Why Liberalize Trade?

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Courtesy of ACDI/VOCA

About half of the global benefits from freer trade in goods would go to people in developing countries, such as this Angolan fruit trader.

The evidence is clear. Opening trade creates wealth for societies to address their needs and promotes economic development; erecting barriers to trade leaves people and countries worse off overall. The United States learned this lesson after imposing the damaging Smoot-Hawley tariffs in the 1930s. Since then, the United States has led the world in opening international markets, which has fuelled countries' growth and development and helped raise millions of people out of poverty. But much more remains to be done to realize the benefits of freer trade in agriculture, manufactured goods, services, and other areas. Developing countries especially stand to gain if the impasse is broken in multilateral trade negotiations. World Bank studies have found that tens of millions more can be lifted out of poverty through increased trade.

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"We will fight to lift the burden of poverty from places of suffering—not just for the moment, but permanently. And the surest path to greater wealth is greater trade."

President George W. Bush
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The world of the 21st century faces enormous challenges. More than 1 billion of its people live in poverty, a condition that devastates families, communities, and nations. Developed and developing countries alike share the goals of alleviating poverty around the globe, achieving greater economic growth and higher standards of living, and generating new employment and opportunities for their citizens.

As governments seek to break the impasse in the current World Trade Organization (WTO) Doha Round of negotiations, it is worth recalling that economic theory and practical experience demonstrate that open markets and trade liberalization—dismantling tariff and nontariff barriers to trade—provide a proven path to wealth creation and development. Countries that are open to trade tend to have more wealth, healthier populations, higher rates of education and literacy, stronger labor rights and environmental standards, and greater investment opportunities. Trade barriers, in contrast, may shield narrow special interests from competition, but ultimately they leave a nation as a whole worse off in terms of wealth foregone, slower growth, and, hence, fewer resources to address pressing societal needs.

Theory and Evidence

Why do countries trade? The intellectual underpinnings of free trade are well known to economists. Simply put, nations benefit by specializing in the production of goods and services that they can produce most efficiently, and exchanging these for the goods and services that other countries produce at higher quality and lower cost. In this arrangement, countries benefit from more efficient production, increased consumer choice, and better goods and services at lower prices. Dismantling government barriers to trade allows individuals access to the world's supermarket for food, clothing, and other manufactured goods, and for services that form the infrastructure of the modern economy, ranging from finance to telecommunications and transportation to education.

Competition also motivates businesses to innovate, to find new production processes and technologies to better serve customers, and to advance knowledge. For example, the development of advanced computer technologies and life-saving medicines in recent years has flourished under conditions of open markets and export opportunities for industry growth, coupled with enforcement of strong copyright and patent laws.

Barriers to competition produce the opposite effect—less efficient domestic industries; higher costs, poorer quality, and fewer choices of goods and services; less innovation; and slower economic growth.

The economic history of the 20th century provides a potent demonstration of the vast benefits of trade liberalization for hundreds of millions around the world and a dramatically painful lesson on the global costs of trade barriers. In 1930, the United States imposed unprecedented trade barriers in the mistaken belief that U.S. producers could not successfully compete against foreign producers due to lower foreign wages and production costs. At that time, the U.S. Congress passed the Smoot-Hawley Tariff Act, which erected high tariff walls to shield the U.S. market from foreign competition. The consequences were disastrous. Trading partners retaliated by protecting their own markets from foreign imports. World trade fell by 70 percent in the early 1930s, throwing tens of millions out of work, deepening the Great Depression, and fuelling the political tensions that helped give rise to World War II.

Since then, successive American presidents and Congresses have laid the foundations and forged consensus for peaceful economic cooperation and shared prosperity through the General Agreement on Tariffs and Trade (GATT) and its successor institution, the World Trade Organization. From its original 23 founding members under the GATT in 1947, today's WTO has 150 members at every level of development and representing every region of the globe, with more than two dozen countries seeking to join. The goal remains the same: to lower barriers to trade and spur new trade flows among nations, thereby unlocking the benefits of economic growth and development on the broadest basis. Trade rules also provide certainty, transparency, and predictability in international commerce, help foster the rule of law, and allow for countries to settle their trade disputes peacefully.

Trade Creates Wealth

Empirically, expanded trade has been essential to economic growth and wealth for both developed and developing countries.

The openness of the U.S. market to the world has been a cornerstone of this nation's strength and prosperity. The United States is the world's largest economy and largest importer and exporter. Since the 1990s, freer trade has helped raise U.S. national economic output by nearly 47 percent, and, over the same period, the U.S. economy added nearly 19 million jobs. Manufactured exports support more than one in six U.S. manufacturing jobs, an estimated 5.2 million jobs, and agricultural exports support an additional one million jobs. Jobs supported by exports pay about 13 to 18 percent more than the national average.

American households also benefit from the freedom to choose imports from around the world. It is estimated that the two major trade agreements of the 1990s—the WTO Uruguay Round and the North American Free Trade Agreement between the United States, Canada, and Mexico—generate increased purchasing power of $1,300 to $2,000 per year for the average American family of four.

For developing countries, the benefits of trade openness coupled with pro-market domestic reforms are also proven by experience, and the potential for greater growth and poverty reduction through trade liberalization is substantial. The World Bank has reported that per capita real income grew nearly three times faster for the developing countries that lowered trade barriers (5 percent per year) than for other developing countries (1.4 percent per year) in the 1990s.

With respect to poverty, Columbia University economics professor Xavier Sala-i-Martin finds that global poverty rates have declined significantly over the last three decades, estimating between 250 million and 500 million fewer poor in 2000 than in 1970, coupled with reductions in global income inequality during the 1980s and 1990s. China, for example, has aggressively opened its market and expanded its trade, lifting more than 250 million people out of poverty. Chile, which has also actively opened its market to trade and commerce, has more than halved its poverty rate, which declined from 46 percent in 1987 to around 18 percent in 2004. On the other hand, in sub-Saharan Africa, a region that has been much less open to trade, countries are only now beginning to open markets and expand trade in a way that will alleviate increased poverty.

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Countries such as India that have begun opening markets to imports give their consumers many more choices in groceries and other goods.

Studies by the World Bank and the Peterson Institute for International Economics estimate that global free trade could lift tens of millions more out of poverty and inject $200 billion annually into the economies of developing countries. However, for developing countries to fully realize the benefits of liberalization, trade should be accompanied by other domestic reforms, assistance, and capacity building.

With regard to trade capacity building, the United States has made it a priority to provide developing countries with the tools to benefit from the global trading system. The United States is the largest single-country provider of trade-related assistance, which includes trade-related physical infrastructure. U.S. cumulative spending on such aid in 2001-2006 totaled more than $5.6 billion in grants.

Trade Liberalization and Development

Developing countries are potentially large beneficiaries of further multilateral trade liberalization in agriculture, manufactured goods, and services through the WTO Doha Round.

Agriculture: More than 70 percent of the poor in developing countries live in rural areas. World Bank and Organization for Economic Cooperation and Development (OECD) studies concur that the most important thing developed countries can do to benefit developing countries is to make deep cuts in agricultural tariffs. Eliminating agricultural distortions by developed and developing countries alike would deliver nearly two-thirds (63 percent) of the potential benefit to developing countries. World Bank studies indicate that 93 percent of the welfare gains from removing distortions to agricultural trade globally would come from reducing import tariffs, while only 2 percent of gains would come from reducing export subsidies and 5 percent from reducing domestic support. Virtually all of the welfare gains to developing countries from removing distortions to agricultural trade globally come from the removal of import tariffs.

Goods: According to the World Bank, roughly half of global economic benefits from free trade in goods would be enjoyed by developing countries. The estimated increase in developing countries' annual income by 2015 is $142 billion, or 49 percent of global gains. Taking dynamic changes to economies into account, that estimated increase rises to as much as $259 billion, or 56 percent of global gains. Trade barriers in developing countries are higher than in developed countries: The

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A Taiwan-made wrench for sale in Mexico City demonstrates the benefits of open trade for both of these advanced developing economies.

International Monetary Fund finds that trade restrictions in developing countries are four times higher than in high-income countries. Because roughly 70 percent of the tariffs on goods traded by developing countries are paid to other developing countries, low- and middle-income nations could benefit from eliminating their own barriers and stimulate further South-South trade flows.

Services: Services are now the major source of employment in developing economies, accounting for more than 50 percent of jobs in Latin America, the Caribbean, and East Asia. Services are the future of developing countries because they are the fastest-growing component of their total economic output and the largest component of foreign direct investment (FDI). Services account for more than 60 percent of global FDI, increasing from $870 billion to $5.9 trillion from 1990 to 2004. Because the barriers to trade in services are extensive, the payoff for reducing them is great. For example, a recent World Bank report indicates that countries with open financial services sectors have grown on average one percentage point faster than other countries. A University of Michigan study estimates that liberalization of services would produce more than two-thirds of the global economic welfare gain from the elimination of trade barriers.

Trade and the Environment

Trade liberalization can and should support sustainable development. Generally speaking, countries that are wealthier tend to devote greater societal resources to domestic environmental preservation. In the WTO, the Doha Round holds great promise for win-win situations with regard to trade and environment, whereby liberalization yields positive environmental outcomes. For example, many prominent environmental nongovernmental organizations, such as Oceana and World Wildlife Fund, have supported the efforts of trade ministers to eliminate harmful fish subsidies, which lead to overfishing of the world's oceans and depletion of fish stocks, as part of the Doha negotiations. Further, liberalizing trade in environmental goods and services can support sustainable development goals by providing greater access at lower cost to key environmental technologies in areas such as wastewater management, solid and hazardous waste management, remediation of soil and water, and protection of ambient air and renewable energy production.

The Wiser Path

Developing and developed countries alike face an important choice in the direction of their trade policy. In a rapidly shifting global economy, policy makers may be tempted to shield their domestic markets from competition and erect new barriers that advantage a relatively small group at the expense of the vast majority of producers, workers, and consumers. Theory and empirical evidence counsel a wiser path. Openness to trade has been the foundation for economic growth, prosperity, rising standards of living, and a better life for countless millions in countries around the world.

The United States stands ready to dismantle remaining trade barriers as others do the same and create real, new trade flows that will benefit businesses both large and small, workers, farmers, and families. The gains from trade yet to be realized for the hundreds of millions more who seek greater freedom, opportunity, and a path out of poverty mean that it is imperative to expand new markets abroad. ■