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Mercosur Economic Research Network

# On the Benefits of full Integration in Mercosur: An Economic Evaluation of restrictions to internal trade and its regional impact

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Trade restrictions related to domestic regulations are not a new phenomenon, but they become especially important once traditional tariff and non tariff restrictions are removed. Differences in regulatory institutions and standards thus become sources of cost differences between countries. In this project the evaluation of the costs was not restricted to a review, through case studies and a systematic survey, of the perceptions of the firms involved, but also a quantitative evaluation of the consumer's cost of protection was also made.

Regarding the internal borders of Mercosur, the removal of tariffs already accomplished brought along an asymmetrical distribution of benefits. The impacts on different regions were different given their heterogeneous factor endowments and geographical characteristics. Full integration of Mercosur's internal market would increase the efficiency of the firms as a consequence of the increased size of the market and more intense competition. The benefits of deep integration would become widespread when tariff and non-tariff restrictions are removed and investments in infrastructure would reduce the costs of natural frontiers. On the other hand, this optimistic outlook has been questioned on the grounds that it underestimates the time needed for barriers removal, related in turn to the preference of many firms to maintain segmented markets.

It is known that technical restrictions to trade are in place every time that a national producer has to modify his product to comply with other country's regulations or has to satisfy testing and/or certification requirements in the importing country. The main sources of these technical barriers are compulsory rules set by the governments and voluntary standards drawn by non government institutions that become in fact mandatory. It is convenient for that reason to differentiate technical regulations and non-regulatory barriers, the latter originating in a request to the exporter to comply with national standards related to historical or technical traditions, i.e. mandatory but not part of regulatory government policy. To a great extent international harmonization and non-tariff barriers reduction has taken place in the context of regional integration, largely as a feature of European integration. It has been shown that in small groups of countries it has been easier to agree about the convergence of policy objectives in the field of standardization, mostly in the area of mutual recognition, than at a multilateral level.

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## A. PERCEPTION OF TRADE RESTRICTIONS IN FIRMS' CASE STUDIES

### 1. ARGENTINA

In all case studies conducted in Argentina, with the exception of the one on a Biological Fertilizers plant, exports to Brazil were found to be just a complement to domestic production of the importing country. This was the case in the supply of Dairy Products and Rice, the products more often in the daily news.

From the point of view of realized exports and their relation to less visible restrictions, two main groups of products could be identified, those for which exports were steadily inhibited by the process of obtaining product registration in Brazil, and those for which access to the Brazilian market has been significant since regional liberalization started, but at the same time subject to frequent restriction episodes deriving from formal requisites, swings of the economic cycle and conflicts among rules established before the trade liberalization process was started.

The variety, intensity and frequency of use of the various means of commercial restriction applied, is most visible in Dairy Products and Rice, but it is an open question whether the reason was the threat of damage to their production or prices in Brazil, or as a retaliatory reply given conflicts regarding other activities. In its turn, the removal of restrictions tends to be carried out in an "ad-hoc" fashion, not by formal appropriate rules or procedures.

### 2. BRAZIL

The main restrictions detected in direct interviews with exporting firms and their associations, were as follows. In the footwear trade, requests for unusual information contents in labels, certification of such labels by the Argentine National Institute of Technology, prior licensing for imports into Argentina, inspection of the goods prior to shipping to Argentina, and delays in Customs clearance, later on a quota on Argentine imports was introduced. For chicken exports, sanitary certification beyond the requisites in place in the main world markets, anti-dumping duties, difficulties in the Customs process regarding prior inspection and delays in clearance. Regarding steel products, compulsory request of Argentine National Standards Institute's seal of approval for steel building products, start of anti-dumping hearings, compensating duties on alleged subsidies, and prior licensing.

### 3. URUGUAY

The certification, distribution, marketing and financial costs have affected access of Dairy Products to the Brazilian market. Freight and insurance costs vary between 6% and 15% of FOB export price, according to the point of destination within Brazil. Indirect taxes range from 0% to 7% depending on the Brazilian State collecting such taxes. Some administrative rules operate as a first barrier to access but are later removed or require minor adaptation. Other requisites become permanent barriers. In the case of this market the non-automatic prior licenses were identified as the main non tariff restriction, followed by discrimination against imported goods in the rates of domestic taxes applied in different states of Brazil.

Regarding the paper industry, the main restrictions on exports to Mercosur were costs due to an excess of Customs bureaucratic procedures, regulations on regional transportation and delays at the border due to the fact that border crossing is not allowed at all times. Another lesser but stable difficulty perceived by the exporters is the requirement for certificates of origin. In the case of shippings to Argentina, it was very important the required advance payments of Value Added tax and corporation income tax which added up to an estimated 12% of FOB value, what placed exporters at a disadvantage regarding local producers. On occasions, Uruguayan firms have been faced with other barriers such as import licenses, surveillance over imports or restrictions on trade-related financial practices. While the last one has been dismantled, the others have created actual problems.

## B. PERCEPTION OF RESTRICTIONS ACCORDING TO SURVEYS OF FIRMS

### 1. ARGENTINA

Considering replies of all answering firms regardless of the type, duration or efficacy of the restrictions placed on their exports, 49 out of 82 replying firms indicated they had been subject to restrictions in Mercosur, whether just one isolated event or many instances of experiencing across-the-board/generic restrictions, or sector-specific restrictions.

Restriction experiences were more frequently mentioned regarding products with better exporting performance. It turns out that the dominant factor in generating reports on restrictions is the accumulation of exporting experience while the possible causality running from restrictions to weak exporting performance or low penetration of the (Mercosur) target market, does not seem to hold strongly. Furthermore, products showing good export performance are the target of both generic and specific restrictions.

In the sectors of food and related products, the ones suffering more restrictions in trade, restricted firms tend to be of national (Argentine) ownership belonging to the segment of better exporting performance. On the other hand an apparent correlation was detected between foreign ownership, process industry affiliation and intensity of restrictions. In many cases in both groups comments were put forward regarding the fact that restrictions were always latent; the type of restriction "activated" as well as the opportunity or timing of such move, were both uncertain.

In those cases in which specific restrictions were in place, only a few were temporary. Specific restrictions, requiring certain effort or dedication to be set up, being more deeply rooted or being justified on allegedly structural motivations (like health protection) are in place permanently or come into effect time after time.

Considering the kind of effect they have, many restrictions have little effect. Also, temporary restrictions have, as would be expected, weak effects, while permanent restrictions have both weak and strong effects, but most strong effects tend to be associated to permanent restrictions. Brazil shows up as the country that establishes more restrictions, but given the larger volume of this country's trade, such concentration may have no specific meaning. Furthermore Brazilian restrictions are not the most effective in terms of restricting ingoing trade.

## 2. BRAZIL

There were 412 replies to the questionnaire sent to 4 683 firms. 310 firms stated that non tariff barriers were one of the obstacles to exporting to Mercosur. The average rating of the importance of NTBs´ as an obstacle was equivalent to "moderately important"

Regarding access to the Argentine market the sectors with higher proportion of complaints were plastics (71.4%), footwear (66.7%), "other" food products (63.6%), machinery and tractors (52.5%), and then textiles, packing-house products, and mining and non ferrous metallurgy products. Regarding access to Paraguay it was mainly firms exporting "other" food products that mentioned (36.4% of them) the existence of restrictions. For exports to Uruguay the percentages of firms mentioning barriers in specific sectors were 100% in the vegetable oil industry, 45.5% in "other" food products and 40% in Pharmaceuticals and veterinary products.

Regarding visible barriers 201 firms singled out freight and insurance, and 197 custom expenses, in both cases estimating on average a "medium" intensity of the restriction. Generally speaking, a majority of firms exporting to Mercosur perceive those two restrictions as "moderately important" obstacles for exports to the region. The four more frequently mentioned invisible barriers were labeling requirements (196 firms), cumbersome or excessive customs procedures (145), prior inspection (132) and testing and inspection requisites (129)

The perception on possible improvements was that the main obstacles to Brazilian exports to Mercosur could be minimized through the following actions: harmonizing requirements on labeling, harmonizing sanitary and fitosanitary requirements, acceptance everywhere in Mercosur of documents issued by approved government agencies or private firms, unifying customs procedures throughout Mercosur, and abstaining from levying anti-dumping duties in intra-Mercosur trade. In the last case dumping practices between partner countries had to be evaluated by offices in charge of fostering competition.

## 3. URUGUAY

The latest available information indicates that the question of product value assessment by customs and the use of the "purple channel" are NTBs effective both in Argentina and Brazil. The result is that variable duties are charged according to product valuation by importing countries´s Customs. In practice this is very similar to the Minimum Export Prices mechanism often used by Uruguay and given up after joining Mercosur.

Difficulties in obtaining import prior-licenses operate indirectly as a quota mechanism. Discrimination in domestic taxes acts as a tariff. Technical barriers to trade are as well present in many branches.

The survey results confirm the relevance of the effects of NTBs on the definition of the dynamics of commercial flows to Mercosur, as perceived by the exporters of Uruguay, even at times when macroeconomic level events such as relative price changes following the Brazilian devaluation, had the strongest effects. The results of the survey are consistent with preceding remarks and new information is generated that allows to incorporate other type of indicators to the analysis.

In the case of exports to Argentina Uruguayan exporters consider the problems of prior inspection as an important barrier, while in the case of exports to Brazil it is import licenses that have such role. Both countries use requisites on labeling as a NTB and in both cases domestic taxes are applied in a discriminatory way.

Costs associated to the presence of NTB are of two kinds. On the one hand those that imply a fixed sum regardless of the quantity exported, operating as a barrier on low volume trades. Secondly, barriers that come into application when trade flows start reaching some noticeable level. The latter are of a different kind, they act on the export price. In extreme cases they become prohibitions that trigger a negotiation between the parties, generally leading to the exporter opting for a unilateral restriction regarding market share.

## C. THE COST OF PROTECTION

The cost of protection was estimated in the context of a computable partial equilibrium model in which imported and domestic goods are imperfect substitutes, the supply of the imported good is infinitely elastic and all markets are perfectly competitive. Given data on price and quantity changes and the tariff equivalent of the restrictions, the comparative statics of a change in the level of protection and its effect on welfare changes were computed. The methodology for the study of the NTB effects is straightforward but the product level information requirements are high. Calculations were conducted for 5 products exported by Argentina, 3 in the case of Brazil and 7 of Uruguay to obtain orders of magnitude.

The estimated magnitudes of the cost of protection indicate the importance of considering special situations, this is related to the estimation of the implicit tariff based on the price comparison as well as to the decomposition of their tariff and non tariff components. But the orientative nature of the estimates made should be stressed, this is related not only to the difficulty in estimating elasticities of demand and supply but also to the need to consider the effect of markets with imperfect competition.

The removal of the NTBs on Argentine exports would bring about a benefit for the Brazilian consumer at the level of 23% in powder milk, 49.7% in tires for road vehicles and 27.1% for biological fertilizers. In the case of Brazilian exports of footwear the increase in Argentine consumer surplus from removing those NTB's would be 184 M$ (million US dollars), while values in the cases of steel products and poultry would be 87 M$ and 54 M$ respectively. In the case of Uruguay the results concerning exports to Brazil were important for its imports of UHT milk and for rice, with potential increases in consumer surpluses of 44.4 M$ and 86.8M$ respectively. Regarding exports to Argentina the corresponding amount for paper was 9.2M$. In the case of Uruguay the effect of the loss in terms of trade, given the large country assumption, was computed for exports to Brazil and Argentina.

## D. FINAL REMARKS

Both sporadic restrictions on exports and the recourse to ad-hoc solutions introduce uncertainty that translates into reduction of exports and higher costs associated to minimizing such effect. In some cases this inhibits regional exporters who redirect sales to less conflictive markets. The cases without a solution or with an ad-hoc solution are mostly related to the lack of efforts to harmonize the legislations or to incorporate to national legislations (internalize) the decisions adopted at the Mercosur level.

Those cases in which the restrictions were associated to the requirement of compliance with national standards can be considered similar to experiences in the European Community, where the main problems were related to lack of information and experience, as well as to lags or delays in obtaining approval from national entities in the country of destination of exports, in some cases specifically to the costs of repeating tests the results of which were not considered acceptable. It may also be noticed that regulations on natural-resource based products acquired a national-regional characteristic due to the fact that they belong to traditional industries, while other, human-capital intensive, are "standard-takers" on the technological frontier. In the first group a competition can be noticed between national systems of regulation requiring a longer time for convergence, while for the second group the reference is external.

Thus, consideration in the project of the various aspects of the problems related to deep integration, has led to conclusions on the importance of non tariff restrictions as a permanent hindrance to the flows of trade within Mercosur. Furthermore, as shown by the European experience of the Single Market Program, in order to overcome them a credible bargaining attitude is required encouraging exporters to undertake institutional solutions regardless of the advantages conferred to "free riders". Also needed is a commitment by the governments to start bilateral or multilateral negotiations towards mutual recognition and harmonization in the case of asymmetric national restrictions.

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