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Foreign Tariff Reductions and Southern California's Small and Medium-Sized Exporters

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Thank you for inviting me to participate in this important hearing. My remarks today are based on research conducted at the Public Policy Institute of California, an independent, nonpartisan research institute. PPIC does not take positions on legislation, but provides objective information for decision-makers as they consider policy issues.

The current downturn in global economic activity has clearly taken its toll on California's exporters. In 2002, California exported 23 percent less than it did in 2000. Through the second quarter of this year, California's exports experienced a further decline relative to the same period last year. What I am going to talk about today is the potential importance of federal international policy initiatives for stimulating California's exports. I will then discuss their implications for small and medium-sized enterprises in Southern California.

The basis for this testimony is recent work in which I have explored the U.S. international policy agenda and the extent to which it is likely to boost U.S. exports, with an emphasis on the extent to which California's exporters will share in the benefits.[2] There are certainly other elements of this complicated policy mosaic that are left out of this analysis: for instance, the effects of tariff reductions on imports, prices, the labor market, and the environment, both here and abroad. These issues, though very important, are not addressed in the report.

The Bush administration is arguably pursuing a more aggressive promotion of foreign-market access than any president since FDR. The approach is three-pronged, consisting of multilateral, regional, and bilateral negotiations, all of which are designed to increase access to foreign markets for U.S. exports.

Multilateral negotiations have been common throughout the post-World War II era and consist of a large number of countries with a broad agenda of opening markets to more trade. These negotiations are by design nondiscriminatory, so any tariffs that are lowered on goods from one country are automatically lowered on the same goods from all other countries. Regional initiatives tend to include a smaller number of countries and generally provide more comprehensive liberalization than do multilateral initiatives, but they do so on a preferential basis, discriminating in favor of goods originating in the participating countries; the NAFTA is a good example of a regional

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[2] Haveman (2003).

initiative. Bilateral initiatives resemble regional initiatives except they involve the United States and only one other country. For example, the United States currently has bilateral free trade agreements with Israel, Jordan, Chile, and Singapore.

This three-pronged approach is likely to be especially effective, as there tend to be spillovers among the different types of agreements. For instance, the bilateral approach, if done right, can spur progress in the regional area. At the same time, success with regional initiatives has in the past led to increased success in the multilateral arena. In particular, much of the success in the Uruguay round of multilateral negotiations was attributed to the success of former President Bush in negotiating NAFTA. It has been argued that the European Union was more forthcoming with concessions on agricultural protections and subsidies once it realized that the United States was prepared to obtain market access elsewhere.

The current administration's multilateral prong consists of the Doha Round of negotiations under the auspices of the World Trade Organization, so named because they were launched in Doha, Qatar in November of 2001. These negotiations have the potential to produce significant results for California exporters. Indeed, the Bush administration has offered a proposal to eliminate all of the world's tariffs. I have analyzed the effects of this proposal on both California exports and exports from the rest of the country. The bottom line for California is fairly significant; its manufacturing exports could increase by as much as $27 billion if all the world's tariffs were eliminated. This is an increase of about 24 percent over exports in 2000, whereas exports from other states would increase by only 20 percent.

The vast majority of the increase in California's exports would be in the high-technology sectors, but significant increases would also occur in transportation equipment and chemicals. The countries to which these increased exports would flow are highly concentrated in Eastern and Northern Asia, which account for almost three-quarters of the increased exports, most of which would be absorbed by Korea, China, and Taiwan.

Perhaps a more startling finding is that exports to Canada and Mexico would actually decline by about 8 percent. But the explanation for this finding is straightforward. The decline would occur because U.S. exporters would lose the preferential access they now hold as a result of NAFTA and thereby become less competitive in these markets.

The proposal to eliminate all of the world's tariffs has not been taken terribly seriously, and it is unlikely to become reality in the near term. Accordingly, the administration is also working on other fronts. These fronts are the other two prongs of the liberalization agenda: regional and bilateral agreements.

Regionally, the United States is pursuing the Free Trade Area of the Americas (FTAA), which would establish a free trade agreement encompassing all of North and South America except Cuba. Further, the Bush administration is pursuing a regional agreement with countries in Central America, the so-called CAFTA. The CAFTA countries are also participating in the FTAA negotiations. Here is an important example of how the various prongs of the administration's policy intersect. By granting a subset of FTAA countries preferential access to the U.S. market, the barriers to the larger agreement may be reduced. The members of the CAFTA may be more likely to join the FTAA—it is simply easier for them to agree to it having already formed the CAFTA—and other countries may be more eager to enhance their standing in the U.S. market, which could be eroded by the existence of the CAFTA. Success in one arena can support or encourage advances in another.

Also prominent on the regional front are negotiations with the members of the South African Customs Union (SACU): Botswana, Lesotho, Namibia, South Africa, and Swaziland. This effort is an outgrowth of the African Growth and Opportunities Act, an initiative implemented by President Clinton to increase U.S. trade with, and hence growth of, African economies.

Although important for various reasons, none of these regional initiatives is of great significance for California's exporters. The FTAA is worth less than $4 billion in increased exports, a relatively small portion of the $27 billion potential. The CAFTA and SACU initiatives are even less important. The CAFTA is unlikely to increase California exports by more than $60 million, and SACU by no more than $250 million. The current set of regional initiatives, therefore, represents no panacea for California's exporters.

The final prong of the administration's agenda is made up of several bilateral initiatives. The administration has been pursuing, or has recently signed, agreements with various countries. Recent signings include those with Singapore in May and Chile earlier this spring, both of which were recently passed by Congress. Agreements with Morocco and Australia are both in the early stages.

Unfortunately, these agreements are also unlikely to expand California's exports significantly. Although Singapore and Australia are significant markets for California's exports—the 11th- and 13th-ranked export destinations, respectively—neither agreement will give a significant boost to California exports. Singapore is an important market, but its formal barriers to trade are already very limited. This agreement, therefore, is more important for California firms looking to invest abroad and for companies providing services internationally than it is for exporters. As for Australia, it is a smaller market with relatively low barriers. California's exports are expected to expand by just under $650 million should the agreement become reality.

In the end, the WTO negotiations hold the most promise for California exporters. Largely because of their size or geographic location, California has not so far exported great quantities to many of the markets targeted in the regional and bilateral initiatives, and will not following their liberalization. Quite the opposite is true for exports from the rest of the country. Under each of these regional and bilateral initiatives, exports from the rest of the country are projected to grow three times more, on a percentage basis, than are exports from California—despite the fact that California has more to gain from general liberalization of world trade than does the rest of the country.

The importance for California of more general trade liberalization, and the Doha Round in particular, stems from the fact that many of its important export markets are participating in the WTO negotiations. Liberalization in Korea, China, Taiwan, India, the European Union, and Japan will be more important for California exporters than will be the liberalization of markets targeted by other initiatives. Furthermore, liberalization undertaken by the WTO is generally regarded as more likely to enhance economic efficiency than are regional and bilateral liberalization. Trade liberalization as conceived by the WTO is not preferential in nature and grants market access regardless of the exporter's location. This quality ensures a more efficient flow of goods worldwide than is achieved by preferential agreements.

There is another element of the agenda that I have not yet mentioned, and that is the Asia Pacific Economic Cooperation Forum (APEC). Although the United States still participates in APEC's quarterly meetings, that forum has not made significant progress on trade liberalization for three or four years. That said, success in APEC would raise California's merchandise exports by about $19 billion. The importance of APEC is that it includes many of the markets mentioned above as being important to California. APEC can also lay claim to the high road. The original goal of the APEC member nations was liberalization on an "open" or non-discriminatory basis. The liberalization to date has generally stuck to this principle, which has also guided the WTO negotiations, though APEC has accomplished relatively little in recent years.

What does all of this mean for Southern California's exporters—in particular, its small and medium-sized manufacturers? In my remarks, I will be using a relatively broad definition of Southern California. The geographic area, which includes Congressional Districts 20 through 53 excluding 21 and parts of 20 and 25, ranges from Kern County in the north to Imperial County in the South – or all those counties below the sixth standard parallel. More specifically, I will be referring to employment and establishments located in Metropolitan Statistical Areas (MSAs) included in these districts. As the vast majority of California's manufacturing takes place within these MSAs, these data generalize quite easily to the broader region.

Manufacturing firms in this region account for two-thirds of all such firms in California. They also employ just under two-thirds of all manufacturing workers in the state.[3] In 2000, there were 32,746 manufacturing establishments in the region,

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[3] U.S. Small Business Administration (2003).

employing some 1.1 million people. The Los Angeles-Long Beach Metropolitan area alone accounts for just over half the region's total of both establishments and employees.

Of these Southern California manufacturing establishments, more than 90 percent employ 500 or fewer workers. Employment in these establishments accounts for just under 60 percent of the region's manufacturing employment, totaling 674,000 workers. By way of contrast, the rest of California employs only 268,000 workers in small or medium-sized manufacturing establishments, which is less than the 384,000 employed in the metropolitan area including Los Angeles and Long Beach.

In his testimony, Dr. Shatz has established that small and medium-sized enterprises are important contributors to U.S. exports. Unfortunately, the available data do not aid us in assigning credit for these exports, other than to say that small firms are important. Nonetheless, we can discuss the effects of foreign tariff reductions and the consequent increase in U.S. manufacturing exports for small and medium-sized enterprises. Regardless of which firms do the actual exporting, foreign tariff reductions result in an increase in the demand for products produced in the United States. This increase in demand will likely raise prices in the United States, which is not desirable for consumers but would result in more production and hence employment by firms generally. These production and employment effects would hold for firms regardless of their propensity to export their products.

As I mentioned earlier, the elimination of all foreign tariffs on manufacturing trade is expected to increase California's exports by about $27 billion. The majority of this increase would come in six industrial sectors, each of which accounts for a sizable portion of California exports and Southern California employment. In these six sectors, California's exports could increase by as much as $22 billion. Allocating this increase evenly over employees, Southern California establishments could see an increase in demand for their exports by nearly half of that, or $11 billion. Of this $11 billion, almost $6.4 billion would accrue to small and medium-sized enterprises (Table 1).[4]

[4] These figures result from an allocation of exports across establishments according to their share of employment. The data necessary to accurately allocate increases in exports across firms of different sizes are not publicly available. According to Bernard and Jensen (2001), larger firms generally account for the majority of U.S. exports. The figures produced here therefore represent an overstatement of the likely increase in the exports of small and medium-sized enterprises. However, small businesses likely benefit from increased exports both through the aforementioned price rise and through an increase in the demand for intermediate inputs by firms producing goods for export.

Table 1
Foreign Tariff Liberalization and California Exports

			Expansion of California exports (billions of dollars)		
2-digit SIC Code	Industrial sector	Industry employment in Southern California (%)	Total	Southern California	Southern California SMEs
20	Food and Kindred Products	40.0	2.0	0.80	0.47
28	Chemicals and Allied Products	66.8	1.3	0.87	0.51
35	Industrial Machinery and Equipment	46.0	7.6	3.50	2.06
36	Electronic & Other Electric Equipment	47.0	7.2	3.38	2.00
37	Transportation Equipment	80.7	1.2	0.97	0.57
38	Instruments and Related Products	42.5	3.0	1.28	0.75
	Total in above industries		22.3	10.80	6.37

Source: Calculations by the author using data from the U.S. Department of Labor (2003) and Haveman (2003)

A similar exercise can be carried out for some of the trade agreements currently being pursued. Success in APEC would bring about an expansion of SME exports in Southern California of just under $5.4 billion, nearly all of the benefits of the worldwide tariff liberalization. Other important arrangements for the United States include the FTAA and the other bilateral negotiations mentioned earlier. None of these, however, is terribly important for SMEs in Southern California. The most far reaching initiative, the FTAA, is expected to increase California's exports by no more than $4.6 billion. This translates to an increase in the demand for exports from Southern California's SMEs of just over $1 billion. This is about 3 percent of total exports from California's SMEs, which is loosely estimated at just over $34 billion.

Such estimates raise the question of what is likely to come about. The complete elimination of foreign tariffs is unlikely to happen anytime soon. Prospects for the completion of the APEC mandate have been reduced drastically, first because of economic crisis during the late 1990s and now because of global security concerns. The FTAA seems to be encountering significant roadblocks, but I remain optimistic that it will come to pass. Some broad-based liberalization through the WTO's ongoing Doha Round seems quite likely, but it will fall far short of eliminating all tariff barriers.

The prospects for significant liberalization in the next decade exist, but they likely represent only a fraction of the potential liberalization that could benefit California's exporters. Much of the liberalization will be outside of the manufacturing sector. In particular, the European Union and the United States seem to be coming to terms on reducing agricultural subsidies and other domestic support programs. Trade in services will likely experience some liberalization, which is important for California's small and medium-sized service establishments. Most of these benefits, however, are very hard to quantify at this time.

Of the benefits that I have been able to quantify, a more commercially based approach to the selection of liberalization initiatives would yield greater benefits for California's small and medium-sized enterprises than does the current agenda. In particular, Asia includes very important markets, and the current liberalization initiatives largely neglect them. If California is to benefit from liberalization abroad, the peculiarities of its trade flows need to be given voice, or California will be left out of the liberalization bonanza that the rest of the country may experience. The current agenda, unfortunately, is not one drafted with California's interests in mind.

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