing power) ranging from $2,200 in Nicaragua to $9,000 in Costa Rica.[20] At this stage of development, individuals, companies, and governments in the region cannot afford to devote the level of resources to higher standards that are available in more advanced economies.

Demands for tougher language are based on the false premise of a “race to the bottom.” In reality, there is no evidence that nations have been able to gain any advantage in attracting investment or expanding exports by systematically lowering their national labor and environmental standards. For multinational companies, the costs of complying with labor and environmental regulations are relatively small. Far more important are political stability, access to consumers, a skilled workforce, modern infrastructure, rule of law, and freedom to trade and repatriate profits. That is why the large majority of outward U.S. foreign direct investment (FDI) migrates to other high-wage, high-standard countries. Nations with low labor and environmental standards attract far less FDI per capita than nations with high standards, while higher standards are generally associated with higher FDI inflows.[21]

In practice, trade liberalization is helping to create a world of higher standards—a “race to the top,” not to the bottom. Nations open to trade tend to grow faster and achieve higher incomes, and higher incomes promote higher labor and environmental standards. Higher incomes allow more private and public spending on pollution control and create demand for higher labor standards from an expanding middle class. By promoting trade, development, and higher incomes, a free-trade agreement with Central America and the Dominican Republic would in reality help to build the capacity of those countries to maintain and raise their domestic standards.

In Central America, trade liberalization and other reforms of the past two decades have spurred not only growth in incomes but also measurable social progress. According to the World Bank, literacy rates for men and women 15 and older have risen significantly in every one of the CAFTA-plus countries since 1980. In fact, between 1980 and 2001, the average literacy rate in the region increased from 67 percent to above 80 percent. At the same time, the percentage of children aged 10 to 14 who are in the workforce has been steadily declining in all six countries. The average share of children in the labor force across the six countries dropped from 17.4 percent in 1980 to 10.0 percent in 2002.[22] Expanding trade with the United States would likely accelerate those positive trends.

Perversely, withholding trade benefits because of allegedly low standards would in effect punish those countries for being poor. It would deprive them of the expanded market access that offers the best hope for raising incomes and standards. The use of trade sanctions would target the very export industries that typically pay the highest wages and maintain the highest standards in those countries. The effect of sanctions would be to shrink the more globally integrated sectors that are pulling standards upward, forcing workers into informal domestic sectors where wages, working conditions, and labor-rights protections are much lower. Lower wages paid to parents would make it more difficult for families on marginal incomes to keep children in school and out of fields or factories. “Tough” sanctions to allegedly enforce higher standards would be tough only on the poorest people in the region.

### CAFTA Fulfills TPA Mandate

CAFTA already fulfills the letter and the spirit of the negotiating mandate set out in the Trade Promotion Authority bill passed by Congress. The Trade Act of 2002 directs the

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administration, in the section on Trade Negotiation Objectives,

> to ensure that a party to a trade agreement with the United States does not fail to effectively enforce its environmental or labor laws, through a sustained or recurring course of action or inaction, in a manner affecting trade between the United States and that party after entry into force of a trade agreement between those countries.[23]

The law directs the administration to seek agreements that strengthen the capacity of U.S. trading partners "to promote respect for core labor standards" and "to protect the environment through the promotion of sustainable development."[24] The TPA wisely recognizes the need of trading partners to exercise discretion on enforcement, regulatory, and compliance matters and "to make decisions regarding the allocation of resources to enforcement with respect to other labor or environmental matters determined to have higher priorities." No retaliation should be authorized against a country exercising its sovereign right "to establish domestic labor standards and levels of environmental protection."[25]

**The CAFTA agreement's language on labor and environmental standards is essentially the same as the language in the Morocco Free Trade Agreement, which breezed through Congress in July 2004 with broad bipartisan support.**

TPA legislation further requires that all of the participating countries uphold their commitments as members of the International Labor Organization and requires them to strive not to waive or otherwise derogate from recognized labor rights in order to gain any trade advantage. Violations are subject to dispute settlement under the terms of the agreement.

By any reasonable measure, CAFTA meets those requirements. In Chapters 16 (Labor) and 17 (Environment) it contains language that reflects the concerns of Congress as contained in the TPA. It requires that each party to the agreement "shall not fail to effectively enforce its labor [and environmental] laws, through a sustained or recurring course of action or inaction, in a manner affecting trade between the parties."[26]

The CAFTA agreement's language on labor and environmental standards is essentially the same as the language in the Morocco Free Trade Agreement, which breezed through Congress in July 2004 with broad bipartisan support. If that language was acceptable for Morocco, it should be acceptable for Central American countries, where living conditions and environmental and labor standards are comparable to and, in certain ways, more advanced than those in Morocco. For example, according to the World Bank, a higher percentage of the population in the CAFTA-plus countries enjoys access to improved water and sanitation systems than in Morocco. Literacy rates of young workers age 15–24 are also higher in Central America, especially among young women.[27]

The comparison of Central America to sub-Saharan Africa is even more striking. Congress overwhelmingly passed the Africa Growth and Opportunity Act in 2000 and extended it in 2004, granting unilateral trade preferences to a number of sub-Saharan countries. The labor and environmental provisions in the AGOA are relatively light, requiring as a condition of eligibility that the U.S. president determine that countries are making progress toward establishing protection of internationally recognized workers' rights. It also seeks to reward African countries that are making progress toward establishing a market-based economy, the rule of law, political pluralism, nondiscrimination toward U.S. products and investment, protection of intellectual property, and reducing poverty. By all those measures, the countries of Central America are star performers.

## Existing Laws Reflect Core ILO Standards

The labor laws of the CAFTA countries meet the general standards set by the ILO. According to a survey that the ILO itself published in October 2003, the constitutions and statutes of each of the five CAFTA countries—Costa Rica, El Salvador, Guatemala, Honduras, and Nicaragua—are consistent with "core" ILO conventions covering collective bargaining, forced labor, child labor, and workplace discrimination. (The survey did not cover the Dominican Republic.)

Specifically, the ILO survey found that "the right of workers to freely exercise their right to form trade unions is recognized by the respective constitutions of these countries."[28] National legislation in all five recognizes the right to voluntary collective bargaining and the right to strike. The ILO also concluded, "The principles of equality and prohibition against discrimination are enshrined in the constitutions of all the countries covered by this survey."[29] Moreover, constitutional law in all five countries prohibits forced labor and sets limits on the employment of minors. Five of the six CAFTA-plus countries have ratified all eight of the core ILO conventions. El Salvador has ratified six. In contrast, the United States has ratified only two while Jordan and Morocco have each ratified seven.[30] CAFTA already requires that its members not stray from those accepted international standards, providing a legal backstop against any feared backsliding on labor standards.

If members of Congress want to encourage higher labor and environmental standards in our hemisphere, they should seek to promote more trade and development with our neighbors by reducing barriers to trade and investment in our corner of the world.

## Conclusion

A free-trade agreement with the countries of Central America and the Dominican Republic would further a range of American interests. It would open the U.S. market to more price competition from producers in nearby countries, delivering lower prices for American families. It would open markets to U.S. products in countries that together represent our second-largest export market in Latin America behind only Mexico. It would enhance our national security by reinforcing the positive economic, political, and social trends that have swept the region in the past two decades.

CAFTA is not a perfect agreement, nor is it a magic bullet that will by itself lift the region to a higher level of freedom and prosperity. A better agreement would have liberalized virtually all trade immediately, especially those sectors that are the most protected now and most desperately need the kind of import competition that can deliver lower prices to consumers. But CAFTA would still result in lower trade barriers on a wide range of products immediately and others after phase-in periods—and would then guarantee that access through an enforceable international agreement.

As the Nicaraguan trade minister Arena concluded during his recent Washington visit:

> The purpose of CAFTA is precisely to secure and solidify this mutually beneficial trade relationship that has given such positive results in the last two decades, therefore locking in the remarkable changes that our countries have made in this generation, moving away from dictatorship, civil war and conflict to democracy and economic reforms in order to promote equity and justice, and ultimately, better standards of living for our citizens. CAFTA offers a once-in-a-lifetime opportunity to consolidate all the progress that we have made so far and move forward on a "race to the top."[31]

Congress should take advantage of that opportunity by lowering barriers to trade with our neighbors and, by doing so, quickening the march of economic and political freedom in our very own neighborhood.

**CAFTA is not a perfect agreement, but it would still result in lower trade barriers on a wide range of products.**

## Notes

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4. U.S. Bureau of the Census, Foreign Trade Statistics, Imports for Consumption, IM 146 series.

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