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The Trade Front
Combating Terrorism with Open Markets

by Brink Lindsey

Executive Summary

In May 2003 President Bush announced plans to create a U.S.–Middle East free-trade area within a decade. The new trade initiative aims to combat terrorism, and the Islamist extremism that underlies it, by promoting economic and political development in the Muslim world. The administration moved quickly to begin putting its plans into action by announcing that the United States and Bahrain would soon commence negotiations for a free-trade agreement (FTA). Meanwhile, negotiations for an FTA with Morocco are already under way, and a U.S.-Jordan FTA, now in its second year, has produced a boom in Jordanian exports.

The Bush administration should be congratulated for opening a trade front in the war on terrorism. With the proper commitment and follow-through, a major U.S. trade initiative in the Muslim world can give real encouragement to desperately needed growth and reform in that troubled region.

The fact is, though, that negotiating FTAs will take time. Relatively few countries in the region are ready to begin serious talks. Hammering out all the details of a mutually acceptable agreement with those that are prepared to take the plunge—and then guiding that agreement through approval by Congress—will be a complex, contentious, and time-consuming process. A U.S.–Middle East free-trade area, however desirable, is a policy goal for the long term. Meanwhile, the administration's initiative fails to include Turkey, Afghanistan, or Pakistan—all countries with obvious geopolitical significance.

Accordingly, the Bush administration should supplement its pursuit of FTAs with an initiative that is simultaneously broader in scope and capable of generating immediate results. Specifically, the administration should endorse and actively support legislation to grant temporary duty-free, quota-free access to the U.S. market for exports of selected Muslim countries. The unilateral elimination of U.S. trade barriers would give tangible, dramatic proof of U.S. commitment to the region, thereby providing a jump-start for the longer, arduous process of negotiating FTAs.

Brink Lindsey, director of the Cato Institute's Center for Trade Policy Studies, is the author of Against the Dead Hand: The Uncertain Struggle for Global Capitalism *and coauthor of the forthcoming* Antidumping Exposed: The Devilish Details of Unfair Trade Law.

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Introduction

On May 9, 2003, in a commencement address at the University of South Carolina, President Bush unveiled plans for establishing a U.S.–Middle East free-trade area within the next decade. With that announcement, he has assigned trade policy a major role in winning the peace after the military victories in Afghanistan and Iraq.

The new trade initiative aims to combat terrorism, and the Islamist extremism that underlies it, by promoting economic and political development in the Muslim world. "The Arab world has a great cultural tradition, but is largely missing out on the economic progress of our time," the president declared in his May 9 speech. "Across the globe, free markets and trade have helped defeat poverty, and taught men and women the habits of liberty."[1] The hope is that better integration of Arab countries into the global economy will initiate a virtuous circle of increased growth and broader economic reforms and that, in turn, a freer and more prosperous Middle East will be less susceptible to the radical Islamist movements that support and perpetrate terrorism.

The linkage of trade policy and national security has been a recurring theme with the Bush administration since the September 11, 2001, terrorist attacks. The white paper outlining the administration's national security strategy made headlines last fall by endorsing preventive military action against "emerging threats." That document also envisioned many other fronts in the war on terrorism in addition to military action. In particular, it drew an explicit connection between trade expansion and threat reduction:

> We will actively work to bring the hope of democracy, development, free markets, and free trade to every corner of the world. The events of September 11, 2001, taught us that weak states, like Afghanistan, can pose as great a danger to our national interests as strong states. Poverty does not make poor people into terrorists and murderers. Yet poverty, weak institutions, and corruption can make weak states vulnerable to terrorist networks . . . within their borders.[2]

The national security paper emphasized this connection by devoting an entire chapter to trade policy.

The administration's refashioning of trade policy to respond to the terrorist threat has moved beyond rhetoric and into concrete action. On May 21 the United States and Bahrain announced plans to negotiate a bilateral free-trade agreement (FTA). Talks on an FTA with Morocco are already under way, with completion scheduled for the end of this year. The initiatives with Morocco and Bahrain follow on the heels of the U.S.-Jordan FTA, initiated during the Clinton administration but signed into law by President Bush just weeks after the terrorist attacks on New York and Washington. The current plan is for these bilateral FTAs to serve as building blocks for an eventual region-wide agreement.

In preparation for additional FTAs, the administration has announced that it will be stepping up efforts to negotiate bilateral investment treaties (BITs) and trade and investment framework agreements (TIFAs) in the region. BITs guarantee basic rights for foreign investors, and TIFAs provide for regular bilateral consultations aimed at strengthening commercial ties. The United States has already entered into BITs with Azerbaijan, Bahrain, Bangladesh, Egypt, Jordan (now superceded by the FTA), Kazakhstan, Kyrgyzstan, Morocco, Tunisia, and Turkey. In July 2003, Pakistan signed a TIFA with the United States, joining Algeria, Bahrain, Egypt, Jordan (now superceded by the FTA), Morocco, and Turkey. As has happened with Jordan, Morocco, and Bahrain, BITs and TIFAs can lead eventually to FTA negotiations.

Meanwhile, foreign policy considerations have been exerting influence on the U.S. trade agenda outside the Middle East. Signing of the FTA with Chile was delayed several weeks after Chile failed to support the U.S. position on Iraq

in the United Nations Security Council. As the trade pact with Chile hung in limbo, U.S. Trade Representative Robert Zoellick unveiled the criteria that will guide the selection of future FTA partners. In addition to satisfying various trade and general economic requirements, countries must cooperate with the United States on foreign policy and national security matters. USTR officials have stated that the United States will not seek an FTA with New Zealand because of its refusal to allow nuclear-powered and nuclear-armed vessels in its waters. By contrast, the United States is seeking to expedite an FTA with neighboring Australia, a staunch U.S. ally in Afghanistan and Iraq.[3]

Although the Bush administration's linkage of trade issues with the war on terrorism marks a new direction for U.S. trade policy, it is only a variation on a well-played theme. During the Cold War, American trade policy pursued aims that transcended merely commercial considerations. Market-opening trade agreements were seen as a way to contain communism, not just militarily, but economically as well. Strengthening commercial ties with our allies would serve to maintain Western solidarity; opening our markets to developing countries would help to keep them out of the Soviet orbit.

Now, in the midst of a struggle against terrorism that will likely continue for many years, the national security dimension of trade policy is once again plainly visible. It has become painfully clear that Americans live in a dangerous world—and that the primary danger at present emanates from the economic and political failures of the Muslim world. Those failures breed the despair on which violent Islamist extremism feeds; no comprehensive campaign against terrorism can leave them unaddressed. Promoting economic and political reform throughout the Muslim world has become an urgent priority for U.S. foreign policy—and trade liberalization, while no panacea, is an important part of the equation.

The Bush administration should therefore be congratulated for opening a trade front in the war on terrorism. With the proper commitment and follow-through, a major U.S. trade initiative in the Muslim world can give real encouragement to desperately needed restructuring in that troubled region. In particular, properly structured FTAs can promote fundamental reform in participating countries. Their successes, in turn, can turn those countries into models for change throughout the region.

The fact is, though, that negotiating FTAs will take time. Relatively few countries in the region are currently ready to commit themselves to the sweeping policy changes that are entailed, and hammering out all the details of a mutually acceptable agreement with those that are prepared to take the plunge—and then guiding that agreement through approval by Congress—is a complex, contentious, and time-consuming process. A U.S.–Middle East free-trade area, however desirable, is a policy goal for the long term. President Bush's proposed timetable of a decade may well prove too optimistic.

A major U.S. trade initiative in the Muslim world can give real encouragement to desperately needed restructuring in that troubled region.

Meanwhile, the U.S. interest in pursuing economic engagement with the Muslim world extends beyond the Middle East. The administration's new initiative, for example, fails to include Turkey, Afghanistan, or Pakistan—all countries with obvious geopolitical significance.

Accordingly, the Bush administration should supplement its pursuit of FTAs with an initiative that is simultaneously broader in scope and capable of generating immediate results. Specifically, the administration should endorse and actively support legislation to grant temporary duty-free, quota-free access to the U.S. market for exports of selected Muslim countries. Legislation along those lines was introduced on May 22, 2003, by Sens. Max Baucus (D-Mont.) and John McCain (R-Ariz.). The unilateral elimination of U.S. trade barriers would give tangible, dramatic proof of U.S. commitment to the region, thereby providing a jump-start for the longer, arduous process of negotiating FTAs.

While the administration deserves credit for enlisting trade policy in the fight against terrorism, it needs to be careful about the extent to which it subordinates trade policy to foreign policy considerations. In particular, using trade policy instruments to reward or punish countries for specific positions on specific foreign policy issues is highly unlikely to advance U.S. eco-

nomic or national security interests.

It is one thing to refrain from pursuing closer economic ties with hostile, terrorist-sponsoring dictatorships. It is quite another thing, however, to maintain barriers that restrict trade with liberal democracies simply because their current governments and ours fail to see eye to eye on some particular issue. From an economic perspective, failure to pursue trade liberalization with willing partners amounts to cutting off our nose to spite our face. From the standpoint of national security, the heavy-handed use of America's economic leverage will only perpetuate foreign resentment of U.S. power.

Stagnation, Repression, and Terror

The rise of Islamist extremism over recent decades is a complex historical phenomenon, and it would be facile to try to ascribe it to any single root cause. That said, the Muslim world's woeful deficits in economic and political freedom surely deserve much of the blame. Widespread poverty, high unemployment, the absence of opportunities for upward mobility, brutal and corrupt ruling elites, the stifling of dissent, the exasperation caused by seeing spectacular successes elsewhere in the world—all stoke the rage and despair that win new converts to Islamist extremism. And all are traceable to the failure of liberal institutions—market competition, the rule of law, popular self-government—to take root in the region.

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The past quarter century has seen a dramatic, worldwide turn away from old ideologies of central planning and top-down control and toward more market-oriented models of economic policymaking.[4] In much of the Muslim world, however, the dead hand of the collectivist past has hardly relaxed its grip at all. Pervasive government controls continue to suffocate competition and throttle entrepreneurship.

As occurred throughout the postcolonial world, collectivism of one stripe or another became the reigning orthodoxy in most Muslim countries in the years after independence. In Egypt and Libya, "Arab socialism" was the ideology of choice; in Syria and Iraq, Baathism rose to power; in Iran, the White Revolution of the Pahlavi dynasty gave way to the ayatollahs' Islamic Revolution. In Saudi Arabia and other Gulf States, oil wealth rather than ideology became the basis for ruling-family patronage and control.

Today the legacy of the collectivist delusion remains a blight on the region's economic prospects. Consider two basic indicators of state control over economic life: the relative importance of state-owned enterprises and the extent of price controls. The *Economic Freedom of the World* report rates countries on a scale from 0 to 10 with respect to both criteria: scores of 6, 8, and 10 indicate increasingly market-oriented environments, while scores of 4, 2, and 0 indicate progressively greater government ownership and control. Of the 13 Middle Eastern, North African, and South Asian Muslim countries included in the survey—Algeria, Bahrain, Bangladesh, Egypt, Iran, Jordan, Kuwait, Morocco, Oman, Pakistan, Syria, Tunisia, and the United Arab Emirates—only 2, Kuwait and the UAE, earned solidly pro-market scores on both criteria. For the other 11 countries, the average score was 2.2 for state-owned enterprises and 3.5 for price controls.[5]

The failure to foster market competition isn't just a matter of government interference from above. In addition, governments fail to support markets from below with the necessary institutions—namely, the political and legal infrastructure needed to define and reliably enforce property and contract rights. Corruption is rampant in the Muslim world—as, indeed, it is in most developing countries. Transparency International, an anti-corruption watchdog group, publishes an annual corruption perceptions index. In the 2002 index, no Muslim country scored as high as 5 out of a possible "clean" score of 10.[6]

Another indicator of the sad state of the region's institutions is the size of the underground economy, known euphemistically as the "informal sector." In the Middle East and North Africa, the informal sector is estimated to account for anywhere from one-quarter to two-thirds of nonfarm employment, depending on

the country.[7] The economist Hernando de Soto has attempted to measure the value of extralegal real estate in underdeveloped countries—i.e., dwellings and property holdings to which the occupants do not hold formal legal title. In Egypt, de Soto estimates that 92 percent of urban dwellings and 83 percent of rural dwellings are held informally. The total value of legally unrecognized property comes to more than $240 billion—or six times the total value of all savings and time deposits in the country's commercial banks and 55 times the total foreign direct investment in Egypt up to 1996.[8]

The underdevelopment of markets in Muslim countries extends beyond the domestic economy into the international sphere. With all-too-limited exceptions, the Muslim world is the land that globalization forgot. Exports from the western Muslim areas (i.e., North Africa, the Middle East, Central Asia, Pakistan, and Bangladesh) currently account for only 4 percent of world exports—down from approximately 13.5 percent in 1980.[9] The situation with respect to capital flows is just as bleak: the entire Muslim world, with 1.3 billion people, receives only slightly more foreign direct investment than Sweden.[10]

Muslim countries' isolation from the global economy is self-imposed: barriers to trade and investment are cripplingly high. Average tariff rates in excess of 20 percent are common in the Muslim world.[11] The *Economic Freedom of the World* report for 2001 featured a trade openness index based on tariff rates, the black-market exchange rate premium, restrictions on capital movements, and the actual size of the trade sector compared to the expected size. Pakistan, Bangladesh, Syria, Algeria, and Iran all ranked in the bottom quintile; not a single Arab or South Asian country made the top half of the 109-country list.[12] Afghanistan, Algeria, Azerbaijan, Iran, Iraq, Lebanon, Libya, Saudi Arabia, Somalia, Sudan, Syria, Yemen, and all the Central Asian republics except Kyrgyzstan have not yet qualified to join the World Trade Organization (which, with 146 members and counting, is hardly an exclusive club).

The interplay between policies and prosperity is subtle and complex, but the bottom line is simple enough: no country ever got rich by suppressing competition, squelching market signals, and cutting itself off from the outside world. It should therefore come as no surprise, given the prevalence of anti-market policies, that most Muslim countries are floundering economically. The GDP of all Arab countries, with a combined population in excess of 280 million, is less than that of Spain.[13] Between 1985 and 1998, per capita GDP declined in real terms in Iran, Iraq, Jordan, Qatar, Saudi Arabia, Syria, the United Arab Emirates, and Yemen. By contrast, it rose 30 percent in Israel, almost 50 percent in Uruguay, and nearly 90 percent in Chile; it more than doubled in Thailand, China, and South Korea.[14] Unemployment rates in the region are commonly in double digits.[15]

The Muslim world's economic backwardness props up autocracy and repression. Elsewhere around the world, in places as diverse as Chile, Mexico, South Korea, Taiwan, and Thailand, the economic dynamism unleashed by market-based development has led to democratization and the expansion of political rights. In most Muslim countries, however, the absence of economic freedom goes hand in hand with an absence of political freedom. Freedom House publishes an annual index of civil freedom and political rights, according to which countries are categorized as "free," "partly free," and "not free." As of 2001–02, Afghanistan, Algeria, Bahrain, Egypt, Iran, Iraq, Kazakhstan, Kyrgyzstan, Libya, Oman, Pakistan, Qatar, Saudi Arabia, Somalia, Sudan, Syria, Tajikistan, Turkmenistan, Tunisia, the United Arab Emirates, Uzbekistan, and Yemen were ranked as not free; Azerbaijan, Bangladesh, Djibouti, Indonesia, Jordan, Kuwait, Lebanon, Malaysia, Morocco, and Turkey were classified as partly free. Freedom House found no free countries in the Muslim world.[16] The Arab countries in particular ranked lower in political freedom than any other region in the world.[17]

Confronted by the grave threat of Islamist terrorism, the United States has an enormous and urgent interest in encouraging economic and political liberalization in the Muslim

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world. In much of the region, violent radicalism is currently the only available avenue for challenging a clearly unacceptable status quo. The advance of freedom would open innumerable new avenues—for building businesses, pursuing careers, forming and joining and supporting nonprofit organizations, expressing viewpoints, and banding together for peaceful political change. The appeal of radicalism—and with it the number of potential recruits for the terrorist jihad—would wane with the emergence of constructive alternatives.

But what can the United States do to foster the growth of liberal institutions in the Muslim world? In two countries, Afghanistan and Iraq, the U.S. military has ousted entrenched despotisms by force and is now overseeing reconstruction with large occupying forces. But what are the options short of war for effecting "regime change"—which, defined broadly to encompass thoroughgoing economic and political reform, is the desired objective for the region? In other words, how can U.S. policy encourage developments in the Muslim world that will make future wars less likely?

The creative and determined use of trade policy is one option with real promise. At the outset, though, a caveat: whether through trade policy or other diplomatic initiatives, the United States can exercise at best only modest leverage over conditions in the Muslim world. Whether countries in the region embrace liberal reform, whether they can find a viable path to prosperity and freedom, is overwhelmingly up to them. Even in Afghanistan and Iraq, where U.S. will is backed by military force on the ground, success in building institutions that provide even tolerable security for property, contract, and political rights is by no means ensured. Elsewhere in the region, we must accept that our capacity to promote needed changes is limited.

With that disclaimer, trade policy is an option for combating terrorism that we ignore or slight at our peril. By removing obstacles to exports from the region, by convincing Muslim countries to open their own markets to foreign competition, we can expand economic opportunities in the region and brighten the prospects for broader, pro-market, pro-growth reforms. And while there is no guarantee that greater economic dynamism would lead inevitably to full-scale liberal democracy, the growth of economic power centers outside the state-run sector would likely create momentum in turn for a wider distribution of political power.

Free-Trade Agreements

Free-trade agreements, if structured properly, can be effective instruments for promoting economic growth and reform in the Muslim world. By eliminating U.S. trade barriers, they can give a helpful boost to exports from a region whose exports are sorely in need of one. More important, they can commit FTA partners in the region to far-ranging economic reforms—not only eliminating tariffs on U.S. goods, but also reducing nontariff barriers to foreign goods generally and opening up vitally important service sectors to both foreign and domestic competition.

Because FTA negotiations involve at most a handful of countries, they can proceed much faster and much further than multilateral talks at the World Trade Organization. Those advantages come at a cost: preferential trade agreements create distortions that can harm partner countries and especially third parties. With proper attention, though, such distortions can be kept within tolerable limits so that agreements yield significant net benefits.[18]

Jordan's experience illustrates the potential of an FTA with the United States to spark an export boom. Jordan's FTA grew out of an earlier program of "qualifying industrial zones," or QIZs, which extend duty-free treatment to goods produced in joint Jordanian-Israeli factories. Under the QIZ program (which began in 1998) and then the FTA (which went into effect in December 2001), U.S. imports from Jordan skyrocketed from $31 million in 1999 to $412 million in 2002.[19] The lion's share of Jordan's U.S. exports is clothing products; jewelry exports have also surged.

Although $400 million is trivial in the context of total U.S. imports, it is significant by Jordanian standards. Jordan's exports to the United States account for more than 4 percent

of its GDP and employ some 40,000 workers.[20] The country's non-U.S. exports increased by more than $290 million, or 20 percent, between 1999 and 2002.[21] Accordingly, the new sales to the United States are not simply coming at the expense of other markets.

The effectiveness of FTAs in promoting the exports of partner countries depends heavily on how the agreements are written. The European Union, for example, has negotiated a number of "association agreements" with "Mediterranean" (i.e., Middle Eastern and North African) countries. Those "Euro-Med" agreements provide for the eventual elimination of duties on industrial goods but generally do little or nothing to liberalize trade in agriculture and services. Consequently, important export opportunities remain blocked. The United States, to its credit, grants more comprehensive market access in its FTAs.

Both the United States and the EU reduce the immediate value of FTAs with extended time periods for full elimination of duties. The U.S.-Jordan FTA, for example, phases out tariffs over a 10-year period. Tariffs of less than 5 percent are eliminated after 2 years; tariffs of at least 5 percent but less than 10 percent are gradually reduced to zero over 4 years; for tariffs of at least 10 percent but less than 20 percent, the phase-out period is 5 years; the highest tariffs are gradually reduced to zero over the course of a decade. For this particular FTA, the leisurely pace of liberalization has been less of a problem because many Jordanian exports already qualify for immediate duty-free treatment under the QIZ program. As additional FTAs with other Muslim countries are negotiated, however, long phase-out periods could significantly compromise the short-term encouragement given to FTA-partner exports.

Another way for FTAs to shortchange on market access is through restrictive rules of origin. FTAs need rules for determining whether goods are products of an FTA partner; otherwise, merchandise from anywhere in the world could be transshipped through one FTA country and receive duty-free treatment in all the rest. In the current world of globalized production, where inputs can come from a number of countries and different types of processing can occur in yet other countries before the final good reaches the consumer, it is far from obvious what criteria should be used to determine whether a given import is "made in Country X."

As long as rules of origin are based on neutral criteria like "substantial transformation" or minimum value added, they amount to no worse than a necessary complication of pursuing liberalization through FTAs. However, when they are manipulated to deny duty-free treatment to legitimate production operations in an FTA partner, rules of origin become instruments of hidden protectionism. A particularly notorious example is the "yarn-forward" rule for textile products that appears in NAFTA and many other U.S. trade-preference programs. Under this rule, clothing is not eligible for duty-free treatment unless it is cut and sewn in the preference area from fabric woven in the preference area out of yarns spun in the preference area. Fortunately, the U.S.-Jordan FTA contains more liberal rules of origin for textiles. Future FTAs in the region need to follow that good example.

Although promoting exports from the Muslim world is one good reason for the United States to pursue additional FTAs in the region, it is not the most important reason. The major potential benefit of the Bush administration's proposed Middle East free-trade area is the market opening in the Muslim world that it would entail—and the impetus to broader economic reforms in the region that it would provide. For anything like the full potential gains to be realized, though, FTAs must be properly designed to minimize the distortions caused by gradual, preferential tariff cutting. Furthermore, FTAs must push far beyond tariff cutting to address nontariff barriers to goods trade as well as pervasive barriers to competition in the services sector.

In addition to reducing export opportunities for FTA partners, extended time periods for duty elimination can also cause problems in the FTA partners' own markets. The political case for long phase-out schedules is clear enough: the gradual reduction of tariffs dampens opposition to liberalization by giving

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Liberalization of key service industries is absolutely vital if Muslim countries are to successfully integrate into the global economy.

domestic import-competing industries time to adjust to the new competitive realities. Nevertheless, the economic effects are perverse because of the problem of tariff dispersion. Paradoxically, the combination of high tariffs on some products and low tariffs on others can actually cause worse economic distortions than high tariffs across the board. Specifically, what economists call the "effective rate of protection" conferred by a high tariff on a final consumer good is much higher when tariffs on upstream, intermediate products are low.[22] Accordingly, zeroing out low tariffs quickly tends to worsen the protectionist effects of the remaining high tariffs, thus compounding the misallocation of resources that must ultimately be corrected. The upshot is that FTAs can actually reduce economic welfare in the short run as effective rates of protection increase.[23] Such transition costs can be mitigated by accelerating duty phase-out schedules.

Tariff cutting through FTAs is further complicated by the problem of trade diversion. Preferential trade agreements result in both trade creation and trade diversion: in other words, they expand total imports by reducing tariffs on imports from FTA partners, and at the same time they reshuffle imports from traditional sources to the now-favored FTA partners. Trade creation enhances economic welfare in the liberalizing country; trade diversion reduces welfare by depriving the government of tariff revenue without any compensating benefit in the way of increased competition. If trade diversion predominates over trade creation, eliminating tariffs under an FTA can end up causing a net welfare loss.[24]

The trade diversion effects of future FTAs with Muslim countries will be mitigated by the fact that many of the countries in question have already entered into association agreements with the EU, which is a major source of imports into the region. Efforts to negotiate intraregional free trade among Muslim countries further reduce distortions caused by "hub-and-spoke" trading arrangements in which one country has preferential agreements with a number of countries that lack such preferences among themselves.

Tariffs may be the most obvious and easily quantifiable barrier to trade in goods, but they are by no means the only barrier—or even necessarily the most important one. Many Muslim countries supplement customs duties with a wide range of nontariff barriers, including quantitative restrictions, onerous product testing and certification requirements, unscientific and arbitrary food safety inspection systems, customs valuation methodologies that inflate dutiable value, and good old-fashioned corruption. A recent study by the International Monetary Fund estimated that the incidence of such nontariff barriers in many Middle Eastern and North African countries is 10 times higher than in the developing markets of Southeast Asia.[25]

Trade in goods is not really free as long as nontariff barriers remain so prevalent. And although reforming such trade restrictive practices and policies is far more complicated than simply cutting tariff rates, doing so in an FTA entails fewer risks of inadvertently distorting trade flows. The problem of dispersion is less relevant here; likewise, it is more difficult to reform nontariff barriers on a preferential basis, and so concerns about trade diversion are less pressing. Consequently, FTAs are well suited to addressing these kinds of trade barriers. The country-specific focus of FTA negotiations allows for detailed treatment of the specific barriers of concern. And when negotiations succeed in tackling a problem, the country's policies toward the whole world, not just its FTA partner, are often improved.

The biggest prize in FTA negotiations—the hardest to attain, but offering the richest rewards—is liberalization of trade in services. Services are the dominant contributor to GDP throughout much of the Muslim world and are frequently the largest employer. Yet in those critical service industries that constitute the backbone of a modern economy—transportation, utilities, telecommunications, financial services, distribution—competition, whether foreign or domestic, is typically stunted or nonexistent. As a result, productivity in those industries is abysmal by world standards—and thus the potential benefits of liberalization are immense.

A recent study by the Council on Foreign Relations found that service reform through FTAs can bring considerably bigger welfare gains than conventional tariff removal. Estimating the effects of Euro-Med agreements with Egypt and Tunisia, the study concluded that removal of all tariffs on trade with the EU would increase real income by 4.4 percent in Tunisia but would actually decrease welfare in Egypt by 0.3 percent because of trade diversion. By contrast, service reform—full liberalization of cross-border trade in services and elimination of barriers to investment in service industries—would boost real income by 9.3 percent in Tunisia and 6.5 percent in Egypt.[26]

Opening up competition in services would do more than raise productivity in the liberalized sectors: it would boost performance throughout the whole economy. Agriculture and manufacturing in Muslim countries would enjoy greater competitiveness in world markets if the cost of service inputs were substantially reduced. Likewise, foreign investment in the region would be much more attractive if various costs of doing business now inflated by inefficient services could be slashed. In short, liberalization of key service industries is absolutely vital if Muslim countries are to successfully integrate into the global economy.[27]

The U.S.-Jordan FTA has taken real if limited steps toward liberalizing Jordanian service industries. In particular, the agreement allows 100 percent foreign ownership by 2002 in research and development, convention services, education, health care, and social services; 100 percent foreign ownership in courier services by 2004; and 60 percent foreign ownership in air transportation immediately.[28] That elimination or loosening of ownership restrictions either accelerates or adds to commitments made by Jordan under the WTO General Agreement on Trade in Services. Meanwhile, outside the FTA, Jordan has been pursuing a vigorous program of privatization in the services sector. Privatization transactions undertaken thus far include the sell-off of the Public Transportation Corporation (which operates bus routes in the greater Amman area), the Water Authority of Jordan, the Aqaba Railway Corporation, and the Ma'in Spa.[29]

Future U.S. FTAs in the region should build upon the Jordanian example. Ambitious, far-reaching FTA commitments on services can facilitate and energize purely domestic privatization and reform initiatives. In that way FTAs can pave the way for the broader economic restructuring that the region so desperately needs.

Opening U.S. Markets Now

For all their promise, FTAs suffer one crippling drawback: they are slow. They take years to negotiate and gain congressional approval, whereupon their commitments are gradually phased in over yet additional years. Jordan is in only the second year of a 10-year period of tariff elimination; negotiations with Morocco have just gotten under way; plans for talks with Bahrain have just been announced. Meanwhile, the rest of the countries in the region have not even begun the process; many if not most are years away from being ready to launch FTA talks with the United States. President Bush spoke in May of a U.S.–Middle East free-trade area within a decade. A decade is probably optimistic under the circumstances—and yet, with the urgent need for action that confronts us in the post-9/11 world, a decade seems interminably long.

Meanwhile, the administration's plans for a U.S.–Middle East free-trade area are confined to countries in the Middle East and North Africa. As a result, many Muslim countries (including some, like Afghanistan, Pakistan, and Turkey, of critical importance in the war on terrorism) are left on the outside looking in.

Although the Bush administration's FTA-based strategy is a good one, it needs to be supplemented with an initiative that is broader in scope and offers immediate results. Specifically, the administration should call upon Congress to extend duty-free, quota-free access to the U.S. market now to selected countries in the Muslim world. Such a unilateral preference program would demonstrate the seriousness of the U.S. commitment to Muslim economic growth and development, thereby helping to lay the groundwork for future FTAs in the region.

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The need to open the U.S. market to exports from the Muslim world is especially pressing in light of the impending elimination of import quotas on fabrics and clothing.

Legislation along those lines was recently proposed in Congress. On May 22, 2003, Sens. Max Baucus (D-Mont.) and John McCain (R-Ariz.) introduced the Middle East Trade and Engagement Act, which authorizes the president to extend duty-free treatment to countries of the "greater Middle East."[30] The bill lists 18 countries (Afghanistan, Algeria, Azerbaijan, Bahrain, Bangladesh, Egypt, Iraq, Kuwait, Lebanon, Morocco, Oman, Pakistan, Qatar, Saudi Arabia, Tunisia, Turkey, the United Arab Emirates, and Yemen) and the Palestinian Authority as potentially eligible for benefits. Under the legislation's provisions, though, countries qualify for trade preferences only if the president finds that they meet certain criteria: the countries are making progress toward economic and political reform; they do not engage in activities that undermine U.S. national security or foreign policy; they are not listed by the State Department as state sponsors of terrorism; and they do not participate in the Arab League boycott of Israel. The bill stipulates that duty-free treatment would expire at the end of 2011.

In addition to providing unilateral trade preferences, the Baucus-McCain bill seeks to encourage the negotiation of FTAs between the United States and countries in the region. In particular, it would establish a "United States–Middle East Trade and Economic Cooperation Forum" that would convene annual high-level meetings among officials of the U.S. government, the governments of Israel and Jordan (our present FTA partners in the region), and the governments of all beneficiary countries for purposes of improving commercial ties between the United States and the region. The bill would also require the president to report to Congress on plans for negotiating additional FTAs.

The case for something like the Baucus-McCain bill is compelling. The United States already has three regional trade-preference programs that provide duty-free access to the U.S. market: the U.S.–Caribbean Basin Trade Partnership Act, the Andean Trade Preference Act, and the African Growth and Opportunity Act. Yes, the United States has a strong interest in encouraging economic development in the Western Hemisphere and sub-Saharan Africa. But is the U.S. interest in promoting growth in the Muslim world any less strong? Surely, in the midst of an ongoing war against Islamist terrorism, the goal of overcoming the Muslim world's sad legacy of stagnation and repression is of paramount importance. How serious, though, can the United States really be about achieving that goal if we fail to offer Muslim countries the same market access that Caribbean, Andean, and African nations now enjoy?

The need to open the U.S. market to exports from the Muslim world is especially pressing in light of the impending elimination of import quotas on fabrics and clothing at the end of 2004. Textile products are major export items for many countries in the region: in 2002, textiles' share of total U.S. imports was 37 percent for Egypt, 48 percent for Turkey, 86 percent for Pakistan, and 88 percent for Bangladesh.[31] The quota system currently insulates Muslim countries from the full brunt of foreign competition for the U.S. market. In 2005, however, when quotas have been eliminated, many exporters from Muslim countries are likely to suffer serious erosion in market share at the hands of Chinese competition—especially since they do not at present enjoy the preferential treatment now accorded to fabric and clothing exporters from Caribbean, Andean, and African countries. Extending similar preferential treatment to Muslim countries is necessary if the region's already precarious position in the global economy is to avoid another major setback.[32]

A region-wide preference program would also protect against inadvertent trade diversion damage caused by negotiating FTAs in the region. For example, as Edward Gresser of the Progressive Policy Institute has pointed out, an FTA with Morocco would allow olive oil producers to boost their sales to the United States—at the expense not only of European rivals but also competitors in Turkey, Lebanon, and Tunisia.[33] Since competitiveness in exporting a particular product to the United States is often shared by a number of Muslim countries, granting duty-free treatment to one country

through an FTA would likely inflict harm on other exporters in the region. Legislation like that proposed by Senators Baucus and McCain would prevent such trade diversion by putting countries on an equal footing in the U.S. market regardless of FTA status.

The whole purpose of a regional preference program is to encourage exports to the United States from that region. Accordingly, it is utterly counterproductive to thwart the favored exports with restrictive rules of origin. To its credit, the Baucus-McCain bill proposes a sensible, across-the-board rule under which products are eligible for preferential treatment when at least 35 percent of their value was added in any of the beneficiary countries as well as Jordan and Israel. By contrast, other regional preference programs have been marred by a protectionist "yarn-forward" rule for textile products. In the case of the AGOA, for example, a recent IMF study concluded that the legislation's boost to exports would have been more than four times greater if a liberal rule of origin for clothing had been used.[34] Making the same mistake in a preference program for the Muslim world would likely have similarly dismal consequences, given the region's dependence on textile exports.

Such protectionist games must be avoided this time. It is bad enough to put the parochial interests of the U.S. textile industry ahead of the U.S. national interest in promoting economic development in poor countries. But to do so in legislation that aims to reduce the likelihood of future 9/11s would be unforgivable.

Unilateral trade preferences, when structured properly, can be a real help to people in the Muslim world. Nevertheless, they are no substitute for the determined pursuit of FTAs. As discussed above, the primary obstacle to economic development in the Muslim world—the failure to foster market competition through appropriate policies and institutions—is self-imposed. Removing U.S. barriers to exports from the region will do nothing to address that fundamental problem. Indeed, without other tracks of U.S. engagement with the region, unilateral trade preferences on their own could actually reduce momentum for reform. A recent World Bank study of the U.S. Generalized System of Preferences (a program that gives duty-free treatment to selected exports of underdeveloped countries) between 1976 and 2000 concluded that countries that lost their eligibility for GSP adopted freer trade policies than those receiving GSP benefits.[35]

Accordingly, U.S. policy must look beyond unilateral preferences and set its sights on encouraging internal reform in the Muslim world. Immediate opening of the U.S. market should be seen as just a first step—a down payment, as it were, that demonstrates the seriousness of American resolve to work with Muslim countries and help them to help themselves. The ultimate aim of U.S. policy must be, as President Bush has indicated, mutual liberalization in which Muslim countries commit to open their own markets and overhaul their own policies and institutions.

By granting unrestricted access to the American market unilaterally, the United States would give up one type of leverage—the ability to use U.S. trade barriers as a bargaining chip in FTA negotiations—to accomplish that ultimate aim. However, the benefits of unilateral U.S. liberalization—providing immediate encouragement to regional exports, protecting against fallout from the lapse of textile quotas and FTA-caused trade diversion, and offering a potent demonstration of U.S. goodwill—should greatly outweigh any loss of U.S. bargaining power.

Meanwhile, the United States still has plenty of leverage in FTA negotiations. FTAs make permanent unrestricted access to the American market a binding international commitment of the United States. By contrast, duty-free access under unilateral preference legislation typically comes with an expiration date—the end of 2011 under the current Baucus-McCain bill. FTAs thus allow countries to "lock in" their access to the U.S. market with the added security of mutual international obligations—a distinct improvement over dependence on temporary, if renewable, trade preferences. In addition, FTAs with the United States offer a kind of official "seal of approval" of a country's commitment to international

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openness and ongoing economic reform. Since the credibility of that commitment is a crucial factor in determining the attractiveness of a country to foreign investors, countries seeking to encourage foreign investment will have a strong incentive to pursue FTAs with the United States. For example, the countries of the Southern African Customs Union are now negotiating an FTA with the United States even though they enjoy unilateral benefits under AGOA.

Finally, it is possible to structure regional preference legislation with staged benefits that link a country's access to the U.S. market to its own track record in reducing trade barriers at home. The current Baucus-McCain bill features an all-or-nothing approach: countries must meet certain criteria to be eligible for preferential treatment, but once they do they receive full duty-free access. It is worth considering the addition of an intermediate level of preferences: for example, duty-free treatment for a country's top exports accounting for 50 percent of its exports to the United States and a 50 percent cut in duty rates for all remaining exports.

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With that addition, preference legislation would offer staged benefits that lead gradually from the status quo to FTA partnership with the United States. Criteria along the lines of those set forth in the Baucus-McCain bill would determine eligibility for the intermediate level of benefits. For full duty-free access, though, a country would have to meet additional requirements. Possible requirements might include maxima for average tariff levels and tariff peaks and benchmarks for progress in privatization and service-sector reform. Countries entitled to full duty-free access would then be eligible to enter into FTA negotiations.

Whether or not it featured staged benefits, the immediate opening of the U.S. market would energize U.S. economic engagement with the Muslim world. While a regional preference program is no substitute for the administration's FTA strategy, it would complement that strategy superbly. The Bush administration should therefore embrace the concepts embodied in the legislation proposed by Senators Baucus and McCain and call upon Congress to enact legislation with those objectives in mind.

An Olive-Branch Trade Policy

In the immediate aftermath of the terrorist attacks on New York and Washington, U.S. Trade Representative Robert Zoellick characterized the administration's trade agenda as an integral element of the "counteroffensive" against America's terrorist adversaries. "Trade is about more than economic efficiency," he wrote in a September 20, 2001, op-ed in the *Washington Post*. "It promotes the values at the heart of this protracted struggle."[36]

The Bush administration deserves praise for drawing the connection between trade policy and combating terrorism—and then pursuing that connection with plans for FTAs with Morocco, Bahrain, and other Muslim countries. And as the administration recognizes, trade policy's role in bolstering national security goes beyond initiatives with the Muslim world. In his provocative *Washington Post* op-ed, Zoellick called for responding to the 9/11 attacks with a vigorous assertion of American economic leadership across the board—in particular, through an aggressive policy of bilateral, regional, and multilateral market opening.

How does reducing trade barriers around the world make America safer? First, by helping the global spread of markets and liberal democracy. Wherever it exists and in whatever form, tyranny spawns war and conflict and terror—and, consequently, threats to U.S. global interests and national security. Promoting pro-market policies in other countries is one small but effective way for the United States to minimize those threats by fostering conditions more favorable to human freedom.

Second, leading the world toward closer commercial ties can reduce threats to American interests and security by calming fears and resentment of American power. A nation as overwhelmingly dominant as ours will inevitably face some level of reactionary opposition—opposition that has now intensified after the recent exertions of U.S. military

might. Although some of the backlash may be unavoidable, it is clearly true that, all things being equal, we would be better off with fewer detractors around the world. Accordingly, whenever we can avoid giving gratuitous offense or causing unintended harm, we would be wise to do so.

Seen in this light, U.S. trade policy can serve as an olive branch to the world. By opening our markets to the rest of the world—whether unilaterally or in concert with other nations—we demonstrate that America's interest lies, not in keeping other countries down, but in encouraging them to rise and prosper.

The Bush administration should therefore reconsider its recent tendency to use trade policy as a means for settling scores with countries that have "crossed" us. Specifically, the threatening delay in signing the FTA with Chile and the frosty attitude toward FTA negotiations with New Zealand run directly counter to what should be the guiding spirit of U.S. trade policy. Those nations are two of globalization's glittering success stories; we should be doing everything possible to encourage other countries to follow their example. To fail to do so because of specific foreign policy disagreements would only undermine U.S. interests in the long run. Trade policy is woefully ineffective at securing unswerving international support for U.S. foreign policy positions—as amply demonstrated by the failure of NAFTA partners Canada and Mexico and new FTA partner Chile to support the U.S. position on Iraq. But attempting to use trade policy this way can be all too effective at giving credence to the caricature of the United States as a heavy-handed bully.

In aligning overall U.S. trade policy with the needs of national security, the proper focus is not on our grievances against other countries. We have other, better ways of dealing with those when we have to. Rather, we should be focusing on other countries' legitimate grievances against us. Textiles tariffs and quotas, high trade barriers and profligate subsidies for many U.S. farm products, arbitrary and prohibitive protectionism under the antidumping and other trade remedy laws—all of these policies inflict heavy damage on exporters in the world's poorest and most desperate countries. We cannot right those wrongs soon enough.

To date the Bush administration's overall record on trade policy is mixed. There have been serious protectionist lapses—notably, the imposition of 30 percent steel tariffs and the signing of extravagant farm subsidies legislation. On the plus side, the administration is now actively pursuing market opening through a variety of bilateral, regional, and multilateral initiatives. If those initiatives can be brought to successful completion, this presidency will have significant trade policy accomplishments to be proud of.

That, however, is a big if. The Bush administration's ambitious trade agenda in the Muslim world and elsewhere will not be easily implemented. Finding common ground at the negotiating table will frequently be difficult, though it may seem simple in comparison with the challenges of pushing the resulting trade deals through Congress. Creativity and dedication and, not least, significant expenditures of political capital will be required if the administration's bold plans are actually to become policy.

In pursuing his trade agenda, President Bush would do well to remember the example of other presidents who understood that free trade is about more than dollars and cents. During the Cold War, President Eisenhower insisted that anti-import special interests must take a back seat to the larger national interest in an open and prosperous international economy. "[A]ll problems of local industry pale into insignificance in relation to the world crisis," he declared. Protectionism, in the context of the twilight struggle against communism, amounted to "shortsightedness bordering upon tragic stupidity."[37] President Kennedy, likewise, was adamant in linking open markets and national security. Trade liberalization, he said, was "an important new weapon to advance the cause of freedom," since "a vital expanding economy in the free world is a strong counter to the threat of the world Communist movement."[38]

Previously the threat was communism; today it is Islamist terrorism. But whether we are contending with secular totalitarians or religious ones, trade policy can lend valuable assistance.

By opening our markets to the rest of the world, we demonstrate that America's interest lies, not in keeping other countries down, but in encouraging them to rise and prosper.

A determined policy of market opening can help to reduce the appeal of Islamist extremism—and fear of the American colossus.

The liberal trading system constructed after World War II was crucial to two great Cold War victories: the reconstruction of Western Europe and the rise of East Asia. Today, a determined policy of market opening can help to reduce the appeal of Islamist extremism—and fear of the American colossus.

The domestic and international political challenges are, as usual, formidable: tenacious political opposition here and abroad will seek to undermine trade liberalization at every turn. But if the task is daunting, the potential rewards are surely worth the effort.

Notes

1. The president's speech is available at www. whitehouse.gov/news/releases/2003/05/20030509-11. html.

2. *The National Security Strategy of the United States of America,* September 2002, introduction, www. whitehouse.gov/nsc/nss.pdf.

3. See "Zoellick Says FTA Candidates Must Support U.S. Foreign Policy," *Inside U.S. Trade,* May 16, 2003.

4. See Brink Lindsey, *Against the Dead Hand: The Uncertain Struggle for Global Capitalism* (New York: John Wiley & Sons, 2002).

5. James Gwartney et al., *Economic Freedom of the World: 2002 Annual Report* (Vancouver: Fraser Institute, 2002). Kuwait scored 6 on state-owned enterprises and 6 on price controls; the UAE scored 6 and 8.

6. The 2002 index is available at www. transparency. org/pressreleases_archive/2002/2002.08.28.cpi.en. html.

7. See Economic Research Forum for the Arab Countries, Iran and Turkey, "The Informal Sector in the MENA Region: Engine of Growth?" *Forum* 3, no. 1 (March 1996), www.erf.org.eg/nletter/ Mar96-01.asp.

8. Hernando de Soto, *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000), p. 254.

9. Edward Gresser, "Blank Spot on the Map: How Trade Policy Is Working against the War on Terror," Progressive Policy Institute Policy Report, February 2003, p. 2, www.ppionline.org/ documents/Muslim_Trade_0203.pdf.

10. Ibid., p. 2.

11. See Maria-Angels Oliva, "Estimation of Trade Protection in Middle East and North African Countries," International Monetary Fund Working Paper 00/27, February 2000, p. 21, www. imf.org/external/pubs/ft/wp/2000/wp0027.pdf.

12. James Gwartney et al., *Economic Freedom of the World: 2001 Report* (Vancouver: Fraser Institute, 2001), p. 73.

13. United Nations Development Programme, *Arab Human Development Report 2002: Creating Opportunities for Future Generations* (New York: United Nations Development Programme, 2002), p. 85, www.undp. org/rbas/ahdr/CompleteEnglish.pdf.

14. Per capita GDP statistics were taken from Angus Maddison, *The World Economy: A Millennial Perspective* (Paris: Organisation for Economic Cooperation and Development, 2001).

15. United Nations Development Programme, p. 92.

16. Freedom House's rankings are available at www.freedomhouse.org/ratings/index.htm.

17. United Nations Development Programme, p. 27.

18. See Daniel T. Griswold, "Free-Trade Agreements: Steppingstones to a More Open World," Cato Institute Trade Briefing Paper no. 18, July 9, 2003.

19. Trade statistics were obtained from the Library of International Trade Resources at www. litr.com.

20. For the employment effects of Jordan's export boom, see Gresser, "Blank Spot on the Map," p. 4.

21. Trade statistics were obtained from the website of the Jordan Export Development & Commercial Centers Corporation, www.jedco. gov.jo.

22. Consider a hypothetical case involving, unsurprisingly, widgets. Assume that a widget is manufactured from one tradable input called a gadget. The price of a widget under free-trade conditions is $100 and that of a gadget is $60. Value added in widget production is therefore $40 per unit. Now assume that the tariff on widgets is 30 percent, but gadgets can be imported duty-free. Widgets now sell for $130, and value added has climbed to $70. The effective rate of protection is equal to the difference between value added with the tariff and value added under free trade divided by value added under free trade—in this case, 75 percent. By contrast, if gadgets were also subject to a 30 percent tariff, the effective rate of protection for widgets would fall to 30 percent.

23. See Thomas F. Rutherford, Elisabet E. Rutström, and David Tarr, "The Free-Trade Agreement between the European Union and a Representative

Arab Mediterranean Country: A Quantitative Assessment," unpublished paper, July 13, 1999, p. 16, copy in author's files. The authors examined the practice in Euro-Med agreements of first eliminating tariffs on goods with the lowest tariffs that account for 40 percent of total import value and then phasing out remaining duties over 12 years. They found that the initial elimination of low tariffs in the Arab country produced welfare gains by reducing the overall average tariff level but that those gains were overwhelmed by losses produced by increasing tariff dispersion. In other words, they concluded that such an agreement would produce a net welfare loss for the Arab country in the short term. See also Henri Ghesquiere, "Impact of European Association Agreements on Mediterranean Countries," International Monetary Fund Working Paper 98/116, August 1998, p. 7, www.imf.org/external/pubs/ft/wp/ wp98116.pdf.

24. See Griswold.

25. Oliva, pp. 12–13.

26. Bernard Hoekman and Patrick Messerlin, *Harnessing Trade for Development and Growth in the Middle East* (New York: Council on Foreign Relations, 2002), p. 50.

27. See Bernard Hoekman and Patrick Messerlin, "Initial Conditions and Incentives for Arab Economic Integration: Can the European Community's Success Be Emulated?" World Bank Research Working Paper 2921, October 2002.

28. See U.S. Agency for International Develop-ment, "Economic Impact and Implications for Jordan of the U.S.-Jordan Free Trade Agreement," February 2001, pp. 65–76, http://usembassy-amman.org.jo/FTA-USAID.pdf.

29. See World Bank, "Privatization: The Jordanian Success Story," http://lnweb18.worldbank.org/mna/mena.nsf/Attachments/Privatization+Story/$File/Jordan_Privatization_Story_for_Exweb. PDF.

30. The proposed legislation, S. 1121, is available at http://frwebgate.access.gpo.gov/cgi-bin/getdoc.cgi?dbname=108_cong_bills&docid=f:s1121is.txt.pdf.

31. Library of International Trade Resources.

32. See Gresser, "Blank Spot on the Map," pp. 5–6.

33. Edward Gresser, "String of Pearls or Multi-Car Pile Up? The U.S. Negotiates New Trade Agreements with 15 Countries," Progressive Policy Institute Policy Report, April 2003, p. 3, www.ppionline.org/documents/FTA_0503.pdf.

34. Aaditya Mattoo, Devesh Roy, and Arvind Subramanian, "The African Growth and Opportunity Act and Its Rules of Origin: Generosity Undermined?" International Monetary Fund Working Paper 02/158, September 2002, p. 17, www.imf.org/external/pubs/ft/wp/2002/wp02158.pdf.

35. Çaglar Özden and Eric Reinhardt, "The Perversity of Preferences: The Generalized System of Preferences and Developing Country Trade Policies, 1976–2000," World Bank Working Paper no. 2955, January 13, 2003, http://econ.worldbank.org/files/23188_wps2955.pdf.

36. Robert B. Zoellick, "Countering Terror with Trade," *Washington Post,* September 20, 2001, www.washingtonpost.com/ac2/wp-dyn/A59531-2001Sep19? language=printer.

37. Quoted in Alfred E. Eckes Jr., *Opening America's Market: U.S. Foreign Trade Policy since 1776* (Chapel Hill: University of North Carolina Press, 1995), p. 167.

38. Quoted in ibid., p. 178.

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