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## **Trade Policy Options for Argentina in the Short and Long Runs**

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### **I. Background and Introduction**

As discussed in the note on “Stabilization and Sustainable Growth,” Argentina’s current economic depression followed a historical record of high growth volatility and low historical average growth rates characterized by particularly low productivity growth. The recent crisis was in part the consequence of external shocks that impaired the competitiveness of the tradable sectors, including the fall of certain commodity prices and the devaluation of the Brazilian currency in 1999, coupled with the appreciation of the U.S. dollar during the late 1990s. The extent of the economic depression, however, was not caused by the external shocks per se, but rather by the combination of these shocks with the rigid exchange rate regime and financial structure of the economy (Perry and Servén 2003).

In any case, the Argentine devaluation of early 2002 brought an overshooting of the real exchange rate (RER) and a significant decline in imports. However, as of December 2002, it had not brought significant increases in exports. Export dynamism has only become apparent in recent months, as exporting firms have been able to secure financing for their operations from various sources, including domestic banks. The rise of the current account surplus observed during the last year, which reached 16% of GDP, was thus the result of the dramatic contraction of domestic demand associated with the 11% fall in GDP.

The crisis also brought changes in trade policies. In early 2001, before the devaluation, the government raised tariffs on imports from non-Mercosur countries of final consumption goods. Also, the government eliminated capital-good import tariffs and raised export reimbursements.<sup>1</sup> In addition, Argentina increased its use of anti-dumping duties against important trading partners, including Brazil. The aim of these policies was to raise the profitability of the tradable sector, which had been battered by the

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<sup>1</sup> These reimbursements are similar to duty drawbacks, whereby exporters are reimbursed for import taxes or other indirect taxes paid for the acquisition of production inputs.

aforementioned external shocks while the Currency Board, in the context of relatively rigid domestic prices, impeded a quick RER adjustment.

The government partially reversed these measures after the devaluation, when it imposed export taxes and reduced export reimbursements. The RER depreciation brought significant relief to the tradable sectors, and thus the main objective of the export taxes and reimbursement measures was to raise public revenues and reduce expenditures when the recession hampered the fiscal sustainability of the public sector.

The purpose of this note is to discuss trade policy options for Argentina in this new context, which includes the challenge of fiscal sustainability in the short-run, the challenge of achieving higher growth rates in the long-run, as described in the note on “fiscal sustainability and sustainable growth,” as well as the prevalence of a flexible exchange-rate regime. The rest of this note is organized as follows. Section II examines the role of export taxes and subsidies. We conclude that export taxes are playing an important role in revenue raising, but exports taxes and subsidies have not had a major effect on export real exchange rates (ERER), primarily due to the fact that the overall RER remains quite depreciated. However, in the longer term, these taxes should be removed as the ERERs appreciate during the recovery.

Section III briefly reviews both the recent evolution of Argentina’s import policies and the international evidence regarding the potential gains for Argentina from further import liberalization. We conclude that the preponderance of the evidence suggests that the dynamic gains from trade can be substantial. Moreover, the new flexible exchange-rate regime should allow trade policies to be oriented towards improving economic efficiency and growth rather than for dealing with external shocks. Consequently Argentina should negotiate with its Mercosur partners a reduction of the Common External Tariff (CET) with special emphasis on the CET affecting imports of capital goods. In addition, the use of anti-dumping duties (ADs) should also be reduced, both against Mercosur partners as well as against the rest of the world, especially China. This can be accomplished by resorting to safeguard actions and harmonizing anti-trust regulations within Mercosur.

Section IV looks at market access for Argentine exports. The analysis includes a brief review of existing estimates of the potential static gains from preferential and global trade liberalization for Argentina in the context of Mercosur. We complement this analysis with a discussion of what can be achieved in FTA negotiations with the U.S. and the European Union (E.U.). We conclude that Argentina’s best option is to face these negotiations together with its Mercosur partners, but it should negotiate FTAs with the U.S. and the E.U. as well as actively push forward the agriculture liberalization agenda in the context of the Doha Round of the WTO. It is unlikely that Argentina by itself would be able to gain significant concessions for its agricultural exports if it goes at it alone.

To help our policy-oriented readers, the main policy recommendations from each section appear in bold letters under each section. The final Section V summarizes seven key policy recommendations.

## **II. Export Taxes, Subsidies, and Export Promotion in the Short- and Long-Term**

Table 1 shows the structure of export taxes and reimbursements for 2001 and 2002 across productive sectors. Export duties were almost non-existent before 2002. Reimbursements were at relatively high levels as suggested by the overall simple average of 8.35%, but with significant variance around this mean. In general, rates rose with the degree of product elaboration, thus favoring exports of manufactures. The maximum rate reached 12%.<sup>2</sup> Clearly the main motivation for these export subsidies was to compensate the decline in export competitiveness brought by the reduction in international prices in 1999-2000 under the fixed exchange-rate regime.

The devaluation of the peso at the beginning of 2002 brought a change in these export policies as shown in Table 1. Export taxes were significantly raised whereas reimbursements were reduced by about 50%. The structure of export taxes is not uniform. Primary and petroleum products have an average rate of about 10%; for commodities like crude petroleum and oilseeds these rates reached 20%. Most primary-based manufactures and industrial manufactures pay 5%, again within these items corn-based products and oils face higher rates. In terms of the “net” treatment (i.e., the difference between the export tax and the reimbursement rates) of the various exports, primary products were taxed about 9% on average, primary-based manufactures and industrial manufactures exports faced lower net rates of 3.5% and 0.6%, respectively.

### **[Insert: Table 1. Argentina: Structure of Export Taxes and Reimbursements, Dec. 2001 & April 2002]**

An assessment of the “optimality” of these export taxes requires addressing some key analytical issues, including the fiscal implications, the extent to which these taxes affect the availability of foreign currency, and whether Argentina can influence international prices in some export markets. We consider these issues in the next subsections.

#### **A. Exports taxes and fiscal revenues**

If there is one lesson that the convertibility crisis has established is that fiscal sustainability should be a critical concern of any macro program. This is even more important now given that the default on the public debt have closed any possibility of financing fiscal deficits in a voluntary and non inflationary way. So the key issue to

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<sup>2</sup> High reimbursement rates were difficult to justify in terms of the incidence of indirect taxes. Thus Argentina faced countervailing duty (CVD) investigations. This was the case, for example, with honey exports to the U.S.

consider is whether export taxes are an important source of public revenues and under what circumstances they can or should be replaced by other forms of taxation.

Table 2 shows the composition of tax revenues of the national government since 1995. The most important sources of revenues are the VAT and the income tax. The rapid growth of the economy after 1995, plus tax reforms that eliminated loopholes helped increase the share of these taxes. By 1998, before the recession started, these two sources brought almost 60% of total revenues. Afterwards, the contraction of economic activity hampered revenues from these sources and in 2001 VAT revenues fell more than 20% in real terms.

**[Insert: Table 2. Argentina: Composition of Central Government Revenues, 1995-2002]**

The decline in total revenues was also the consequence of various reforms. One of the most relevant was the change in the social security system (for a capitalization regime) which implied a substantial reduction in workers personal contributions. Also, labor taxes paid by firms were reduced since 1994 (partially reversed in 1998) also as a way to compensate the external shocks affecting the competitiveness of the tradable sector. This type of policy was pushed even further in 2001 when the administration launched the “Competitiveness Program” (*Planes de Competitividad*) that allowed new reductions in tax obligations such as the ability to count labor taxes as advanced payments on the VAT. The government also sought revenues from a new tax on financial transactions. Nevertheless, *total revenues* fell almost 10% in 2001.

In 2002, VAT revenues declined an additional 8% in nominal terms and much more in real terms given that inflation was closed to 40%. Consequently, the share of VAT revenues was only 27% of total revenues, the lowest contribution since 1993. The newly imposed export taxes, re-established after a decade of being eliminated, brought an average 10% of all government revenues in that year, but its share has averaged almost 12% during July 2002-January 2003. This tax together with the increase in gasoline revenues (as a consequence of the increase in gasoline prices) plus the rise in the collection of the financial transaction duty (as a consequence of the increase in the tax rate) were the main causes behind the increase in nominal revenues observed in 2002 with respect to 2001. Yet real revenues declined almost 30% as a consequence of the indicated 40% inflation rate.

A key question is whether export taxes can be justified as a source of revenue in the short and long runs. One way to approach this question is to examine evasion of these and other taxes. It is well known that Argentina suffers from low tax compliance. Libonatti (2000) calculates that in 1997 VAT evasion was around 30%. That is, for every 100 pesos of tax obligations, the government collects only 70. IERAL estimates that in 2000 the evasion rate was 41.6%.<sup>3</sup> Tax compliance in income taxes is even worse. Based on household survey data, Di Grecia (2000) estimates evasion rates that are between 45%

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<sup>3</sup> These levels of evasion are relative large for international standards. For example, Serra (2000) estimates that evasion reaches 20% for the VAT in Chile.

and 50% for personal incomes taxes.<sup>4</sup> Labor taxes are also subject to a significant evasion as reflected by the significant amount of informal labor employment in many Argentine cities (see Gasparini 2000).

There are very few studies that have analyzed the evasion of export taxes in Argentina, partly because these levies were abolished in the 1990s.<sup>5</sup> The main way to evade export taxes is through underreporting of export earnings. Fiel (1987) estimates that during 1980-1985, when export taxes were applied in Argentina, this underreporting oscillated between a 10 and 13%. These evasion rates are significantly lower than the ones documented for the other major taxes.

There are various reasons why export tax evasion might be lower than for other forms of taxations. First, the control and administration of export taxes is less costly for both the public service and the taxpayer. This is so because the number of export tax payers or the number of exporting firms is relatively small and shipments are easy to monitor. The monitoring of export tax compliance has benefited from the computerization of all export activities and from the fact that export transactions are intermediated by banks which also serve as information gathering agencies. Second, and perhaps more importantly, export tax evasion might be low because for most commodities export tax rates are presently (as it was in the case in the eighties) not very high (around 10%). It is well known that the incentive to evade taxes and the distortions associated with taxes rise exponentially with tax rates. Hence it would not be surprising if evasion tends to be much higher with respect to the VAT and income taxes which have much higher rates.

From the above discussion we conclude that export taxes are currently an important source of fiscal revenues and that these taxes offer some advantages in terms of tax administration costs and low evasion rates. However, this does not mean that these export taxes should be maintained as they are for the long haul. We deal with issues of economic efficiency and hard-currency earnings in the next subsections.

## **B. The case against export taxes: export performance and hard currency needs**

Besides a very restrictive fiscal situation, Argentina also faces a strong need of hard currency to be able to pay begin foreign debt payments that would help it regain access to international capital markets. The key issue is whether the requirement of a significant surplus in the trade account is inconsistent with the export taxes given its potential negative effect on export behavior.

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<sup>4</sup> In the United States, the evasion rate for these taxes was about 17% in the late 1980s (Blumenthal and Slemrod 1992).

<sup>5</sup> There is also a lack of studies for other countries. On the other hand, the literature on evasion and problem of underreporting for the case of imports operations is relative abundant. See for example Yeats (1991). For the case of Argentina, see Cristini and Moya (1999).

Of course, the trade balance does not only depend on exports but also on imports. The experience of Argentina during 2002 showed that in the short run imports adjust much faster than exports and that the import substitution and disabsorption effects brought by the devaluation and the ensuing recession can alone secure a significant amount of foreign reserves. As indicated, during 2002 the trade surplus (including real services) was equal to 15 billion dollars (about 15% of GDP) thanks to a 50% reduction in imports. This tremendous decline implies that even if imports grow at a rate of about 15% per year during 2003-2008, while exports increase at a 7% rate (similar to the one observed in the nineties), the trade account surplus in 2008 will still be around 15,000 million dollars (Cepal 2003).<sup>6</sup>

Beyond the behavior of imports, the key issue is whether a reasonable growth of exports, such as the 7% annual increase assumed above, is reasonable given the presence of export taxes. The effect of these taxes on foreign sales can be decomposed into two parts: how taxes affect the exporters' real exchange rates (ERER) and the short- and long-run elasticity of exports with respect to changes in the ERER.

The dollar ERER can be calculated as:

$$(1) \quad \text{ERER} = (EP^*(1+s-t))/P,$$

where E is the dollar nominal exchange rate, P\* is the international price of export products, s is the export subsidy or reimbursement rate, t is the export tax rate, and P is the general domestic price level. To reflect the fact that the exportable sector uses also tradable goods as inputs of production, we measure P as the simple average of the CPI and producer prices.<sup>7</sup> Figure 1 shows the evolution of the average ERER since 1990. Figure 2 shows the ERERs for major export products. For 2001 and 2002 we show two calculation one with the actual structure of export taxes /subsidies and a second in which all these export/subsidies are set to zero.

**[Insert: Figure 1. Argentina: General Export Real Exchange Rate, 1990-2002]**  
**[Insert: Figure 2. Argentina: Selected Export Real Exchange Rates, 1990-2002]**

The evidence indicates that the devaluation had a substantial effect on the ERER, even assuming that tradable inputs weight 50% in export production.<sup>8</sup> The general ERER goes from 0.93 in the last quarter of 2001 to 1.76 one year later.<sup>9</sup> This is a 90% increase.

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<sup>6</sup> The projection of import growth uses actual income and real exchange rate elasticities computed for the 1975-2001 period (3.5 and -0.6, respectively) and assumes that GDP grows at an average rate of 3% and that the real exchange rate appreciates so that in 2008 ends up at a value 50% higher than the one observed in 2001 -- see Cepal (2003).

<sup>7</sup> For total exports this weighting is very conservative. Using the 1997 input-output matrix, the participation of tradable inputs within the exportable sector is about 0.42.

<sup>8</sup> This is probably an over-estimation of the actual participation considering the high share of agriculture in total exports.

<sup>9</sup> Notice also that the ERER at the end of 2002 is just 10% below the level of the first quarter of 1990 which is one of the peak values of the series. Interestingly, Argentina this time produced a significant swing in the ERER without hyperinflation.

Excluding export taxes and reimbursements, the increase was of 93%. The magnitude of the negative shocks of 1999 is also notable: during the second quarter of that year the indicator is 20% below the average values of 1993-1997.

Regarding the evolution of selected product ERERs, they reflect the significant swings in relative prices suffered by primary agriculture exports. The corresponding ERER index goes from 1.26 in the third quarter of 1996 to 0.81 in the second quarter of 2000, a 36% decline. This sector enjoyed a boost in competitiveness after the devaluation, which was associated with a 97% increase in the ERER, even after considering the export taxes. In petroleum and energy product, the ERER increased significantly even before the devaluation as a result of the continuous rise of oil prices since 2000. The comparison of the ERER index between 2001 and 2002 also shows a sizeable increase (100%) even when this sector has been affected by the largest export tax rate (close to 20%). The reason behind this behavior is again the fact that oil prices rose significantly during 2002.

The ongoing analysis assumes that export taxes and subsidies were set independently of other determinants of the ERER. As mentioned, before the 1990s Argentina had a long history of using export taxes. They tended to be high when international prices were high and tended to increase after devaluations. Besides obtaining fiscal revenues, export taxes were used to stabilize domestic prices of exportable commodities so as to moderate the redistribution of income from the urban population to rural producers. Sturzenegger (1990) provided evidence suggesting that export taxes were negatively correlated with international prices. These redistributive policies had always been conservative in the sense of maintaining the status quo in terms of the pattern of income distribution. Thus, any reasonable future scenario for these taxes has to take into account not only fiscal needs but also the perspective that these duties may have to be reduced or eliminated as the ERERs fall.<sup>10</sup>

The second issue to consider is how exports react to changes in the ERER. Using quarterly aggregate data, Ahumada (1996) estimates that lagged (from 4 to 5 quarters) changes in the ERER positively affect export performance.<sup>11</sup> This author also tries to estimate the long run effect of the ERER. She finds that the maximum value achieved by the ERER in the past also has a positive and permanent effect on export performance. The finding of this “ratchet” (or “hysteresis”) effect<sup>12</sup> is very relevant for Argentina in the current situation.<sup>13</sup> The value of the general ERER in 2002 was a maximum and was only 10% below that observed during the currency (and hyperinflation) crisis of 1989.<sup>14</sup>

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<sup>10</sup> This is clearly the case for example with oil. The current high prices are not going to last. Thus the high levels of taxes affecting these exports (20%) may not be sustainable when the price of oil goes down to, say, 25 US\$.

<sup>11</sup> Navajas (1993) also found a lagged effect using annual data.

<sup>12</sup> Dixit (1988) found similar results for the U.S. import demand function.

<sup>13</sup> Intuitively this “hysteresis” effect can be justified by the presence of fixed cost affecting exports, which requires very high prices to finance initial export operations. Afterwards, once this entry cost is paid, exports can continue even when the ERER declines.

<sup>14</sup> Márquez (2002) provides an extensive literature review on the estimation of short- and long-run trade elasticities. Of particular relevance is the finding that for most Asian economies, the RER misalignments of

Two conclusions can be drawn from this discussion. First, it takes time for changes in the ERER to affect exports so we should not be surprised that they did not react in 2002. This lagged effect might also be more pronounced in the context of a financial crisis with a credit crunch. In this respect, therefore, the discussion provided by the note on reforms needed to reinvigorate the domestic banking system is inextricable from the performance of the Argentine tradable sector in the near future. Second, in terms of long run behavior, what matters is the sharp change in the ERER that has already taken place. This change was only marginally affected by the introduction of export taxes, and thus it is unlikely that these taxes will hamper export performance in the coming year.

However, there are other valid concerns about these export taxes. First, there is no convincing economic argument in favor of having a differentiated export tax structure that favors manufactures over other exports (De Ferranti et al. 2002; Maloney 2002; Lederman and Maloney 2003). Although there could be social and political considerations to redistribute income from rural producers to urban consumers, it is unlikely that differentiated export taxes are the appropriate instrument to deal with these issues. The only exception might be the export taxes on food staples, which tend to reduce the domestic price of these staples and thus might help contain the resurgence in poverty. But there are more efficient ways of handling the poverty concerns than using the export taxes on food to reduce domestic prices. The companion notes on poverty and social protection provide more detailed guidance about poverty trends and proper safety net policies.

Second, these taxes cannot be justified as an “optimal” trade tax, because it is very unlikely that Argentina possesses significant market power in terms of being able to affect international prices of its exports. Table 3 shows Argentina’s top exports and the corresponding indexes of revealed comparative advantage and the share of world exports. For Argentina to be able to benefit from an “optimal” export tax, in theory its contribution to world production (not exports per se) of its main exports should be close to 100% of the global market. This is clearly not the case, as shown in Table 3. Moreover, it would need to have multiple firms producing those products, which in turn must not be organized in a private-sector association. Otherwise, a domestic, organized private sector can easily notice its market power and adjust its own production decisions accordingly so as to maximize its profits by raising world prices. Argentina does not seem to have a sufficiently large share of world markets in any commodity, and its private sector is well organized anyway, thus rendering the export taxes redundant even if it had market power in those commodities.<sup>15</sup>

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the early 1990s had statistically significant impacts on export behavior due to significant long-run elasticities. See also the estimates from Rienhart (1995), which also show that relative price changes have permanent effects on demand for developing-country exports, including Argentina. However, most estimates of export elasticities are below unity, whereas Ahumada (1996) finds elasticities greater than one only for “maximum” ERERs.

<sup>15</sup> The optimal export tax argument also requires that there are severe entry costs in these markets so that firms in other countries do not increase production or enter the commodity markets when prices rise as a result of production cuts in Argentina. That is, even if Argentina had 100% of the world market in a

**[Insert: Table 3. Argentina: Top Ten Exports Ranked by the Index of Revealed Comparative Advantage, 2001]**

Thus, given that revenue concerns are paramount in the short-run, it is advisable that the export tax be simplified very soon by establishing a single rate affecting all products. In theory, there is a single rate that will produce the same fiscal revenues as the current export tax structure. **Hence a uniform and revenue-neutral export tax can be designed and implemented immediately. In the medium term, the government should be ready to reduce this tax as the ERERs fall.** When this occurs, the revenue raised export taxes will also decline as relative prices of exports fall, thus reducing the revenue share of such taxes. It is not advisable, however, to set a specific date for the elimination of the tax, since exporters can easily either under-report current export earnings or postpone export shipments until after the given date. Rather, the elimination of the export uniform export tax should be implemented decisively sometime in the next year or two as international prices of Argentine exports fall and/or as the RER appreciates with the economic recovery.

Regarding export promotion activities, **the government should also consider eliminating the export reimbursements as soon as possible.** There are two important reasons for this. One is that these reimbursements and similar benefits are known to reduce the incentives of exporters to press governments to reduce import barriers, and thus hamper the political viability of implementing further trade reforms. There is strong evidence that this has been the case in Mercosur countries as documented by Cadot, de Melo and Olarreaga (2003). The other reason is that the public resources now being used to reimburse exporters for indirect taxes (including import duties) are quite small relative to the fluctuations of the ERERs, as demonstrated above, but can be redirected to strengthen the public sector's capacity to negotiate trade agreements and provide direct services to the exporters in terms of providing market feasibility information and improving the image of the country in foreign markets. Chile, for example, has been relatively successful in conducting several simultaneous negotiations through the Foreign Affairs Ministry's Economic Directorate (DIRECON) and providing effective export promotion services through its Pro-Chile program. Having analyzed the role of export policies, the following section looks at import policies.

### **III. Liberalization of Imports: Tariffs and Non-Tariff Barriers**

As mentioned in the introduction, Argentina's import policies changed before and after the devaluation episode. Table 4 describes the evolution of import tariffs since 1996. The average external tariff, which is applied to *non-Mercosur* countries, rose steadily since 1998. The big jump in the tariff level in 2001 is related to legislation approved on March 8 and 27 when tariffs on most consumption goods were set at 35%, the maximum allowed by the WTO. The significant increase in tariff dispersion from 6.5% to 9.91% was related to the second main change introduced by the mentioned legislation, which

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commodity, these markets could still be "contestable" and thus the equilibrium price would approach a competitive equilibrium.

eliminated tariffs on capital goods. Clearly these measures were aimed at improving the domestic terms of trade of domestic industry in the context of a severe domestic contraction that was causing an alarming reduction in production and employment. Together with the already mentioned increase in export reimbursements, the main objective of these measures was to mimic a devaluation (i.e., an increase in relative prices of tradable goods) through trade policy instruments.

**[Insert: Table 4. Argentina: The Level and Dispersion of Import Tariffs since 1996]**

These changes were applied by using exemptions to Mercosur's Common External Tariff (CET), while the Mercosur "internal" tariffs suffered no serious setback. Consequently, it is likely that the threat of welfare losses due to trade diversion increased significantly due to these unilateral measures.<sup>16</sup> On the other hand, the elimination of tariffs for capital good imports significantly reduced the preferential treatment of Brazilian imports of capital goods, and thus Brazilian exporters opposed this policy change by Argentina (see Nogués 2002).<sup>17</sup>

At the end of 2002 these measures were partially reversed. Table 4 shows that the average tariff declined from 18.2% in 2001 to 14.25% in December 2002. This reduction was due to the fall in consumption-goods tariffs, which were set at the pre march-2001 level. Table 5 offers a more detailed description of the country's current tariff structure (as of end of 2002). We disaggregated import duties by main product categories and an estimation of capital-goods tariffs. The level of protection rises with the degree of elaboration of the product: primary goods and petroleum and energy products have relatively low tariffs (9.23 and 0.29%, respectively) whereas tariffs on primary-based manufactures and manufactures of industrial origin are 12.8 and 16.37% respectively. On the other hand, capital goods imports face a tariff of 3.31%, still reflecting the decrease in tariff of 2001.

**[Insert: Table 5. Argentina: Tariff Structure in 2002 by Main Product Categories and Capital Goods]**

Finally we want to briefly refer to non-tariff barriers. Within these barriers Argentina has been a significant user of antidumping (AD) measures.<sup>18</sup> This has taken place since the mid-nineties when Argentina updated its legislation following the Uruguay Round guidelines on these matters.

Table 6 shows the evolution of AD decisions. The most notable pattern that emerges from this evidence is that the number of initiated AD investigations was initially high when Argentina was facing the Tequila crisis in 1995, they declined steadily until

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<sup>16</sup> There is already evidence showing that trade diversion in favor of Brazilian exporters has occurred when Argentina raised to 35% the external tariff of some CET-exempted products like textiles and shoes (see Sanguinetti and Salustro 2000).

<sup>17</sup> Because these changes implied major departures from the CET, they required a waiver from other Mercosur members. The permission was granted but under a very conflictive situation which jeopardized the whole structure of the CU (see Nogués 2002).

<sup>18</sup> Not so much of safeguards and countervailing duties. Since 1996, Argentina has on average initiated one investigation per year in each case.

1998, and the increased afterwards with the coming of the economic recession in 1999 until 2001. Consistent with a view that recession and increasing import competition made instigated AD duties, during 1999-2001 we observe a big decline in the number of investigations that are closed without imposing AD duties. However, the picture seems to have changed in 2002 after the devaluation, when the number of initiated investigations (the least “backward looking” of the indicators) was just seven. We again can interpret this evidence as suggesting that the disequilibria observed in certain basic macro variables (unemployment, production, RER) since 1999 generated a negative spillover on trade policies.

**[Insert: Table 6. Argentina: Antidumping Investigations since 1995]**

How important were these AD investigations in terms of the affected value of imports? Also, did AD investigations affect imports from Mercosur partners, especially Brazil to a greater extent than other countries? Regarding the first question, the value of affected imports can be a poor predictor of the economic costs of these non-tariff barriers, because the threat of the use of these instruments by itself might affect the behavior of foreign and domestic firms. While in theory it is possible that domestic firms might lower domestic prices in order to increase the likelihood that foreign firms will be found guilty of dumping, which would increase national welfare if there is imperfect competition in the relevant import-competing products, it is also possible that foreign firms will decide not to export to Argentina precisely because they realize that they will be subject to AD investigations (Fischer 1992; 1997). Standard estimates of the welfare costs of these types of barriers, however, suggest that the costs can be quite significant, partly because the tariffs imposed tend to be quite high. Unfortunately, there is no available quantitative assessment of the costs of ADs in Argentina. For the case of the United States in 1993, available estimates indicate that AD and counter-vailing duties are second only to the import restrictions on textiles and apparel (the MFA quota system) in terms of the welfare losses for the U.S. (Gallaway, Blonigen, and Flynn 1999). We return to the issue of ADs in section III.B. below.

For the case of Argentina, the CNCE (2002) reported that in 2001 a total of 324 million dollars of imports were subject to AD investigations, representing 1.8% of total Argentine imports during that year. With respect to the country composition of these investigations, the information indicates that Brazil and China are at the top of the list with 19 and 17 cases, respectively, out of 98 product-country investigations still standing in 2001. Thus even though intra-Mercosur tariffs were in fact eliminated during the second half of the nineties, this liberalization was partly undone by the use of non-tariff barriers like AD measures.<sup>19</sup> This was an instrument that Argentina used in increasing doses especially since the Brazilian devaluation of January 1999. However, trade data show that the incidence of ADs in regional trade is not larger compared to external trade flows. If anything it is lower. In this regard, the amount of Brazilian imports involved in

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<sup>19</sup> The initial agreement stipulated that starting in 1998 AD measures would be prohibited within Mercosur. In practice, the use of this instrument was successively extended on a yearly basis reflecting the pressure on Argentina to maintain some type of import relief mechanism given that safeguards actions were explicitly prohibited after 1995 -- see Sanguinetti and Salustro (2000).

AD investigation was around 145 millions in 2001 while for China it was equal to 45 millions. Now this represented approximately 3% of total imports from Brazil and 5% from China (CNCE 2002).

The above discussion provided a brief analysis of the recent changes in Argentina's structure of import protection. We suggested that the instability that has affected the levels of tariffs and non-tariff measures was in part a consequence of the macro shocks suffered by the economy which could not be accommodated, before 2002, by (moderate and relatively costless) modifications in the RER. From a policy viewpoint it is now important to assess whether Argentina should again change its import policies under the new flexible exchange rate regime in order to pursue long-term efficiency and growth objectives. We deal with these issues in the following subsections.

#### **A. Potential static and dynamic gains from further liberalization**

In general, it is well known that trade liberalization can have positive welfare effects for the economy as whole, especially for a relatively small economy such as Argentina, which cannot noticeably affect international prices of its imports. These benefits come from the fact that consumers benefit from lower domestic prices of imports and import-competing goods, whereas the economy as a whole also benefits from a more efficient long-term re-allocation of labor, capital and other mobile factors of production within the national economy. However, these gains are usually small relative to the overall size of the economy such as Argentina, partly because the tariff barriers themselves are not currently very high. We already mentioned that ADs might be having negative effects on national welfare, but even these duties seem to be affecting a rather small share of total imports, and we cannot know with certainty how ADs are affecting foreign and domestic firm behavior.

Trade liberalization, however, can have different types of dynamic benefits, which can help accelerate the long-run growth rate of Argentina. First, the elimination or reduction of taxes on capital goods can help elevate the long-term investment rate. Second, imports of capital and other goods that have embodied technical knowledge can have so-called spillover effects on domestic productivity that also help increase productivity growth. Third, the elimination of trade barriers can help reduce corruption and unproductive activities related to industry lobbying for special trade favors. This latter effect could then release capital and other productive factors for use by the productive economy.

These dynamic gains from trade can be substantial. There is a rather extensive literature that has empirically suggested that trade liberalization tends to accelerate long-term growth. For example, Frankel and Romer (1999) show that (the exogenous portion of) international trade *causes* higher long-term levels of GDP per capita. Wacziarg (2001) shows that international trade driven by trade policy liberalization causes increases in economic growth, mainly through its effect on national investment levels. It is worth noting that these two studies do *not* suffer from the technical criticisms from Rodríguez

and Rodrik (2000) on five other empirical papers that also suggested that trade accelerates growth.

In addition, more recent studies of the impact of international trade on firm-level productivity growth in Mexico and Brazil have shown that import competition tends to be associated with improvements in manufacturing productivity (see the review of the evidence discussed in IDB 2002, Chapter 11). The study by Rama (1994) showed that historically trade-related rent-seeking activities in Uruguay have been substantial. Finally, several analysts have demonstrated that the knowledge content of imports (usually measured by research and development expenditures in your trading partners) can accelerate the growth of manufacturing productivity in developing and developed countries (Keller 2001; Eaton and Kortum 2002). Thus the preponderance of the scientific evidence strongly suggests that trade liberalization can have a lasting impact on long-term growth and it is likely that these effects are significantly higher than the traditional static welfare gains from trade. Thus the relevant policy question is how Argentina should pursue a further opening of its economy.

## **B. How can Mercosur liberalize?**

The previous section surveyed the arguments in favor of liberalizing trade, whereas Argentina had a tendency to increase its level of protectionism since 1998. If Argentina's optimal trade policy in the new macro scenario entails a lowering of trade barriers, how can this can be implemented? Is Mercosur an impediment to achieve this end or can it be an instrument to pursue further trade liberalization? The following discussion covers intra-Mercosur as well as external trade barriers.

### *1. Remaining intra-Mercosur trade barriers*

Most intra-Merocur tariffs are already close to zero. The remaining barriers are non-tariff barriers, namely ADs.<sup>20</sup> Though their incidence over total imports coming from Brazil is low, it is not the case for all sectors. For example, there is a big concentration of cases affecting basic steel products (hot and cold rolled steel plates).<sup>21</sup> Thus for some specific products, Argentine imports from Mercosur countries are virtually closed. **One potential solution to this problem could be to resort to harmonize anti-trust regulations across Mercosur countries and eliminate the use of intra-Mercosur ADs altogether. If this is not possible, then it might be useful to re-negotiate a regional Safeguards codes and eliminate the use of ADs as well.** The advantage of reviving the use of safeguard duties that are consistent with WTO standards is that the duties must be temporary and the executive branch of the government must make the final policy decision. This mechanism is more transparent than the use of ADs because the final decision is recognized to be a political one, rather than pretending that it is supported by pseudo-technical criteria.

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<sup>20</sup> On the other hand Brazil has not applied this mechanism against Argentine imports.

<sup>21</sup> These actions not only affect imports from Brazil but also from most other third country origins (CNCE 2002).

In addition to ADs, there are two conspicuous sectors where Mercosur discipline has not been imposed, namely the sugar and automotive sectors. An ad-hoc group for sugar and a technical committee for autos were created to work towards consensus final solution. In the interim, trade in these products has been subjected to a very complicated set of rules and restrictions. Argentina maintained tariffs and quotas on sugar imports from its Mercosur partners. For autos, a managed trade arrangement is currently in place. It features local content requirements, preferential entry of auto-parts, and a bilateral trade balance requirement. **It is now time to reform these protectionist arrangements, which are supposed to be addressed by existing Mercosur institutions.** Argentina could now take a leading role in regional negotiations to increase the flexibility of the rigid auto regime, aiming first to eliminate or otherwise increase the flexibility of local content requirements and also eliminate the trade balance requirement. The preferential access to the Brazilian market should obviously continue to be a negotiating priority, but in the long-run it might be useful to subject both the sugar and the auto sectors to the discipline of a reduced CET. The latter, however, is part of the broader issue of how to reduce Mercosur external barriers.

## *2. Mercosur's external barriers*

Mercosur's CET was put into practice in 1995, but its full operation was delayed until 2006. There are general exemptions consisting of product lists proposed by each country. Argentina, Brazil, and Uruguay selected 300 products while Paraguay was given 399. The agreement entailed the progressive convergence of tariff levels across the four countries.<sup>22</sup> A second group of exemptions covers products included in the internal tariff adaptation list. These are the products for which the internal tariffs have been set at a level higher than the negotiated CET. Thus to avoid a negative preference margin, countries were allowed to set a higher external tariff for these items. The convergence of the external tariff to the CET was then linked to the reduction of intra-Mercosur tariffs within the adaptation list. Argentina has 155 items in this list.

Besides these country-specific exemptions to the CET, it was agreed that capital goods (machines and equipment) could also be subject to temporary differential treatments. Many products within this category have a CET of 14% (the mean value is about 12%), level to which Argentina and Brazil should have converged no later than year 2001, whereas Uruguay and Paraguay have until 2006. Capital good imports include approximately 1146 8-digit positions. Argentina for most of these items had in 1995 an external tariff below the CET and, by the end of 1996, they were increased to 10%, and to 14% in 1998. As we already indicated, in 2001 Argentina lowered again its tariffs on these products so in practice convergence has not been achieved as initially planned. For computers and telecommunications equipment there was also a process of convergence to the CET. The agreed CET in this sector has a maximum level of 16% and a minimum of 0%. Each country must converge toward the common aliquot in a progressive way until the year 2006. As in the case of capital goods, Argentina had in 1995 an external tariff for these items below the agreed CET.

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<sup>22</sup> In the case of Argentina, out of these 300 items approximately 200 converged to the CET from above while 100 from below (see Crespo Armengol and Perez Constanzó 1998).

Table 7 contains information regarding the level and structure of the Mercosur CET as of December 2002. The CET has been subject to numerous changes since its initial approval in 1995<sup>23</sup>. One of the more noticeable was the 3% increase that took place at the end of 1997 as a result of the Argentina's request to include the statistical import tax within the tariff level structure. Mercosur countries agreed to implement this change but only on a temporary basis.<sup>24</sup> The right-hand panel of Table 7 shows the CET raised by 1.5%, which is what remains to be eliminated to go back to the original tariff structure.<sup>25</sup>

Going back to the structure of the CET as it will stand at the end of the year (left-hand panel of table 7) we see that the average tariff level is around 11% (min level 0% and max 20%) and the dispersion is around 6%. On the other hand, capital goods have an average tariff of around 11%, and there is tariff escalation with the degree of elaboration of the product. How does this tariff structure compare with the one Argentina has today? Alternatively, does the full implementation of the CET fulfill Argentina's objectives in terms of external tariff liberalization? Should the CET be reduced further?

**[Insert: Table 7. The Structure of Common External Tariffs]**

The simple comparison between the information in tables 5 and 7 indicates that in terms of average protection there is a significant difference between the CET and the current tariff levels (10.7% against 14.25%). This is partly explained by the fact that the current level of the CET is 1.5% higher than the level that will prevail at the end of the current year. A second reason is that we still have national exemptions to the CET. Decision 68/2000 of the Common Market Council, have extended the permission to have national exceptions, allowing the countries to select 100 8-digit items.<sup>26</sup> Finally, besides the national lists, there are the exceptions for capital goods, which still, as of December of 2002, are in place. This is clearly seen by the fact that the current average tariff for these products is 3.31% while the CET is around 12.7% (including the 1.5% extra tariff).

The full implementation of the CET would thus bring a reduction in Argentina's average external protection and also a reduction in the dispersion of tariff levels. This is a movement in the right direction, but it may not be enough. The fact that Mercosur countries, especially Argentina and Brazil, have now flexible exchange-rate regimes makes the fear of potential overvaluations of the currency less probable (Goldfajn and Valdes 1999). In this sense, future shocks, like declines in international prices or hikes in international interest rates, can be partially absorbed by the RER through fluctuations in the value of currency. Combined with an adequate safeguards regime (see above), in this

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<sup>23</sup> The Technical Committee N0 1 is in charge of managing the petitions for CET modifications and looking for the 4-country approval.

<sup>24</sup> It was stipulated that at the end of 2000 the CET would go back to its original level. Yet, at the end of 2000 the CET was reduced only 0.5% and another 1% in December 2001.

<sup>25</sup> The elimination of the remaining 1.5% is scheduled for December 2003.

<sup>26</sup> The current list for Argentina is detailed in Decree 540/2002 issued in October of 2002.

new policy regime, tariffs should aim at assuring that resources are allocated where the social return is maximized.

Still the most conflicting issue of the CET for Argentina is the relatively high level of **the CET affecting capital good imports**. As indicated, the full implementation of the CET implies an increase from 3.3% to 11.2%. **Argentina should look for a compromise: in exchange for not delaying CET convergence, it should ask for a significant downward revision of the corresponding tariffs. This is particularly important given the existing empirical evidence that capital goods prices might play a special role in the process of international technology diffusion as discussed above (Keller 2001; Eaton and Kortum 2002).**

Are Mercosur countries willing to take these steps toward more liberalization? There is evidence that convergence in exchange-rate regimes between Argentina and Brazil have brought more support to revise the structure of the CET (INTAL/BID 2003). In fact the Council of the Common Market has decided to create a technical group to elaborate a proposal for a revised CET. As of December of 2002, there had not yet been any real progress in the negotiations. In part this is because Mercosur countries are still too concerned about maintaining discretion or independence in the use of protectionist policies favoring “sensitive” sectors. These concerns are partly political and partly ideological. This is generally true for all countries of the world; most offer some sort of protection to their corresponding “sensitive” sectors. However, the combination of the flexible exchange rate with an adequate and transparent use of safeguard duties can go a long way towards responding to recurrent protectionist pressures.

A second source of opposition to further import liberalization by Mercosur countries, including Argentina, is the idea that unilateral reductions in the CET would hurt future market access negotiations. Yet, as we will see below, Chile, a country with already a very low level of external tariffs, has gotten quite significant market access in FTA negotiations with the U.S. and the European Union. In fact, Freund (2003) presents convincing empirical evidence that high levels of protection in developing countries does not generally lead to successful market-access negotiations. The following section addresses market access issues and trade negotiations for Argentina.

#### **IV. Negotiation of Market Access for Exports: With Whom and How?**

Whereas most of the gains from import liberalization can be attained either through unilateral or Mercosur actions, there could be substantial economic gains for Argentina from market access negotiations. The experience of the nineties showed that many Latin American economies liberalized their trade regimes but this process was not always accompanied by improvements in export behavior. Sturzenegger et al (2001) showed that Argentine intra-Mercosur and developing-country exports were relatively dynamic, while those to the U.S. and the E.U. were stagnant. For example, Argentina’s worldwide export rose by 7% per annum during 1990-2000, while those sent to Europe increased by 2%. These authors find that this is partially related to the presence of trade

barriers in these countries, especially in agriculture products where Argentina has a strong comparative advantage (Sanguinetti and Bianchi 2002).

The key question we want to address in this section is whether FTAs can be an efficient instrument for solving this market access problem. The first specific issue concerns the choosing of trading partners to engage in market access negotiations. What are the key FTA negotiations that are most important from the point of view of Argentina's short- and long-term interests? A second issue is whether Argentina should pursue these negotiations alone or, alternatively, jointly with its Mercosur partners.

### A. Choosing partners

In theory, the greatest gains from market access negotiations are likely to come from the opening of markets of countries that have complementary trade structure to that of Argentina. That is, Argentina can probably gain the most from market access to countries that are net importers of its exports, especially agricultural commodities and processed foods. Likewise, it is likely that on the import side, Argentina can gain the most from trade agreements with countries that export manufactures. This is the essential argument of Schiff (1999). Also, the most sensitive import-competing sectors are usually those with the highest levels of protection, and thus the greatest potential gains from liberalization are also in those sectors. This logic predominates most existing estimates of the potential gains from FTAs derived from so-called "general equilibrium" models. However, these models assume that all countries can affect world prices of their exports. Whereas it is theoretically necessary to consider some form of terms of trade effects in these models, because otherwise there would not be any gains from market access for exports, it leads to biased estimates of the gains from import liberalization. This bias works systematically against any scenario that increases exports without gains in market access (e.g., reciprocal tariff reductions). Thus, these are poor models for assessing the impact of unilateral liberalization in small open economies such as Argentina. Also, the gains estimated by these models are proportional to existing trade flows, and thus are biased against FTAs that open up markets (or create imports) from previously negligible sources. But these exercises might nevertheless be useful for comparing the potential static (but not the dynamic) gains of various FTAs.<sup>27</sup>

Table 8 summarizes the ranking of various Mercosur FTAs from the viewpoint of Argentina based on the welfare gains estimates from four different computable general equilibrium (CGE) models. Three come from World Bank staff and one from Argentina's *Centro de Economía Internacional* of the Ministry of Economics (CEI). While we do not show the exact welfare gain estimates, they are all small due to the fact that they are estimates of the static gains only and range from -0.2 to +1.3% of GDP. In the four exercises, a Mercosur-EU FTA provides greater net benefits for Argentina than one with NAFTA countries. The Free Trade Area of the Americas (FTAA) provides relatively low

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<sup>27</sup> CEI (2002) did model dynamic gains from capital accumulation effects and increasing returns to scale. But it is highly questionable that these effects will be of the same proportional magnitude for all trade. In fact, there is substantial evidence that the productivity gains from the use of foreign capital goods might be proportional to the R&D of trading partners and geographic location – see Keller (2001) and Keller (2002).

net gains, primarily due to the loss of preferential access to the Brazilian market, which produces a terms of trade deterioration for Argentina. However, in some instances, the combination of FTAs with the EU and the FTAA provide greater benefits than an FTA with the EU alone. The same is potentially true for a global process of liberalization.

**[Insert: Table 8. CGE Results for Argentina – Various FTAs]**

These results might be misleading in important ways that cannot be overstated. For example, Tarr (2002) shows that the ranking of the options changes when the models use a low price elasticity of exports. As shown in Table 8, with low elasticities the EU+FTAA option becomes superior to the EU option. If Argentina were considered to be a small economy it would not be hurt by trade diversion since it could find alternative export markets. Another important source of biases in these CGE estimates is that they do not consider differential dynamic effects. That is, it is possible that Argentina might benefit disproportionately more from liberalizing trade with respect to economies that do substantial research and development or innovation activities. For instance, it is clear that the U.S. is one of the world's leaders in terms of innovation – see Table 9. Therefore, the dynamic spillovers from trading more with the U.S. might have a stronger impact on productivity growth than FTAs with other Latin American or even European countries (see also Keller 2002).<sup>28</sup>

**[Insert: Table 9. Argentina and Selected Countries: Innovation Indicators, Annual Averages for the 1990s]**

**In sum, we have identified two sets of criteria for choosing partners. One considers the existing trade flows and their corresponding barriers. In these static models, the larger these flows and the higher the barriers, the larger the estimated gains from trade liberalization. The existing CGE models indicate that an FTA with the E.U. might be the best option from this viewpoint. In contrast, another set of criteria is related to the amount and quality of innovative activity of the potential trading partners, and the U.S. would be the best potential partner.** Whereas this discussion has assumed that the various proposed FTAs would succeed at liberalizing Mercosur trade with respect to those potential partners, we now turn our attention to some key negotiating issues.

## **B. FTAs and agriculture**

Mercosur countries and Argentina in particular have developed strong comparative advantages in primary agriculture and food products. Thus a key criterion to judge the convenience of a FTA negotiation is whether they can actually provide market

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<sup>28</sup> The patents used in Table 9 are “utility” patents, which are mostly capital goods and chemicals, mainly machinery, equipment, industrial chemicals of different types, agricultural chemicals, and medicines. These sectors are also the goods defined as “capital goods” in the analysis of Eaton and Kortum (2002), who selected these goods based on their R&D intensity. However, medicines are not included as capital goods in the study by Keller (2002). The patent data do not include “design” patents or “plants”.

access in these items. What is the evidence regarding agricultural liberalization in the context of FTAs? Did they perform better than efforts at multilateral liberalization?

Agricultural liberalization within regional agreements was in the past (say up to 1980) very limited with the potential exception of the European Economic Cooperation Agreement (1957). Most FTAs formed in the last ten to fifteen years included agriculture in the removal of intra-bloc trade barriers. The degree of inclusion and the depth of liberalization they reached in each case varied significantly (Sheffield 1998). Still we can fairly say that most of them go beyond what has been reached in the multilateral arena. For example, the Closer Economic Relation Agreement (CER) signed between Australia and New Zealand in 1983 reached free trade in agriculture. In the Western Hemisphere, the US-Canada FTA implemented in 1989 also eliminated tariffs in most agriculture products though there were few sensitive sectors that were left outside the agreement (dairy, poultry, sugar, peanuts).

The NAFTA provisions on agriculture, signed in 1993, went one step further by letting no commodity out of the process of tariff and non-tariff barrier elimination.<sup>29</sup> A key ingredient in this result was the early decision taken by the Mexican authorities to include its politically sensitive corn sector, leaving little room for other exemptions (Orden 1996). The agreement called for the elimination or phase out of existing tariffs. Regarding existing quotas, licenses and other quantitative restrictions, NAFTA converted them into tariff rate quotas (TRQ's). For imports above the TRQs, over-quota tariffs were set to provide initial protection equivalent to the previous non-tariff measures. The over-quota tariffs were completely phased out over adjustment periods of 10 or, in some cases, 15 years. Over 21% of the pre-NAFTA trade was subject to this type of mechanism. It is clear that sectors receiving this treatment were among the most sensitive for both countries and in the short and medium term the level of liberalization agreed upon was not significant. Still the mechanism implied a progressive lifting of these barriers and provided a credible signal that in the long run they would be completely eliminated. This is quite a significant result not only compared to multilateral negotiations but also with regard to other FTAs.<sup>30</sup> In practice, Mexico's TRQs have never been binding, and thus agricultural liberalization by Mexico has been quite significant. Mexico has also gained significant access for non-traditional agricultural products (see Yunez-Naude 2002; Lederman et al. 2003).<sup>31</sup>

A similar approach to agriculture liberalization can be found in the FTA signed between Chile and the U.S. There was no product that was left outside the FTA and all tariffs and quotas are going to be eliminated at the end of the transition period, which in

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<sup>29</sup> This applies to the bilateral agreement signed between US and Mexico. With respect to Canada and US the Nafta agriculture provision incorporated the CUSTA agreement so the previous indicated exemptions were maintained under the new Nafta framework.

<sup>30</sup> As indicated, the CUSTA agreement left key sectors untouched. Also, Nafta liberalized the very sensitive sugar sector, although it is subject to the most lengthy adjustment period of 15 years, whereas sugar in the Mercosur is still subject to tariff and non-tariff barriers and there is no plan or scheme to eliminate them in the long run.

<sup>31</sup> When maize imports surpassed the allotted quota, the Mexican government unilaterally allowed above-quota imports to enter Mexico duty free.

this case has a maximum of 12 years. Thus, for example, in a very sensitive sector for the U.S. like dairy, Chile got an initial 3500 tons quota to enter without tariffs. In turn, this quota will rise 7% per year and reach free trade after the 12-year period. Other sensitive products like meat will be completely liberalized after 4 years.<sup>32</sup>

Agriculture is comparatively more protected in the EU than in the U.S. Thus we expected that gaining access for Chilean agricultural exports was going to be more difficult in the Chile-EU FTA than with respect to the U.S. In practice, the Chile-EU FTA exempted certain sensitive items such as dairy products and meat.<sup>33</sup> Yet, Chile got some substantial market access gains in these products implemented through quotas, which in many cases were set at a significant larger level than current exports.<sup>34</sup> Yet these are precisely the types of products that Argentina (and Brazil) would be interested in gaining access to the E.U. Moreover, neither the Chile-US nor the Chile-EU FTA imposed disciplines on the use of agricultural income support and export subsidies.

It remains unclear whether Mercosur can gain significant market access to the E.U. in agricultural products, but negotiators should nevertheless use the Chilean example to demand at least as much access as the Chileans. Thus the issue is whether Argentina can be more successful in gaining this market access by negotiating jointly with its Mercosur partners. This is the subject of the following section.

### **C. Mercosur's negotiations and Argentina's interests**

The previous section suggested that there are important benefits that Argentina can enjoy if it enters into FTA negotiations with various countries/regions. Benefits are larger if the negotiation involves developed nations like EU and US. We have also shown that even in the case of sensitive agriculture and food products there were notorious advances obtained recently by Chile and previously by Mexico under NAFTA.

The key question is how would Argentina's interests be best addressed in these negotiations. Should it go alone or together with Mercosur countries? Does Mercosur offer a good platform from which to face these negotiations? Can Mercosur replicate or even improve upon what Chile has already obtained?

Mercosur countries by the Ouro Preto protocol are bound to jointly negotiate FTAs with third countries or regions. The first international negotiations were those pursued with Chile and Bolivia in 1996. The agreements provide a comprehensive framework for implementing an integration initiative that not only incorporates trade in goods but also services, investment, and border infrastructure. Yet these FTAs include some exemptions. For example, in the Mercosur-Chile treaty, 90% of the tariff lines got liberalized within an 8-years period ending in January of 2004. The rest of the tariff positions were considered sensitive items and received special treatment. Within these we have, for example, textiles, footwear and sugar with face-out periods of about 15 years.

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<sup>32</sup> Overall Chile got a similar treatment in the US market as the Nafta partners -- see [www.direcon.cl](http://www.direcon.cl).

<sup>33</sup> A similar treatment was applied to some fishery items.

<sup>34</sup> Quotas were also obtained for products that Chile does not export to EU like bovine meat or dairy.

On the other hand, wheat and cars, sectors that are subject to special trade regimes in Chile and Mercosur, respectively, were left outside the liberalization scheme.

The evidence regarding Mercosur FTA negotiations after 1996 is not very impressive. Though initial steps were taken to reach agreements with many other countries and regions so far no treaty has been concluded. For example, negotiations have been started with countries of the Andean Community, with Central America and with Mexico but no formal results have been achieved at least in terms of a reciprocal and comprehensive reduction of trade barriers. There is evidence that in part this poor performance is associated with difficulties to accommodate the various (and sometimes conflicting) interests of Mercosur countries. This is clearly the case with respect to the proposed FTA with Mexico. On the other hand, Mercosur negotiators have been quite busy with two other key initiatives: the FTAA and the Mercosur-EU initiative.

#### *1. Mercosur –US negotiations: FTAA or a bilateral agreement?*

The FTAA negotiations involve 34 countries. Sanguinetti and Bianchi (2002) argued that there is room for Mercosur to pursue a bilateral agreement with US, which eventually can be a part of the broader (in terms of countries) FTAA scheme. These authors indicate that the main trade issues that Mercosur countries have with respect to the US market (the so called “shopping list”) consist of 4 items. First, border barriers affecting some key agriculture and food products like bovine meat, chicken and turkey cuts, powder milk, cheeses and butter, citrus (including orange) juice, sugar, peanuts and tobacco. Second, antidumping and countervailing duties imposed by the U.S. Third, export subsidies, and four, U.S. domestic support for agricultural producers.

With respect to border barriers, we should indicate that most of the above products are explicitly defined as import sensitive items by the Trade Promotion Authority (TPA) legislation approved by the U.S. Congress in 2002. Still the above-described experience of Chile and Mexico’s experience under NAFTA demonstrate that market access can be obtained through bilateral negotiations. Yet these experiences may not be easily applicable to Mercosur, precisely because Argentina and Brazil have comparative advantages in those sensitive products. On the other hand, the Mercosur market as a whole is potentially larger than Mexico’s and Chile’s and thus might be able to gain equivalent market access if it negotiates well. Again, a successful negotiation might entail substantial unilateral liberalization by Mercosur to demonstrate that its member countries are interested and politically capable of implementing trade agreements that will obviously demand further import liberalization.

US AD and CV measures have also affected Argentina (and Brazil) exports. For example, in 1999 US imposed these actions on 5% of the tariff lines through which there were positive Argentina exports (see CNCE 1999). The possibility of arriving at a “WTO plus” treatment of these policies within a bilateral negotiation with US is not clear. In the case of Chile, the US did not promise any limitation in the utilization of its AD/CV regime though it offered some compromises regarding safeguard actions in agriculture and textiles.<sup>35</sup>

Another area where a Mercosur-US framework may also be productive is that of restricting export subsidies for inter-regional trade. The negotiation of this issue within Nafta was not sensitive and current US position is in favor of a total elimination of this practice. On the other hand, domestic support programs are clearly an item of the global agenda that have to be negotiated at the multilateral level, since the U.S. position is that European subsidies need to be addressed before the U.S. dismantles its own support schemes. To be more precise, the U.S. agriculture proposal for the WTO demands drastic reforms of “trade-distorting” subsidies, but considers most of its own support programs to be WTO-legal. Nafta made very little improvements in this respect, other than unilateral decisions taken by Mexico in 1994 and the U.S. in 1996, which de-linked income supports from production decisions in agriculture (see Chapter 3 in Lederman et al. 2003). More recently, the U.S. TPA excluded agricultural supports from the Chile FTA negotiations. **Yet Mercosur, given its importance in global agriculture, could trade off market access into US in exchange for a strong, united international position in favor of a change in the *design* (not so much the *level*) of domestic support with the aim of making these subsidies less prompt to affect production and export decisions across the globe. Indeed, Argentina and Brazil have joined forces with the U.S., Canada, and Australia (the so-called Cairns Group of agricultural exporters) to press for agricultural reforms. Such efforts need to be revived, and Argentina could surprise the world by taking a leading position within Mercosur and within the Cairns Group to press forward for agricultural reforms. Thus, it seems that unilateral, regional, and multilateral efforts to reform Argentina’s, Mercosur’s and the world trading system are strong complements for improving Argentina’s economic future.**

## 2. Mercosur-EU

This negotiation is currently being undertaken under the framework of the Inter Regional Cooperation Agreement between Mercosur and the EU signed in December of 1995. After ratification by all member country authorities (including National Congresses), this treaty entered into effect in July 1999. There were various meetings of

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<sup>35</sup> Nafta’s Chapter 19 provides a panel review mechanism for AD/CVD actions. But the technical panels can only review whether existing national AD/CVD laws have been properly applied. Blonigen (2002) shows empirically that we cannot reject the hypothesis that NAFTA did not reduce Mexico’s vulnerability to U.S. AD/CVD activity. Beyond this, the TPA legislation imposed severe restrictions on U.S. negotiators to advance in this area.

the Bi-Regional Negotiation Committee and already there have been exchanges of tariff offers.

We have already indicated the relevance for Argentina of the EU market. It is the second most important export destination, it has high import barriers on Mercosur exports, and thus the CGE estimates suggest that a Mercosur-EU agreement should be a top priority. This suggests that the emphasis of the negotiation should be to improve market access. In this regard Argentina's share in total EU imports of products subject to direct quantitative restrictions was just 2.2% in 1997 (see Nogués et al 2001). EU foreign purchases of these goods was about 78 billion dollars in that year. This shows that trade barriers not only discriminate in favor of domestic producers, but they also discriminate across potential importers.

To what extent could a Mercosur-driven negotiation meet Argentina's interest in the EU market? The key issue here is that Mercosur assures that in exchange for market access concessions in the European market, Mercosur can offer large benefits to the EU producers. In addition to tariff elimination, there are significant gains in the area of services, an important issue in the EU agenda. Though Argentina, through its process of unilateral privatization and de-regulation has not much else to offer, this is not the case of Brazil, which has maintained a more closed-economy approach to this sector. **In any case, given Mercosur's past history of unstable and often unilaterally rising trade barriers, it is understandable that potential partners might be skeptical of the ability or willingness of Mercosur to implement trade reforms. Thus the previously discussed unilateral and Mercosur trade reforms should be implemented in order to enhance the trade bloc's credibility in future FTA negotiations with the E.U. and the U.S.**

## V. Summary of Policy Recommendations

In general, we have recommended a trade policy strategy that aims first to maintain the use of trade taxes, namely export taxes, as source of fiscal revenue in the short-run. But for the long-run we proposed a strategy based on unilateral, regional and multilateral trade policies. Our main recommendations can be summarized in seven prescriptions:

1. **Export policies.** A uniform and revenue-neutral export tax can be designed and implemented immediately. In the medium term, the government should be ready to reduce this tax as the ERERs fall. The government should also consider eliminating the export reimbursements as soon as possible, which will help raise political support for future reductions of import taxes. In turn, some of the funds now used for export reimbursements should be used to strengthen Argentina's export promotion activities and trade negotiating teams.
2. **Anti-dumping duties.** One plausible solution for reducing the need for ADs affecting intra-Mercosur trade is to harmonize anti-trust regulations across

- Mercosur countries and eliminate the use of intra-Mercosur ADs altogether. If this is not possible, then it might be useful to re-negotiate a regional Safeguards codes and eliminate the use of ADs as well. WTO-legal safeguards duties are also preferable to the use of ADs against non-Mercosur imports. The main advantages of safeguard actions over ADs is that they are transitory and the political responsibility for such actions is more clear than under the use of the pseudo-technical criteria leading to ADs.
3. **Elimination of special trading regimes within Mercosur.** It is also time to reform existing extra-Mercosur protectionist arrangements, such as the ones affecting trade in the sugar and autos industries, which are supposed to be addressed by existing Mercosur institutions. It is time to subject these sectors to Mercosur discipline.
  4. **Elimination of CET exemptions.** With regards to the CET affecting capital good imports, Argentina should look for a Mercosur compromise: in exchange for not delaying CET convergence, it should ask for a significant downward revision of the corresponding tariffs. This is particularly important given the existing empirical evidence that capital goods prices might play a special role in the process of international technology diffusion.
  5. **Unilateral reduction of the Mercosur CET.** Given Mercosur's past history of unstable and often rising trade barriers, it is understandable that potential partners might be skeptical of the ability or willingness of Mercosur to implement trade reforms. Thus the previously discussed unilateral and Mercosur trade reforms should be implemented in order to enhance the trade bloc's credibility in future FTA negotiations.
  6. **Choosing FTA partners for Mercosur – the EU and U.S.** When choosing trading partners there are two set of criteria. One considers the existing trade flows and their corresponding barriers. In these static models, the larger these flows and the higher the barriers, the larger the estimated gains from trade liberalization. The existing CGE models indicate that an FTA with the E.U. might be the best option from this viewpoint. In contrast, another set of criteria is related to the amount and quality of innovative activity of the potential trading partners, and the U.S. would be the best potential partner in this case.
  7. **A multi-pronged strategy for agricultural negotiations.** Mercosur could trade off market access to the US in exchange for a strong, united international position in favor of a change in the *design* (not so much the *level*) of domestic support with the aim of making these subsidies less distortionary across the globe. Indeed, Argentina and Brazil historically have joined forces with the U.S., Canada, and Australia (the so-called Cairnes Group of agricultural exporters) to press for agricultural reforms. Such efforts need to be revived, and Argentina could surprise the world by taking a leading position within Mercosur and within the

Carines Group to press forward for agricultural reforms. The U.S. position in this regard is consistent with Argentina's national interest.

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**Table 1. Argentina: Structure of Export Taxes and Reimbursements, 2001 and 2002**  
(ad-valorem averages)

<i>Product</i>	<i>Export Taxes</i>		<i>Reimbursements</i>		<i>Import Tariffs</i>	
	<i>Dec. 2001</i>	<i>April 2002</i>	<i>Dec. 2001</i>	<i>April 2002</i>	<i>Dec. 2001</i>	<i>April 2002</i>
<b>Primary products</b>	<b>0.1</b>	<b>11.1</b>	<b>3.6</b>	<b>1.8</b>	<b>11.5</b>	<b>8.1</b>
Live animals	0.0	10.0	1.4	1.0	4.6	3.4
Fresh fish	0.0	10.0	2.1	1.1	12.3	11.4
Honey	0.0	10.0	0.0	0.0	28.0	28.0
Fresh vegetables	0.0	10.0	8.1	4.0	20.9	9.7
Fresh fruits	0.0	10.0	6.9	3.4	24.6	11.7
Cereals	0.0	15.1	4.0	2.0	10.4	9.6
Seeds and oilseeds	0.5	17.5	3.1	1.7	5.9	4.8
Tobacco	0.0	10.0	5.4	2.7	16.1	15.1
Unprocessed wool	0.0	10.0	3.2	1.6	10.5	9.5
Cotton Fiber	0.0	10.0	5.3	2.7	8.5	7.5
Other primary products	0.0	10.0	1.8	0.9	6.8	6.0
<b>Primary-Based Manufactures</b>	<b>0.1</b>	<b>5.8</b>	<b>7.0</b>	<b>3.6</b>	<b>17.5</b>	<b>16.8</b>
Meat	0.0	5.1	6.5	3.3	16.6	15.2
Frozen fish	0.0	5.0	6.8	3.4	22.2	19.7
Dairy products	0.0	5.0	9.4	4.7	25.8	25.6
Other products of animal origin	0.0	5.0	2.2	1.1	8.3	7.4
Dried and processed fruits	0.0	5.0	9.2	4.6	24.2	11.5
Coffee, tea, yerba mate and other species	0.0	4.9	7.0	3.5	15.0	14.1
Corn products	0.0	14.5	6.3	3.3	13.4	12.6
Oils	0.0	11.6	4.2	2.2	14.2	13.5
Sugar and confectionary	0.0	5.0	9.9	4.9	23.3	22.8
Processed vegetables	0.0	5.0	9.9	4.9	27.3	25.9
Spirits, vinager	0.0	5.0	9.6	4.9	27.3	27.0
Residues from food manufacturing	0.0	6.4	3.0	1.6	9.3	8.4
Tanning products	0.0	5.0	5.4	2.7	10.8	9.8
Leather and furs	1.0	5.0	1.4	1.0	9.4	8.0
Processed wool	0.0	5.0	5.0	2.5	11.1	9.8
Other primary based manufactures		5.0	8.1	4.0	16.4	15.8
<b>Industrial Manufactures</b>	<b>0.0</b>	<b>5.0</b>	<b>8.7</b>	<b>4.4</b>	<b>18.6</b>	<b>18.4</b>
Chemical Products	0.0	5.0	3.0	1.5	9.4	8.7
Plastics	0.0	5.0	8.5	4.2	17.5	16.6
Cork and its manufactures	0.0	5.0	10.5	5.3	17.7	16.9
Leather products	0.0	5.0	11.7	5.8	27.9	27.8
Paper and publishing	0.0	5.0	8.5	4.2	17.7	17.6
Textiles and clothing	0.0	5.0	10.5	5.3	27.2	27.1
Footwear	0.0	5.0	11.7	5.9	27.0	26.9
Cement, etc.	0.0	5.0	7.7	3.8	17.9	17.2
Precious stones	0.0	5.0	2.3	1.2	18.1	18.0
Metals and metal products	0.0	5.0	9.3	4.7	17.7	17.3
Electrical and non-electrical machinery	0.0	5.0	10.6	5.5	11.0	10.8
Transport material	0.0	5.0	11.4	5.9	21.0	18.7
Other manufactures of industrial origin	0.0	5.0	10.7	5.4	22.1	22.2
<b>Petroleum and energy Products</b>	<b>0.0</b>	<b>1.2</b>	<b>0.2</b>	<b>0.1</b>	<b>0.7</b>	<b>0.7</b>
Crude petroleum	0.0	20.0	0.0	0.0	0.0	0.0
Gas	0.0	0.0	0.2	0.0	0.6	0.0
Electrical power	0.0	5.0	0.0	0.0	0.0	0.0
Other fuels	0.0	0.0	0.2	0.1	1.1	0.9
<b>Total</b>	<b>0.0</b>	<b>5.3</b>	<b>8.4</b>	<b>4.1</b>	<b>18.2</b>	<b>17.5</b>

**Table 2. Composition of Fiscal Revenues**  
(in millions of pesos)

	Income Tax	VAT (Net of Reimb)	VAT Reimbursements	Consumption Taxes	Asset Tax	Checking Accounts	Gasoline	Labor taxes (*)	Import taxes	Export taxes	Total
1995	6238.5	16306.4	1135.7	2060.1	300.5	0	1792.5	10222	1977.9	32.3	42187
1996	6793	18080.5	733	1690.4	652.7	0	2338	10411.4	2225.4	27.6	43069.7
1997	8333.5	19820.2	653.7	1537.4	488.5	0	3927	10551.3	2826.8	6.4	48527
1998	9488.5	20337.2	520.2	1481.8	772.4	0	3692.5	10267.49	2775.74	27.74	50036.33
1999	9240	18196.7	574.3	1475.1	545.3	0	3587.9	9141.56	2278.08	25.16	47642.68
2000	10455.25	18425.62219	582.8277309	1528.368369	1024.26634	0	3478.2894	8998.3356	1976.434	32.11459	49102.25
2001	10091.35	14819.3639	531.7634543	1621.354624	769.352383	2933	3419.5061	8043.7	1575.005	52.22676	45403.19
2002	8919.3	14020	1222.1	1715.4	523.5	4857.3	4399.7	8183.3	1307.6	5021.6	50466.9
Sept02-En03	4676	6581	685	822.6	185.2	2255	1915	3719	685	2905	24545

(in % of total revenues)

	Income Tax	VAT (net of Reimb)	VAT Reimbursements	Consumption Taxes	Asset Tax	Checking Accounts	Gasoline	Labor taxes (*)	Import taxes	Export taxes	Total
1995	14.79	38.65	2.69	4.88	0.71	0.00	4.25	24.23	4.69	0.08	92.28
1996	15.77	41.98	1.70	3.92	1.52	0.00	5.43	24.17	5.17	0.06	98.02
1997	17.17	40.84	1.35	3.17	1.01	0.00	8.09	21.74	5.83	0.01	97.87
1998	18.96	40.64	1.04	2.96	1.54	0.00	7.38	20.52	5.55	0.06	97.62
1999	19.39	38.19	1.21	3.10	1.14	0.00	7.53	19.19	4.78	0.05	93.38
2000	21.29	37.53	1.19	3.11	2.09	0.00	7.08	18.62	4.03	0.07	93.81
2001	22.23	32.64	1.17	3.57	1.69	6.46	7.53	19.82	3.47	0.12	97.53
2002	17.67	27.78	2.42	3.40	1.04	9.62	8.72	16.22	2.59	9.95	96.99
Sept02-En03	19.05	26.81	2.79	3.35	0.75	9.19	7.80	15.15	2.79	11.84	96.74

Source: Ministry of Economy

**Table 3. Argentina: Top Ten Exports Ranked by the Index of Revealed Comparative Advantage, 1998-2000**

Products where exports to the World are greater or equal to US\$ 10 millions.			Total Exports (US\$ Millions)	Share (%) of world exports	IRCA
Nº	HTS 6 digits	Description			
1	230630	Oilcake and other solid residues, resulting from the extraction of vegetable	137	57.49	18.7
2	151211	Sunflower-seed or safflower oil, crude, and their fractions, whether or not	710	56.77	18.5
3	150710	Crude soybean oil, whether or not degummed	1,185	45.39	14.8
4	150810	Crude peanut (ground-nut) oil	56	44.10	14.4
5	090300	Mate	25	41.58	13.5
6	330113	Essential oils of lemon	41	35.11	11.4
7	230400	Oilcake and other solid residues, resulting from the extraction of soybean	1,904	29.78	9.7
8	071333	Seeds of kidney beans and dried kidney beans.	150	28.09	9.1
9	120220	Peanuts (ground-nuts), not roasted or cooked, shelled.	172	26.51	8.6
10	040900	Natural honey	91	26.51	6.9

Source: Authors' calculations based on data from U.N. COMTRADE database.

**Table 4 . Argentina: The Level and Dispersion of Import Tariffs since 1996**

Year	External Tariff				Mercosur Tariff			
	mean	max	min	sd	mean	max	min	sd
1996	11.77	30.00	0.00	7.30	1.03	30.00	0.00	4.77
1997	11.79	30.00	0.00	6.99	0.69	30.00	0.00	3.71
1998	14.00	33.00	0.00	6.83	0.38	30.00	0.00	2.59
1999	16.06	35.00	0.00	7.15	0.14	30.00	0.00	1.99
2000	16.73	35.00	0.00	6.53	0.13	30.00	0.00	1.91
2001	18.15	35.00	0.00	9.91	0.13	30.00	0.00	1.90
2002	14.25	35.00	0.00	7.08	0.13	35.00	0.00	2.00

Source: Ministry of Economy. Note: sd = standard deviation

**Table 5 . Argentina: Tariff Structure in 2002 by Main Product Categories and Capital Goods**

Product category	External tariff				Internal tariff			
	Mean	Max	Min	St. Dev	Mean	Max	Min	St. Dev
Primary Goods	9.23	17.50	0.00	1.42	0.00	9.00	0.00	0.05
Primary based Manufactu	12.80	21.50	0.00	1.94	0.08	18.00	0.00	0.29
Manufactures of Industr	16.37	35.00	0.00	4.36	0.51	35.00	0.00	0.98
Petroleum and Energy P	0.29	7.50	0.00	0.67	0.00	0.00	0.00	0.00
Total	14.25	35.00	0.00	7.08	0.13	35.00	0.00	2.00
Capital Goods	3.31	28.00	0.00	5.96	0.05	14.00	0.00	0.85

Source: Ministry of Economy

**Table 6. Argentina: Antidumping Investigations since 1995**

Year	Initiations	Provisory AD duties applied	Final AD duties applied	Investigations closed without duties
1995	25	2	13	5
1996	24	4	15	18
1997	14	11	10	21
1998	4	4	14	11
1999	24	6	5	4
2000	35	3	14	7
2001	27	21	14	1
2002	7	15	6	2

Note: Initiations during a given year do not necessarily correspond to the request presented during that year.

**Table 7. Mercosur: The Structure of Common External Tariffs**

Product category	CET							
	CET				CET+ 1.5%			
	Mean	Max	Min	St. Dev	Mean	Max	Min	St. Dev
Primary Goods	7.89455	16	0	1.397361	9.280179	17.5	0	1.591529
Primary based Manufactures	11.29704	20	0	2.037082	12.77247	21.5	0	2.086582
Manufactures of Industrial Origin	14.32584	20	0	4.016174	15.82376	21.5	0	4.024333
Petroleum and Energy Products	0.2	6	0	0.510519	0.275	7.5	0	0.686145
Total	10.7625	20	0	6.356216	12.24031	21.5	0	6.399498
Capital Goods	11.23871	14	0	5.516093	12.75714	15.5	0	5.518608

Source: Ministry of Economics

**Table 8. Rankings of *Static* CGE Results for Argentina – Various MERCOSUR FTAs**

FTA with:	Van der Mensbrugge (2002)	Tarr (2002) - high elasticities	Tarr (2002) - low elasticities	CEI (2002)
EU	1	1	2	3
US/NAFTA	3	n.a.	n.a.	5
FTAA	3	5	5	4
EU + FTAA	n.a.	2	1	2
Global lib.	2	3	3	1

Source: Authors' calculations based on the results from the cited studies -- see text.

**Table 9. Argentina and Selected Countries: Innovation Indicators, Annual Averages for the 1990s**

	A	B	A+B	C	D
	USPTO patents per 10,000 workers	EPO patents per 10,000 workers	Total number of patents per 10,000 workers	Journal Articles (Scientific and Technical) per 10,000 workers	R&D as % of GDP
<b>U.S.A.</b>	3.47	0.50	3.97	10.14	2.58%
<b>Germany</b>	1.35	1.40	2.76	6.15	2.38%
<b>France</b>	0.81	0.82	1.63	6.63	2.31%
<b>U.K.</b>	0.71	0.48	1.20	10.20	2.00%
<b>Japan</b>	2.74	0.87	3.60	4.85	2.87%
<b>Korea</b>	0.44	0.02	0.46	1.01	2.33%
<b>Brazil</b>	0.006	0.0013	0.007	0.33	0.83%
<b>Chile</b>	0.008	0.0011	0.009	0.88	0.57%
<b>Mexico</b>	0.008	0.0007	0.009	0.29	0.33%
<b>Argentina</b>	0.014	0.0016	0.015	0.83	0.36%

Source: Lederman and Saenz (2003) based on data from the USPTO, EPO, National Science Foundation, UNESCO, OECD, and World Bank.

**Figure 1 and 2. Export Real Exchange Rate. General and Main Export Categories (1993=100)**



