IRET Congressional Advisory

INSTITUTE FOR RESEARCH ON THE ECONOMICS OF TAXATION

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DR-CAFTA DESERVES HOUSE SUPPORT

The House of Representatives is to vote this week on the free trade agreement with the Dominican Republic and five Central American nations (DR-CAFTA). The vote is expected to be very close. Perhaps a reminder of why trade is beneficial is in order.

Trade enables people to generate more goods and services with the resources that are available. It increases the productivity and efficiency of the participants. How? Trade lets people specialize in the production of what they do relatively well, increasing their output. They can then swap some of their increased output for products they have more difficulty making, obtaining those items from other people who do relatively well producing them. Everyone can produce more than before, and exchange the output to make them all better off.

Trade does not depend on one group of people being absolutely more efficient (having an "absolute advantage") making one set of products, and another group of people being absolutely more efficient making another set of products. Trade can occur, and can enhance living standards, even if one region is more efficient at everything than another. All it takes for trade to be beneficial is for one region's relative efficiency in producing the two sets of goods to differ from the other region's relative efficiency in producing the two sets of goods. These differences are called "comparative advantage".

The classic example in the economic textbooks (see table) is a world consisting of two countries, Britain and Portugal, and two products, wine and textiles. Assume that workers in Britain are more efficient at producing both products, but that their efficiency edge in making cloth (9 to 1) is even greater than their edge in making wine (3 to 2). If so, it will benefit workers in both countries for Britain to reduce its output of wine and raise its

Gains from specialization and trade

	Units of output per worker per day		Potential change from specialization*	
Country	Textiles	Wine	Textiles	Wine
Britain	9	3	+9	-3
Portugal	1	2	-3	+6
Combined change in output			+6	+3

*Change in production if Britain shifts one worker from wine to textile production, and Portugal shifts 3 workers from textile to wine production. (Adapted from James D. Gwartney, Richard L. Stroup, and Russell Sobel, *Economics: Private and Public Choice*, 9th edition, exhibit 17-2, p. 437.)

output of cloth, for Portugal to reduce its output of cloth and raise its output of wine, and to trade some of the added British cloth for some of the added Portuguese wine. Between them, in this example, they will have an additional 6 units of textiles and 3 units of wine to consume.

Both nations gain from trade, and the aggregate gains from trade are very large. These facts do not mean that every worker in each country gains from trade liberalization. Some workers who cannot move readily from a contracting industry to an expanding one may be injured. However, the gains from trade are more than sufficient to compensate those who are adversely affected. Such compensation should take the form of generous but temporary adjustment assistance, not an offsetting subsidy to remain in the industry that ought to retrench. For example, aid to the sugar industry for the minor increase in imports permitted by CAFTA should not take the form of propping up domestic sugar prices by restricting other sugar imports. Nor should the energy bill bend over backward to favor turning sugar cane or sugar beets into ethanol. Resources devoted to excess domestic sugar production can be readily redeployed in higher value uses, include producing other crops that are unsubsidized (or at least where the price props are not so egregious). The land could also be used for recreation or construction, and the labor re-employed in other industries. With unemployment at remarkably low levels, and GDP growing strongly, adjustment should be relatively swift.

U.S. workers are more productive and more highly paid than workers in Central America. The United States can generally manufacture more efficiently and produce food more efficiently. Of course, some types of agricultural products that require a warmer climate can be grown absolutely more efficiently in Central America and the Caribbean islands. Vis-a-vis the DR-CAFTA nations, the United States generally has a comparative advantage in a variety of sophisticated and high tech manufactured goods and in some select agricultural products and processed foods. The other DR-CAFTA nations have a comparative advantage in some agricultural products, certain lower tech manufacturing and assembly work, and the obvious tourist attractions of the region.

Increased specialization would lead to increased trade in both directions. Increased economic growth in Central America, and associated increases in income earned by the CAFTA partners, will enable them to buy more U.S. products, or to invest more heavily in the United States. People do not give away something for nothing. They sell us their goods, services, or assets in order to be able to buy our goods, services, or assets. In that basic and fundamental sense, including investment flows, trade is always balanced.

DR-CAFTA is a small step toward a world with fewer trade barriers. It is not a substitute for a full WTO negotiation that removes global trade restrictions. It may cause some trade diversion (allowing the CAFTA clothing industry, a big user of U.S. textiles, to continue to compete with Asian producers). However, it will also enable Central American workers easier access to U.S. goods that are now priced out of their reach. This increase in the value of their wages would give them added incentive to enter the labor force and to work in the market economy to earn the money to buy these products. U.S., regional, and world output and income should rise. If the United States cannot manage even this small bit of trade progress, it will send a signal to the rest of the world that we are not serious about trade expansion and the global benefits it would bring.

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