BANCO MUNDIAL
BRASIL

Regional, Multilateral and Unilateral Trade Policies of MERCOSUR for Growth and Poverty Reduction in Brazil

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DRAFT: DO NOTE QUOTE WITHOUT THE PERMISSION OF THE AUTHORS

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THIS IS WORK DONE AT THE REQUEST OF THE GOVERNMENT OF BRAZIL

- We had a mission in Brazil in June 2001 to agree on the issues of this paper
- We had a mission in April 2002 to obtain reaction from the government and gave seminars at various think tanks; the draft incorporates those comments
- But "official" reaction not yet received, so this is considered a draft at this time.
- While in the US, Brazil is considered a holdout for the FTAA, the picture in Brazil is quite different. They simply want to consider all their options.
- They would like to consider a EU-Mercosur agreement as well as the FTAA. And they are one of the strongest supporters of multilateral liberalization among developing countries.
- Brazil is quite concerned that contingent protection or excluded products will result in regional agreements that are not beneficial.
- And poverty implications are quite important for the party favored to win the election later this year.

I. ISSUES FOR BRAZIL

1. THE FREE TRADE AGREEMENT OF THE AMERICAS IS PROPOSED.

   But will antidumping actions in the us deny the benefits of this agreement.

2. A FREE TRADE AGREEMENT BETWEEN MERCOSUR AND THE EUROPEAN UNION IS BEING NEGOTIATED.

   But will lack of access to the highly protected agricultural and food markets deny the benefits of this agreement.

3. THE DOHA DEVELOPMENT AGENDA IS MOVING FORWARD WITH THE PROSPECT OF MULTILATERAL LIBERALIZATION AND AGRICULTURAL REFORM

   Given the recognition in Brazil that trade openness has induced productivity increases in the 1990s, what can be expected from unilateral liberalization or tariff uniformity.

   How to use these various options, along with possibly unilateral trade policy changes, optimally? And how are the poor affected relative to the average for the population?

IMPACT ON PARTNER AND EXCLUDED COUNTRIES

- WE ALSO ASSESS THE IMPACT OF THE VARIOUS POLICY OPTIONS ON PARTNER COUNTRIES TO THE AGREEMENT AND ON THE EXCLUDED COUNTRIES?

- HOW DO THE GAINS OF THE REGIONALISM CHOICES COMPARE TO MULTILATERAL TRADE LIBERALIZATION?

II. THE MODEL

- 16 REGION MODEL OF WORLD TRADE, WITH A FOCUS ON THE AMERICAS
- THE 13 REGIONS ARE —BRAZIL, URUGUAY, ARGENTINA, CHILE, COLUMBIA, PERU, VENEZUELA, REST OF ANDEAN PACT, CANADA, MEXICO, US, CENTRAL AMERICA AND CARIBBEAN, REST OF SOUTH AMERICA, EU 15, JAPAN, AND REST OF THE WORLD.
- THERE ARE 22 SECTORS IN EACH REGION, LISTED IN TABLE 1; SECTORS ARE PRESERVED IF THERE IS SIGNIFICANT PROTECTION

ALL AGENTS ARE OPTIMIZERS

CONSTANT RETURNS TO SCALE AND PERFECT COMPETITION

Impacts on Poverty

- THERE ARE 20 HOUSEHOLDS IN THE MODEL: 10 RURAL AND 10 URBAN, WITH HOUSEHOLDS WITHIN EACH OF THE TWO GROUPS SEGMENTED ACCORDING TO INCOME.
- THIS ALLOWS AN ANALYSIS OF THE IMPACT OF POLICY CHANGES ON POVERTY IN BRAZIL—BUT THIS IS WHERE THE CONCEPTUAL WORK WAS DONE AND WHERE THE TIME WAS SPENT WITH THE DATA.
- STOCKHOLM CONFERENCE ON TRADE AND POVERTY: PAPERS GENERALLY WERE NOT READY FOR POLICY APPLICATIONS
- BUT ALL CGE APPLICATIONS CONCLUDED THAT INCOME SOURCES ARE MORE IMPORTANT THAT EXPENDITURE SHARES IN EXPLAINING THE IMPACT OF TRADE POLICY ON POVERTY.

Harrison, Rutherford and Tarr (Journal of Development Economics, forthcoming)

Problem 1. Input-output tables can not be used for factor shares. Otherwise the link between trade policy and income sources of the poor is randomly or perversely mapped and the results are nonsense.

- Unprofitable sectors are reported as labor intensive
- Sherman Robinson has made the point that agriculture and services sectors are systematically reported as excessively capital intensive.

Problem 2. Reported incomes from Household expenditure surveys do not neatly map into the factors of production in our models. This mapping must be very carefully done. We explain these issues and how we resolve them in the case of Brazil in an appendix.

III. PRINCIPAL POLICY CONCLUSIONS

FIRST BRAZIL

1. **FREE TRADE AGREEMENT OF THE AMERICAS AND THE EU-MERCOSUR AGREEMENTS**

   First, assume both are implemented without protective restrictions

   We estimate that both of these agreements are welfare improving for Brazil, so by the standards of regional arrangements we have evaluated, they are relatively beneficial.

   FTAA results in estimated gains of 0.6% of aggregate consumption. (US$ 3.1 billion per year)

   EU-MERCOSUR results in 0.9% of aggregate consumption (US$ 5 billion per year).

2. SUPPOSE THE BIG COUNTRIES RETAIN PROTECTION OF THEIR MOST HIGHLY PROTECTED PRODUCTS

a. European Union does not offer preferred access in Agriculture to countries on its frontier. We assume that the following most highly protected products are not part of the agreement.

   paddy rice (65%); cereal grains (44%); processed rice (86%), other food products (28%), bovine meat products (95%), dairy products (90%), other meat products (61%) and sugar (76%).

   The gains for Brazil drop from 0.9% to 0.1%. Thus, preferred access to the highly protected products is crucial for the agreement with the EU to be very beneficial.

b. FTAA. Suppose the US uses antidumping to exclude oil seeds (18%); other crops, including wheat,

fruits and vegetables (14%); dairy products (42%) and sugar (53%)

The gains from the FTAA for Brazil fall from 0.6% to 0.4%

The fall is not as drastic as with EU-MERCOSUR, since:

1) the US is not the whole market in the Americas, so denial of preferred access to the US, still allows preferred access to the other countries in the Americas, while EU-MERCOSUR is the whole market
2) the tariff peaks in the EU are higher, so the benefits of preferred access is greater.

3. COMBINING THE FTAA WITH EU-MERCOSUR

The gains are 1.8% of consumption or US$ 9.6 billion.
This is greater than the sum of the gains from the agreements separately
0.6 % + 0.9% = 1.5% or US$ (3.1 + 5) billion= US$ 8.1 billion

The two agreements together reduce the trade diversion costs associated with either agreement.

Thus, the strategy of negotiating an agreement with the EU in addition to the FTAA appears to be a useful strategy that is likely to provide benefits to Brazil not only from the bilateral gains from the EU agreement, but because the agreement with the EU will improve the FTAA.

4. UNILATERAL TRADE LIBERALIZATION

We estimate that a 50% cut in the tariffs of MERCOSUR will result in an increase in welfare by about four-tenths of a percent of Brazilian consumption, or about $1.9 billion per year. Thus, the gains from the FTAA with excluded access to the US market on selected products results in approximately the same gains as a unilateral tariff cut by MERCOSUR of 50%.

5. MULTILATERAL TRADE LIBERALIZATION

ASSUME THAT THE DOHA DEVELOPMENT AGENDA LEADS all countries in the world reduce their tariffs and export subsidies and taxes by 50%.

Brazil gains about eight tenths of a percent of personal consumption from multilateral trade liberalization in our static model, or about $4.5 billion. This is larger than the gains from the FTAA

6. FTAA BUT MERCOSUR DOES NOT PROVIDE IMPROVED ACCESS WITHIN THE FTAA—(say reverse antidumping applied)

The gains are 0.4% of consumption. This shows that improved market access is responsible for about two-thirds of the gains from the FTAA and one-third of the gains comes from lowering tariff preferentially

IV. SECTOR IMPACTS

Typically agriculture, food and leather products expand while several manufacturing sectors decline. This reflects relative protection in Brazil.

If EU-MERCOSUR is implemented with full access to the EU, there would be an enormous expansion of agriculture and food exports. But excluded access in the EU results in drastically smaller impacts.

V. HOUSEHOLD AND POVERTY IMPACTS

In percentage terms, the poorest households typically gain 3 to 4 times the average gain for the economy.

For example, with the FTAA, the economy gains 0.6% of consumption and the poorest rural and urban households gains 2.6% and 2.5% of consumption.

Why? The poorest households earn the majority of their income from unskilled labor and the wage rate of unskilled labor increases significantly more that the skilled labor wage rate and the rent on capital (see Table 7).

The poor typically do not have significant real assets or financial assets accumulated. These facts are documented in Appendix D based on the Brazilian LSMS and summarized in Table 4.

In the case of Brazil, the trade policy changes shift production from less unskilled labor intensive manufacturing to more unskilled labor intensive agriculture and manufacturing sectors.

Table 11 documents these results with simulations that show the poor would not gain so much more if the poor earned their income in the same proportions as the average household.

Internal resource reallocation is much more important to the poor than improved market access. While market access accounts for two-thirds of the gains of the FTAA for the economy on average, market access accounts for only about 20 % of the gains for the poor. Resource reallocation in Brazil increases the wage of unskilled labor which benefits the poor disproportionately.

VI. IMPACT ON PARTNER AND EXCLUDED COUNTRIES (TABLE 6)

- The Agreements result in net gains to the partner countries—reflecting the creation of large economic areas with competition and relatively efficient suppliers located within the region for most products.
- Argentina is the only country in the Americas that loses from the FTAA—its preferential access to MERCOSUR markets is eroded, and this dominates the gains from other aspects.
- Virtually all excluded countries lose from these Agreements—they typically suffer a terms of trade loss.
- Multilateral liberalization results in gains to the world more than four times the gains from the best regional arrangement.

VII. OPTIMIZING BRAZIL TRADE POLICY

We assume here that the most likely outcome is that the EU excludes agriculture and that the US applied antidumping. That is, the excluded products scenarios are most likely.

Then how can Brazil optimally combine its various trade policy options?

1. **FTAA with excluded products in the US and 50% unilateral MERCOSUR tariff cuts.**

The estimated gains to Brazil are 0.73% of Brazilian consumption; this is almost twice the gains from the FTAA with excluded products.

By unilaterally lowering the common external tariff of MERCOSUR, Brazil, Uruguay and Argentina reduce the trade diversion costs of the FTAA, while retaining preferred access to the markets of the Americas

In the case of Argentina, the welfare effects go from being negative to being positive (not shown in the Table).

2. **Combining the Free Trade Agreement of the Americas with the MERCOSUR-EU Agreement with Excluded Products.**

   The gains to Brazil (0.8% of consumption) exceeds the *sum* of the gains from the separate agreements with exclusions (0.5% of consumption). The reason again is that the combined agreements reduce the trade diversion impacts of either of the agreements separately.

3. **FTAA plus EU-MERCOSUR (both with excluded products) and 50% MERCOSUR tariff cuts.**

   The estimated gains to Brazil are 0.97 % of Brazilian consumption. Results in column (3) of Table 12 Comparing columns (2) and (3), the additional gains from unilateral liberalization derive from both reducing trade diversion of the preferential arrangements and improved resource allocation from moving closer to world prices of imports.

4. FTAA plus EU-MERCOSUR (both with excluded products) combined with 50% Multilateral Trade reform in goods.

We find that Brazil will gain 1.15 percent of its personal consumption in aggregate. Compared with the results of column (3), which includes unilateral liberalization in MERCOSUR, the gains are due to additional market access to the rest of the world and Japan, along with liberalization in the US and the EU of products excluded in the regional arrangements. The increased gains from multilateral liberalization are muted because the preferred access that MERCOSUR negotiates in these regional arrangements is eroded by the multilateral liberalization.

This is the strategy some of the leaders in Brazil have advocated –- pursue regional trade agreements while at the same time pursuing multilateral trade liberalization, since it is presumed that only multilateral negotiations will succeed in achieving agricultural tariff reduction and export subsidy reduction. These results support that view that the various options can be combined to result in larger gains.

5. Tariff Uniformity

We impose a uniform tariff in MERCOSUR and allow the rate to adjust such that collected revenue from the tariff in Brazil is unchanged. We find that the uniform tariff rate is able to fall to 7%.

The results from this scenario indicate that a movement to a uniform tariff in MERCOSUR would convey significant benefits to Brazil of almost five-tenths of a percent of personal consumption. In fact, the gains are slightly larger than the gains to Brazil from a 50% unilateral across the board tariff cut.

Experience has shown that the large gains from trade liberalization are typically derived from reducing tariff peaks, which is effectively accomplished with tariff uniformity. Reducing low tariffs results in proportionately smaller gains, and may even result in losses if the importing country possesses monopsony power. Thus, we find that tariff uniformity in MERCOSUR can convey significant benefits to Brazil.

6. FTAA plus EU-MERCOSUR (with excluded products) combined with 50% Multilateral Trade reform in goods combined with tariff uniformity in MERCOSUR.

This scenario evaluates the impact of pursuing all avenues –regional, multilateral and unilateral (where the unilateral action in uniformity).

The gains from this scenario are, as expected, the largest of the options considered.

Tariff uniformity adds about 0.21 of a percent to the overall welfare gain to the economy compared to leaving it out.

The gains from adding uniformity are less than when we consider uniformity alone. Uniformity achieves benefits from chopping off the tariff peaks. Since the regional and multilateral policies reduce the tariff peaks significantly, there are less gains from uniformity.

VIII. CONCLUSIONS

1. Regional arrangements

The FTAA and the MERCOSUR agreement with the EU can both be expected to result in gains to Brazil.

The agreement with the EU is almost twice as valuable as the FTAA due to access to highly protected agricultural markets in the EU.

The big countries in these agreements, however, may exclude their most protected products from the agreements. In that case, the FTAA will be more valuable to Brazil than the agreement with the EU.

The combined gains from both agreements will be greater than the gains obtained from the sum of the agreements separately due to a reduction of trade diversion.

2. **Tariff uniformity**
   We find that tariff uniformity also yields benefits for Brazil. Unilateral application of uniform tariffs in MERCOSUR, such that collected tariff revenue in Brazil is unchanged, would yield benefits roughly equal to a unilateral 50% tariff cut in MERCOSUR.
3. **Poverty impacts**
   The regional, multilateral or unilateral policies under consideration can be expected to result in a distribution of the gains to the different households that is progressive, such that the poorest households experience the greatest percentage increase in their incomes. This is because the trade policy changes tend to shift resources from capital intensive manufacturing toward unskilled labor intensive agriculture, thereby inducing an increase in the wage of unskilled labor relative to the other prices of factors of production. The percentage increase in the incomes of the poorest households is several times greater than the percentage increase in the income of the average for the economy as a whole.

4. Optimizing policies

Our estimates indicate that the apparent Brazilian strategy of simultaneously pursuing a MERCOSUR agreement with the EU plus the FTAA, while supporting multilateral trade liberalization at the WTO, is well considered. Brazil can optimize its choice of trade policies by combining regional arrangements in both the Americas and the EU with multilateral liberalization. If tariff uniformity is added to the regional and multilateral liberalization, still further gains would be realized.

5. Impact on Partner and Excluded countries

Both the FTAA and the EU-MERCOSUR arrangements are net trade-creating for the countries involved, but excluded countries almost always lose from the agreements, and Argentina loses from the FTAA due to erosion of preferred access in MERCOSUR. Multilateral trade liberalization results in gains to the world more than four times greater than either of these relatively beneficial regional arrangements, showing the importance to the world trading community of the multilateral negotiations.