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# Trade Policy Reform and Poverty Alleviation

How to implement trade liberalization as part of a strategy for alleviating poverty in developing countries.

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## Summary findings

In this paper, developed as part of the World Bank's Poverty Reduction Strategy Sourcebook, Hoekman, Michalopoulos, Schiff, and Tarr examine how to implement trade liberalization as part of a strategy for alleviating poverty in developing countries. They discuss trade policy instruments, institutions, complementary policies, sector issues, adjustment policies, and safety nets in an integrated approach to trade policy as a tool for poverty alleviation.

The authors examine the patterns or models of trade policy that have been successful in alleviating poverty. They discuss the role of tariffs, nontariff barriers, contingent protection (such as safeguards and antidumping), special import regimes (such as duty drawback), export taxes, export subsidies, and trade-related institutions (such as standards, marketing, export

finance, customs clearance, and regional trade arrangements).

The authors also discuss policies that complement successful trade reform, including macroeconomic stability, a competitive exchange rate, flexible labor markets, competitive product markets, and policies that do not discriminate against foreigners in investment. They suggest approaches to policies and institutions in services and agriculture, key sectors in poverty reduction. They explain the roles of retraining and safety nets in dealing with the adjustment costs of trade liberalization. Finally, the authors elaborate guidelines for implementing trade reform and explain tools for assessing whether trade reform will help or harm the poor in particular sectors in the short run.

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This paper—a product of Trade, Development Research Group—is part of a larger effort in the group to understand the links between trade reforms and poverty reduction. Copies of the paper are available free from the World Bank, 1818 H Street NW, Washington, DC 20433. Please contact Rebecca Martin, room MC3-308, telephone 202-473-9065, fax 202-522-1159, email address [rmartin1@worldbank.org](mailto:rmartin1@worldbank.org). Policy Research Working Papers are also posted on the Web at <http://econ.worldbank.org>. The authors may be contacted at [bhoekman@worldbank.org](mailto:bhoekman@worldbank.org), [cmichalopoulos@worldbank.org](mailto:cmichalopoulos@worldbank.org), [mschiff@worldbank.org](mailto:mschiff@worldbank.org), or [dtarr@worldbank.org](mailto:dtarr@worldbank.org). December 2001. (44 pages)

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# **Trade Policy Reform and Poverty Alleviation \***

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# 1 Introduction

**Trade and Growth.** There is a preponderance of cross-country evidence that trade liberalization and openness to trade increases the growth rate of income and output.<sup>1</sup> In addition, numerous individual country studies over the past three decades suggest that “trade does seem to create, even sustain higher growth” (Bhagwati and Srinivasan 1999). A country’s trade policy is the key link in the transmission of price signals from the world market to the national economy. Undistorted price signals from world markets, in combination with the exchange rate, allow resource allocation consistent with comparative advantage, thereby increasing productivity. An open trade and investment regime encourages integration into the global trading environment and the import of diverse and modern technologies that are important for productivity improvements.<sup>2</sup>

**Trade, Growth and the Poor.** Growth in incomes of the poor is strongly related to overall growth in the economy—although the relationship differs substantially from country to country. The link of overall growth to poverty alleviation has been demonstrated both in cross country analyses (Dollar and Kraay, 2000), and for individual countries.<sup>3</sup> Trade liberalization can therefore be expected to help the poor overall, given the positive association between openness and growth. As important, the political economy of trade policy is such that in practice it is unlikely that the poor have much influence on the pattern of protection that prevails in a country. As trade policy inherently has the effect of redistributing income, this implies that trade policy often acts to tax the poor, and that liberalization can therefore do much to improve incomes of the poor. However, in the short run liberalization may have a negative impact on some of the poor, depending on their sources of income and the impact on prices of goods and services the poor consume. Thus, there is a need to examine the impact of trade liberalization in some detail to help to design policies that protect those among the poor who may be adversely effected, especially in the short run.

**Characteristics of the Poor.** Knowledge of how the poor obtain and how the poor spend their income is important in designing pro-poor policies. As explained at greater length in the Appendix to this chapter, trade policy will affect the welfare of the poor through what they consume and what they produce. Food is by far the most important item of expenditure. In Bangladesh, for example, food represents about 73 percent of the total expenditures of the poor. Fuels, housing and clothing combined account for about 21 percent of expenditures.<sup>4</sup> The sale of unskilled labor tends to be the most important source of income for the poor, complemented by the value of “own consumption,” that is, the imputed value of what the poor consume from their own production.<sup>5</sup>

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<sup>1</sup> Sachs and Warner (1995), Dollar (1992), Edwards (1993, 1998), Ben David (1993) and Frankel and Romer (1999).

<sup>2</sup> See Coe, Helpman and Hoffmaister (1997) for evidence and (Romer, 1994) for a further discussion.

<sup>3</sup> For example, Srinivasan (2000) found that of the 17 percentage point reduction in the population below the poverty line over some 40 years (between 1951-55 and 1993-94), a 15 percentage point reduction is to be attributed to growth and 2 to redistributive policies.

<sup>4</sup> From the 1991 Household Expenditure Survey for Bangladesh.

<sup>5</sup> In Mexico, wages from unskilled labor represents 40 to 45 percent of the income of the poor, and own consumption is the next largest at 15 percent (lanchovichina et al., 2000).

In general, the impact on the source of income of the poor will be a more important determinant of the effect of liberalization than the effect on the prices of their consumption. The reason is that trade reform will affect many relative prices, some of which will move in offsetting directions. In contrast, as the poor generally have limited assets, the most important of which is low-skilled labor, the impact on wages and employment dominates.

**Complementary Policies and Institutions.** While a liberal trade policy is necessary for growth and poverty reduction, it alone is not sufficient for growth of trade. When trade reform has been implemented in an unstable macroeconomic environment or without efforts at strengthening trade-related domestic institutions and appropriate complementary policies, it has often either been reversed or failed to stimulate growth. In this chapter, we will also discuss important “behind the border” reforms that should accompany trade liberalization to effectively allow a country to integrate into world markets. This includes a regime that encourages investment and competition, including openness to foreign direct investment (FDI), so that business services are supplied at competitive prices, and macroeconomic policies that encourage stable prices and a competitive real exchange rate.<sup>6</sup> Although the poor are very diverse, they frequently work in the rural sector and in the urban informal sector. Thus, policies that affect agricultural and labor markets are important complements to trade reform for the poor.

**Political Economy of Protection and the Poor.** Even when trade reform will benefit the poor and the economy broadly, it will often be resisted. The sectors with the highest protection know they receive concentrated gains from protection and they will oppose the reform. The expansion of exports following reform is likely to be spread throughout the economy, often with new and sometimes unexpected industries arising. It is often difficult to identify future exports and exporters. Thus, the employment and income gains from reform are likely to be diffuse. The same is true for the consumers who will gain from the reform through lower prices and greater choice. The diffuse nature of the gains to consumers and producers explains why those who oppose liberalization often are dominant in the political lobbying. Redistributive effects of trade reform can be a major factor impeding the launch of welfare-improving policy changes (Rodrik, 1998).

Abstracting from fiscal revenue considerations, barriers to trade are typically put in place to protect domestic producers from international competition, and usually benefit powerful interest groups, not the poor. Non-tariff barriers are especially pernicious in this regard as they result in the transfer of rents from consumers broadly, including the poor, to license holders. Such rents arise because the restriction on imports results in domestic prices that are above the world price. Whereas in the case of a tariff the government collects the revenue that is implied by the difference between the world price and the tariff-inclusive domestic price, in the case of non-tariff barriers this implicit revenue is captured by those who have the right (hold the license) to import. There is evidence that in developing countries such rents are a major source of inefficiency from rent-seeking activity (Krueger, 1974), i.e., from the spending of real resources to obtain import licenses and influence policy in general. These license holders are often among the wealthiest members of society. Thus, in addition to the inefficiency costs of trade protection, protection will often transfer income toward the rich and away from the poor. Indeed, in

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<sup>6</sup> One view, represented by Rodriguez and Rodrik (2000), is that there is a strong association between exports and growth, but that we are unable to be sure whether this association is a consequence of exports causing output growth, or of the two being jointly determined by the strength of countries' institutions. Even if we were to accept this agnostic view, the resulting policy prescription is a relatively comprehensive approach to development that includes improvement of a range of institutions along with trade liberalization.



percentage terms the effect of trade reform on the incomes of those who currently gain and those who currently lose from reform can easily be a multiple of the economy-wide welfare gains from liberalization. This is because trade policy is inherently a redistributive policy.

**Structure of this Chapter.** In the next section of this chapter we describe briefly the experience with successful trade policy reform and discuss adjustment costs and the implications for the poor. Section III discusses and evaluates the principal trade policy instruments and institutions. In section IV the most important complementary policies are discussed and evaluated. Given the importance of agriculture and business services for a poverty reduction strategy that employs trade, these sectors are accorded special treatment in section V. General and trade policy specific safety nets are discussed in section VI. We briefly summarize the principal points in a successful strategy for using trade for poverty reduction in the last section. The appendix provides a framework for thinking about the impact on the poor from a trade reform in the short and the long run.<sup>7</sup>

## 2 Trade Policy Reform, Growth and Poverty Alleviation

### 2.1 Models of Successful Trade Integration and Poverty Reduction

In the last 40 years of the 20<sup>th</sup> century, several countries have been highly successful in increasing incomes and reducing poverty. Most notable, has been the experience of the South-East Asian economies, especially Singapore, Hong Kong, Japan, Taiwan (China) and Korea. In the final 15 years of the century, Chile and Mauritius also saw remarkable increases in income. All of these countries dramatically increased their exports (and trade to GDP ratio), raised incomes and reduced poverty and are now active participants in the global trading environment. On the other hand, there are no examples of countries that have significantly reduced poverty without significantly increasing their exports. Although export expansion is the common element to all the success stories of poverty reduction, there are considerable differences in the models of trade policy that these countries have adopted. The success stories may be grouped into three broad categories:

- **Economy-wide Trade Liberalization.** Countries like Hong Kong, Singapore and Chile adopted very liberal trade regimes. These countries avoided non-tariff barriers. Hong Kong and Singapore practiced free trade (zero tariffs), while Chile employed low uniform tariffs.
- **Protection with Offsetting Policies for Exporters.** Some countries that experienced rapid growth in trade and GDP did so in the context of trade regimes characterized by significant import controls on the domestic market. Korea, Taiwan (China) and Japan (in the early stages) are the main examples. The key to understanding these experiences has to do with looking at all the factors that affect competitiveness and the incentives to producers to sell in the domestic versus the export market. Protection

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<sup>7</sup> Space constraints prevent a detailed discussion of many of the subjects addressed in this chapter. More in-depth treatments of trade policy from a development perspective can be found on the website [www.worldbank.org/trade](http://www.worldbank.org/trade) and in two recent compilations: McColluch, Winters and Cirera (forthcoming) and Hoekman, English and Mattoo (forthcoming). The World Bank site also offers access to tools that can be used to assist in the design of trade reforms, and cross-country data on trade policies that are useful for benchmarking purposes. Specific tools that focus on the impact of reform on the poor are still being developed and will be posted once available.

creates incentives to produce and sell to the domestic market, i.e., protection creates a bias against exports. Indeed, protection of intermediate products and services creates a serious handicap to export industries because it raises their costs to levels that are higher than those of their potential competitors in world markets, and they are discouraged through the impact of protection on the real exchange rate. But these countries managed elaborate systems that offset the bias against exports (Box 1). The experiences of nearly all other developing countries with high protection of their domestic markets are quite different. Notably, the institutions needed for effective implementation of duty drawback systems have been shown to be weak in most sub-Saharan African countries (World Bank, 2000c). This suggests that the Korean model is not relevant for most developing countries in that it is too difficult to manage and too easily taken over by special interests who will obtain rents.

- **Protection with Export Processing Zones.** In a protected trade regime that discourages exports, export processing zones (EPZs) may be used to partly place exporters on a footing equal to producers for the domestic market. While very many countries have introduced EPZs, few have actually succeeded in stimulating exports substantially and on a sustainable basis through this mechanism (see below). The experience of Mauritius in the last 15 years of the 20<sup>th</sup> century, however, provides an example of a country that expanded exports significantly and reduced poverty through EPZs in a trade regime that was not liberal overall. Exporters in an EPZ have tariff free access to intermediate inputs and often have fewer regulatory constraints on their actions. As a result they may be able to compete on a footing almost equal to producers for the domestic market. Although there is a role for EPZs in countries with institutional constraints (Watson, 2000), there are potential pitfalls in establishing successful EPZs (see below).

#### **Box 1. How Korea Overcame the Anti-Export Bias of Protective Trade Policies**

During the 1960s and 1970s especially, Korea had relatively high import tariffs and also used non-tariff barriers, but both exports and the economy grew very rapidly. In principle, tariffs impose a bias against exports by making production for the home market more profitable. Korea managed an elaborate system that offset the bias against exports. Two of the most important mechanisms used by Korea were duty-free access to intermediates used in production for export (temporary admission) and capital subsidies to exporters. Korea managed a very efficient temporary admission system (supplemented in the 1980s by an efficient duty drawback system) which allowed tariff free access to intermediate inputs for exporters (and "indirect" exporters). Also important was that exporters (and indirect exporters) had preferred access to working capital at interest rates that were considerably lower than the interest rates paid by firms supplying the domestic market. The development and enforcement of these policies over a long period required strong political will supported by a broad national consensus, and a highly competent administration.

*Source:* Based on Westphal and Kim (1977), Westphal (1991) and Rhee, Ross-Larson and Pursell (1984). These studies provide a full treatment of the mechanisms employed by Korea to provide exporters with incentives to offset the bias of the tariffs.

In practice, the most practical way of stimulating trade and opening up to the international economy is through liberal trade regimes, rather than through a complex

structure of protection and export incentives. As a practical matter, duty drawback mechanisms are ineffective in most of the least developed countries. Thus, a regime with high protection will diminish exports and growth. Moreover, differentiated structures of protection and subsidization create opportunities for elites and powerful producer groups to capture trade policy for their special interests. This lobbying for protection and subsidies engenders corruption and inefficiencies which, in the end hurt the poor. These problems can be avoided by simple and transparent protection regimes of low uniform tariffs. For low income countries with weak trade related institutions, EPZs can be an effective vehicle to promote export production, not only because they allow duty-free access to imported inputs, but because they provide a means to deal with infrastructure and public sector service-related weaknesses that impede investment (Watson, 2000).

## **2.2 Adjustment Costs of Trade Liberalization: Impact on the Poor**

Trade reform may not be implemented due to political dynamics or a fear of adjustment costs. A recent review of over 50 empirical studies of adjustment costs by Matusz and Tarr (2000) found that all the evidence supports the view that the adjustment costs to the economy are very small in relation to the benefits of trade liberalization. For example, a retrospective study of trade reform in 19 developing countries by Papageorgiou, Choksi and Michaely (1990) concluded that trade liberalization did not generally result in decreased employment, even in the short run. Compared with the pre-liberalization period, manufacturing employment was larger one year subsequent to the completion of liberalization in all but one of the twelve countries for which data was reported. In fact, manufacturing employment was higher in twelve of thirteen cases during the liberalization period compared with the levels registered prior to liberalization. Parker et al. (1995) and Harrison and Revenga (1995) performed similar but less extensive studies with similar results for market economies.

Although further evidence is needed to generalize these results fully to developing countries—most of the literature has focused on industrialized country experience—Liedholm and Meade (1995) found there were very high start-up rates (twenty percent) for medium and small enterprises (MSEs) in six African economies and the Dominican Republic, where MSEs account (as they do elsewhere as well) for a significant portion of total employment. The high start-up rates, where the business environment is supportive, suggest that entrepreneurs in these countries are quick to respond to new opportunities, making speedy adjustment to trade reform quite likely. Looked at another way, the magnitude of dislocation caused by liberalization is unlikely to be significantly larger than dislocations associated with the everyday workings of the economy in many countries.

Private adjustment costs can be substantial or very small depending on whether displaced workers were earning rents in their initial position and whether markets function reasonably well. The poor are not likely to be earning rents or they would not be poor. The evidence shows that adjustment costs are typically short term and terminate when workers find a job, while the benefits of trade reform can be expected to grow with the economy. In developing economies, trade liberalization should favor labor since exports will typically be labor intensive. Significant within-industry shifts typically occur after trade liberalization, which tend to minimize the dislocation of factors of production. Moreover, the duration of unemployment for most industries is not high, especially where workers were not earning substantial rents in the original job. Finally, in many industries normal labor turnover exceeds dislocation from trade liberalization, so that downsizing where necessary could be accomplished without causing much unemployment.

It is difficult to disentangle the effects of trade liberalization from other events occurring simultaneously, but generally manufacturing employment increased subsequent to the trade liberalization. Thus, while it is necessary to apply caveats to most of the individual studies, the collective weight of their evidence suggests that adjustment costs are low relative to the gains from trade liberalization. Nonetheless, the extreme poor may be incapable of sustaining even short periods with adverse adjustment costs, and there may be selected poor groups that do not gain, while some of those that gain may lose in the short run. In order to minimize adjustment costs and help make trade reform work most effectively for the poor, complementary policies are necessary. One important complementary policy for the poor is an efficient social safety net (discussed below). In general, attaining and sustaining a high rate of economic growth is a key factor in improving outcomes for the poor over time.

### **3 Trade Policy Instruments and Institutions**

The first step in designing a strategy to use trade policy for growth and poverty alleviation is to understand how the trade regime works. This involves learning of the importance of non-tariff barriers, including who gets the licenses and permits. What is the structure of the tariff and including its dispersion, exemptions and rebates? How much revenue comes from tariffs? What policies are in place which may tax or subsidize exports? Are trade-related institutions, such as standards organizations, export finance and marketing facilities adequate to support an expansion of exports? Does the pattern of protection favor the income of the poor or a segment of the poor, and may policies be designed to assist the poor during the transition?

In this section we describe the principal trade policies and institutions that are employed to influence the flow of goods and services and suggest how to evaluate these. We discuss complementary policies in later sections.

#### **3.1 Non-Tariff Barriers**

Non-tariff barriers include mechanisms such as quotas, licenses and monopoly rights to import. When these mechanisms are in place for reasons other than for health or safety they are the most pernicious of trade barriers in terms of their harm to growth and poverty alleviation. Partly this is because non-tariff barriers encourage competing interests to lobby to obtain the valuable licenses to import. This competing lobbying activity (known as "rent-seeking") wastes valuable resources. Non-tariff barriers also lack transparency, and thereby may allow protection to go relatively unnoticed. As discussed above, the political economy of protection suggests that import controls (and sometimes export controls) are usually put in place to benefit powerful interest groups, not to help the poor.

#### **3.2 The Tariff Regime**

Most low-income developing countries have differentiated tariff structures with significant tariff escalation (Michalopoulos, 1999). The main reasons include fiscal objectives, import substitution motivations combined with the political weight of vested interests. Tariff escalation is a problem since it affords high "effective" protection to final goods producers, thereby discouraging the development of intermediate industries. Exporting of intermediate products is an important way for developing countries to participate in the modern global economy; but these activities are discouraged by the escalation of tariffs.

A uniform tariff conveys a number of advantages (Tarr, 2001), the most important of which is that if the tariff is uniform, the gains to industry lobbying are much smaller (and may be negative), creating a kind of free-rider problem for the lobbying industry and dramatically reduces the incentive to lobby for protection. Chile, which has had a uniform tariff since 1979, is a dramatic case in point. In Chile, in 1998, the legislature considered a progressive reduction of the uniform tariff from 11 to 6 percent, to be accomplished by one percent per year reductions through 2003. Chilean industry groups supported a *reduction* of the tariff, which passed the Chilean legislature. Evidently, uniform tariffs led industrialists to conclude that a reduction was in their collective interest.

A uniform tariff greatly simplifies customs operations, eliminates a number of ways used to avoid paying the tariff, and should help reduce corruption (which may have positive spillover effects into other dimensions of government activity) and save on scarce administrative resources. There will also be a direct saving of resources from reduced lobbying for higher protection, and an associated gain from encouraging scarce entrepreneurial talent to be employed more productively in the creation of better and cheaper products. Overall, the level of protection is likely to be lower as the incentive to lobby for higher tariffs is attenuated. Many of these factors are pro-poor as they greatly reduce the scope for the exercise of power and rent-seeking.

Customs and other officials in low-income countries have tended to argue that although uniform tariffs look good in theory, implementing such a structure is not feasible in practice. This is frequently a covert argument for continued protection of particular sectors. In fact, in addition to Chile, El Salvador and the Kyrgyz Republic have tariff structures with very small dispersion, and Hong Kong, Singapore and Estonia have a uniform tariff of zero.

Uniformity does not imply that there can be no exemptions for products that are deemed to be of great social importance such as essential medicines or mosquito nets (Bannister and Thugge, 2001). However, care should be taken that such exceptions target only products that are critical to attain social and public health objectives.

### **3.3 Emergency Protection, Antidumping and Other Trade Remedies**

Liberalization of trade will give rise to adjustment pressures as import competition intensifies. For this reason reform programs often reduce tariffs and other trade barriers gradually and are ideally complemented by measures to facilitate adjustment (complementary reforms—see below). However, in some instances imports may expand so rapidly that governments may want to be able to intervene by raising trade barriers. Import surges that create serious difficulties for a domestic industry may also occur independent of liberalization. In such cases trade intervention may be the most effective instrument available to governments. If so, the appropriate action to take is a so-called safeguard measure—the imposition of a temporary duty against *all* imports of the product concerned. A necessary condition for intervention should be that the domestic industry is seriously injured by import competition, and a determination by economic decision makers that protection is in the national interest (i.e., the associated costs to consumers are less than the benefits that would accrue to producers). Safeguard actions should be temporary, lasting no more than 2 or 3 years, as the objective is not to raise protection permanently but to facilitate adjustment by the industry to increased competition. It is also important that tariffs be used, not quotas, for transparency and political economy reasons.

Many countries tend to use antidumping as a safeguard instrument. This is ill advised. Antidumping is a trade policy instrument that allows duties to be imposed on imports that are sold for less than what is charged in the exporters home market. That is, it can be invoked to offset price discrimination across markets. Such differential pricing usually reflects economic conditions, and is not detrimental to welfare. As antidumping is an instrument that is easily captured by industries to raise the price of imports, and requires the use of scarce administrative resources, it is counterproductive to economic development and poverty reduction. If there is a need to raise protection because imports injure domestic industry, it is preferable to use WTO consistent safeguard actions, as they allow the country to consider the impact of taking action on the economy as a whole, including the poor, as opposed to simply the industry that confronts import competition.<sup>8</sup> Antidumping procedures typically replace considerations of the national interest or the impact on the poor with an assessment of pricing practices of foreign firms. That is, the question of whether it is in the nation's interest to offer protection to the industry under consideration for a duty is never asked.

The best policy option from a development perspective in this area is to have no antidumping instrument. If antidumping procedures are adopted, efforts should be made to establish procedures that allow for the national interest and the impact on the poor to be taken into account prior to the imposition of an antidumping duty.

### **3.4 Special Customs Regimes for Exporters**

Tariffs on imports hurt exports in various ways. Tariffs reduce the demand for foreign exchange, and that tends to appreciate the real exchange rate. The appreciated real exchange rate hurts exporters and competitiveness of national firms as they must pay higher prices for their imported intermediates. Prices of labor and capital are also bid up by import competing sectors that are favored by the tariff.

Programs like duty drawback and temporary admission, if properly administered, allow exporters duty-free access to imported intermediates. Although the exchange rate bias against exports that results from protection remains,<sup>9</sup> provision of tariff-free access to imported intermediates for exporters is crucial. This is also the case for countries with uniform tariffs, although the need for duty-free access declines as the average level of the tariff falls.

The principal problem with duty drawback schemes (involving the repayment of duties paid on imported inputs that are embodied in subsequent exports) is that their administration can be very costly, and lead to cumbersome procedures and delays when tariffs are high. Exporters complain of delays and lack of re-payment in many countries. When tariffs are high there is also the risk of fraudulent claims. The empirical evidence suggests that in countries without well-functioning public administrations, duty drawback becomes ineffective. They are very difficult to administer at tariff rates in excess of 15 or 20 percent because of leakage, delays in payment and fraudulent claims (Mitra, 1992).

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<sup>8</sup> Under the WTO, safeguards also require compensation to be offered to exporting countries if the action lasts more than 3 years. This is a useful mechanism to ensure that protection is temporary. See Hoekman and Kosteci (2001) for more detailed discussion.

<sup>9</sup> In addition, to avoid anti-export bias, duty drawback schemes would have to be extended to indirect exporters as well (i.e., firms which do not export themselves but which sell to exporters). Administration of such mechanisms are quite complicated in practice for most developing countries..

Delays are particularly detrimental to small and medium enterprises and small farmer organizations.

Temporary admission may be more effective at allowing tariff free access to intermediate inputs for exporters in these situations as they do not involve payment of duties on imported inputs, but rather a requirement that firms document ex post that these inputs have been used in the production of exports. The major potential problem with this approach in low-income countries with weak administrative capacity is so-called leakage of goods into the economy (that is, the goods are not used for export production). A frequently used option to control such leakage is the bonded warehouse, or on a greater scale, an export processing zone. These are specific territories that are controlled by customs and where imports are not taxed on entry, but goods are taxed if sold into the domestic market. Export processing zones are discussed further below.

### **3.5 Export Subsidies**

Export subsidies may be appropriate to offset market failures, for example, information problems associated with breaking into new markets by individual firms. In practice, countries have often used them indiscriminately to promote exports and to offset the anti-export bias created by other policies. While they can stimulate exports, they may do so at a huge cost to the budget. From a poverty perspective their impact on the poor may be detrimental as they may result mostly in rents to relatively rich exporters. Using subsidies to offset the negative effect of other policies (such as protection) on exports is inappropriate. Such situations call for the removal of protection and the adoption of instruments such as drawback or EPZs.

Developing country WTO members have become more constrained in the use of export subsidies, but least developed countries and countries with per capita incomes below \$1000 are permitted to use them. This provides legal cover to pursue policies that aim to offset informational asymmetries and related market failures. To be effective and not distort incentives, such policies should be 'horizontal' in nature, not sector-specific.

The main problem with export subsidies is their use by high-income countries for agricultural commodities. This has a destabilizing effect on world prices and is highly detrimental to producers in developing countries of the products concerned (see below).

### **3.6 Export Taxes**

Developing countries often impose export taxes on primary commodity exports. In some cases these are imposed instead of royalties for the extraction of minerals; in others they are used in an attempt to exercise market power or to support local processing industries. In such cases there is often an adverse effect on the poor (Box 2).

Export taxes result in a lower price for the farmers than the prevailing price in world markets for their commodities. Elimination of the tax will raise the incomes of farmers, the majority of whom tend to be poor, and reduce the profitability of the established processing facilities. The latter may employ poor urban labor. Examples include cocoa and coffee processors in West Africa that obtain cocoa and coffee beans at prices below the export price; textile firms in Pakistan, India and Francophone West Africa that obtain domestic cotton at favorable prices from parastatal export monopolies or as a result of export taxes or restrictions; leather processing firms in India that buy local and

partly processed hides at low prices as a result of cascading export taxes; cashew nut processors in Mozambique that benefit from export taxes on raw cashew nuts; and cashmere wool processors in Mongolia that benefit from the price reducing effect of an export tax on raw cashmere. In all these cases the export taxes and restrictions are economically inefficient because they reduce the incentive to produce the primary agricultural product relative to the incentive to process it.

In most cases, the net effect on poverty of removing export taxes and restrictions will be strongly positive. There are many more poor farmers that would benefit from export tax removal than there are industrial workers who might lose, and the highest incidence of the most severe poverty is usually found in rural areas. For example, the cashmere export tax in Mongolia reduces the incomes of about 250,000 goat-herding families, the majority of which are poor, with the poorest heavily dependent on income from cashmere. In contrast, there are only about 2,000 workers employed in cashmere processing. Moreover, part of the income the export tax transfers from the goat herders goes to the owners of the processing firms (Filmer, 2001; and Takacs, 1994).<sup>10</sup> As is generally the case, safety net policies for those adversely impacted by export tax elimination should be carefully considered, especially when the impact on processors is severe.

**Box 2: Madagascar's Marketing Board for Vanilla Exports: Taxing the poor**

In 1960 the international market for natural vanilla was dominated by Madagascar, the World's lowest cost-producer of high-quality bourbon vanilla. From its dominant position of 60 percent of world exports of natural vanilla, Madagascar organized the bourbon vanilla cartel with Comoros and Reunion, setting high export prices and restricting supply by regulating its domestic market through a Marketing Board which fixed low producer prices and required licenses to grow, prepare and export vanilla.

If the Marketing Board was to be assessed by the effect it had on export prices of vanilla from Madagascar, it was a clear success. The export price of vanilla increased from US\$10 in the late 60s to more than US\$ 65 per kilo in the early 90s. However, the share of Madagascar in world markets declined to 30 percent as Indonesia (outside the cartel) took advantage of high world prices to develop a high export capacity. The entry of Indonesia into world markets left the total value of Madagascar's exports constant throughout the 1970s and 80s. The Board's interventions in the domestic market had a similar effect on producer prices, which fluctuated around US\$5 per kilo during the 1980s.

Who benefited from the bourbon vanilla cartel and the marketing board's domestic policies? Indonesian producers were the winners, Madagascar's producers the losers. These were small producers (60,000), with an average production of 130 kilos and an average income of US\$650 per plantation. Estimates of producer prices that would have prevailed in Madagascar had the marketing board been abolished are close to US\$26, well above the US\$5 price fixed by the board. Taking into account the increase in production that such a change in prices would have generated, abolition would have increased vanilla producer surplus eight-fold.

<sup>10</sup> Much of cashmere is smuggled out of the country. While this avoids the tax, herders still lose income as middlemen capture much of the difference between world and domestic prices.



An alternative to free-trade would have been to eliminate intervention in the domestic market, but to continue to exploit market power in international markets through an export tax. Estimates suggest that the optimal export tax would have been close to US\$25 per kilo instead of the US\$61 implicit tax that was imposed on producers.

Why were these policies not adopted? A possible explanation is that taxation of small producers generated an important income redistribution from the rural poor to the urban elite.

Source: De Melo, Olarreaga and Takacs (2000).

### 3.7 Export Processing Zones (EPZs)

EPZs are “enclaves” for export production, especially non-traditional exports, that are often used in contexts where economy-wide trade reform is impeded or infrastructure and regulatory requirements cannot be met on a national basis. Effective EPZs combine clear private property rights and investment regulations, no restrictions on foreign exchange, tariff free imports for export production, moderate levels of taxation, streamlined administrative procedures and private sector management. Some of the most successful EPZs are in Mauritius where, in 1994, EPZs generated 71% of gross exports and employed 16.6% of the work force. Mexico has also had successful EPZs. Such zones can not only expand exports, but may also have a significant effect in raising female employment. Bangladesh zones employ a majority of women (70% of Chittagong EPZ employees are women, a much higher ratio than the national average). In the Dominican Republic, EPZ employment was an important factor in decreasing the share of female poor from 22.6 percent to 15.8 percent over the 1986-93 period (Madani, 1999).

Experience has shown that development of EPZs, including provision of infrastructure and management, should be privately handled. Publicly developed and managed EPZs have typically been unsuccessful. Attracting investment into EPZs is a function of many factors, including some that are national—such as political stability and sound macroeconomic management. An overvalued exchange rate will discourage exporting from EPZs just as much as from the rest of the economy. In general, the conditions that make EPZs successful involve the same complementary policies that are required to make a trade reform successful (see below). Consequently, EPZs are best regarded as transitional mechanisms in the pursuit of an overall liberal trade regime.

### 3.8 Other Trade Related Institutions

In addition to the commercial policy instruments discussed above, there are a number of other trade-related institutions that can have important implications for the impact of trade reforms. These include customs clearance, export finance, product standards and access to information on market opportunities.

**Customs Clearance** efficiency and transparency is an important determinant of the costs associated with trade. Burdensome and redundant procedures—red tape—can give rise to substantial uncertainty and are often associated with rent seeking and corruption. Minimizing discretion by simplifying as much as possible the clearance process, including through adoption of international standards for classification of goods, elimination of most exemptions (see below) and providing officials with training and appropriate information technology are important dimensions of trade reform.

**Export finance** is one of the major constraints inhibiting exports in many low income developing countries. Inadequacies may result from the overall weakness of the financial sector or may reflect difficulties in assessing creditworthiness of traders or because traders do not have sufficient assets to be judged creditworthy. To the extent that the poor are involved in trading activities, they may face special difficulties in obtaining access to the trade credit they need—just as they face such difficulties in accessing other parts of the financial sector. While ensuring availability of trade finance is a matter that needs to be left to the private sector, any effort to expand exports and to promote increased opportunities for the poor in the export sector needs to investigate whether credit is a problem. Remedies should be sought as part of overall efforts to increase access to finance for low-income producers. These are discussed elsewhere in the PRSP sourcebook

**Product standards** based on international norms are important to poverty reduction. When standards are used appropriately in international trade (as well as in domestic transactions), they facilitate interconnection of goods and information exchange, and guarantee safety, health, quality or the environment. As the poor have less access to information and do not have the resources to buy higher quality goods and services, they are more dependent on efficient standardization and consumer protection regimes.

In the area of trade, developing countries face a dual challenge: on the one hand they need to reform regulations and establish efficient testing, certification, and laboratory accreditation requirements to minimize the impact on trade while still attaining sanitary, phytosanitary, and product standards. Low-income developing countries need both technical and financial assistance to meet this objective. Institutional arrangements need to be developed to ensure that poor firms (such as farmers, small producers and artisans) have access to standards organizations—through co-operatives and similar collective organizations—and are not unduly penalized by the use of labor-intensive production technologies.

**Marketing** of exports internationally is a challenging task for all low-income countries. They have to overcome problems of lack of information, product and country recognition, and concerns about quality. Foreign partners and FDI can be helpful in providing the necessary contacts and advice; but frequently it is necessary to organize a local association of exporters or producers. When the producers tend to be a large number of small poor farmers, co-operatives and similar ventures can be very helpful in ensuring that the potential benefits from exports are realized by the poor. But competition in these institutions is important or poor farmers may receive lower prices for their outputs

### 3.9 International Cooperation: Regional Integration and the WTO

Most developing countries have formed or are members of regional integration agreements (RIAs). From an efficiency of resource allocation viewpoint, RIAs between developing countries (so-called South-South agreements) are likely to hurt member countries (World Bank, 2000b). The reason is that the trade preferences typically displace efficiently produced low-priced imports from non-partner countries with inefficiently produced high-priced products from partner countries.<sup>11</sup> A solution to this problem is for member countries to lower their external trade barriers, thereby reducing the inefficient

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<sup>11</sup> The impact of North-South or North-North agreements tends to also involve more efficiently priced imports from partner countries and thus may be beneficial.

displacement of non-partner country imports. In fact, a harmful RIA can be turned into a beneficial one by lowering external trade barriers sufficiently.

From the viewpoint of poverty, the effects of an agreement among developing countries are likely to be asymmetric, with the poorer member countries losing significantly and the higher income members likely to gain (World Bank, 2000b). This is, in part, due to the fact that the relatively developed country produces protected manufactures that are imported on balance by the less developed country. With a RIA, the more advanced country sells its protected manufactures at a higher price since its exports are no longer subject to a tariff in the poorer country's markets. This entails a terms-of-trade loss for the poorer country, since it pays a higher price to its partner country for imports it could buy more cheaply from the rest of the world. This problem of asymmetric distribution of gains and losses emerged in the 1960s in the East African Community--where Kenya gained and Tanzania and Uganda lost--and in the Central American Common Market--where El Salvador gained and Honduras lost. In both cases, the more advanced country resisted external tariff reduction, which led to resentment in the less developed member countries and a breakdown in implementation of the agreements.

Lowering external trade barriers is beneficial both from the viewpoint of efficiency and from the viewpoint of minimizing the losses for the poorer member country. In fact, the losses from regionalism, both in overall efficiency and in adverse distributional consequences, can be reduced by lowering external trade barriers. In terms of implementation, in the case of a free trade agreement (such as the planned Free Trade Agreement of the Americas or the ASEAN Free Trade Agreement), each country can lower its tariffs independently, and can thus protect itself from adverse consequences. For a customs union (such as the West African Economic and Monetary Union or MERCOSUR), the member countries must agree to jointly lower the common external tariff. Thus, customs unions among developing countries should be approached very cautiously, since tariff policy is taken out of the hands of national policy-makers.

Space constraints prohibit a detailed discussion of the WTO, which has many provisions that constrain the use of trade-related policies by members, including developing countries (Box 3). See [www.worldbank.org/trade](http://www.worldbank.org/trade) and [www.wto.org](http://www.wto.org) for more information and references to the literature. A major dimension of the WTO that makes it relevant from a poverty perspective is that it provides a potent mechanism for the reciprocal liberalization of trade barriers. Although most major industrialized markets provide preferential access for exports from developing countries, especially least developed nations, trade restrictions remain prevalent especially for agricultural products, apparel and other labor-intensive products.

### **Box 3. WTO and Poverty Alleviation**

The WTO agreements involve legal commitments by governments regarding the rules and policies they follow in the conduct of international trade in goods and services. As such, the Agreements contain no explicit references or direct links to policies affecting poverty. Their impact derives from the trade policies that governments have committed to pursue based on their WTO commitments. More than 100 of the 140 WTO members are developing countries (although the WTO does not define what constitutes a developing nation--this is largely left to self-selection). Almost all the 30+ countries seeking to accede are also developing countries or economies in transition.

Within the WTO agreements, developing countries are supposed to receive special and more favorable treatment (usually referred to as “Special and Differential” Treatment) aimed at addressing their particular circumstances in international trade. The poorest of the developing countries—the 49 countries on the UN list of least developed countries (LDCs) are provided with further additional more favorable treatment. The Special and Differential Treatment provisions involve five sets of measures: (a) developing countries are given more flexibility in terms of their own trade policies—e.g. they have not had to reduce their tariffs significantly in previous multilateral trade negotiations and they do not have to ‘bind’ all their tariffs; (b) their exports can be charged lower preferential tariff rates in developed or other developing country markets; (c) they are given longer ‘transition’ periods to implement provisions contained in some WTO Agreements; (d) developed countries are supposed to provide them with technical assistance to help them implement the commitments they have assumed; and (e) developed countries are to implement their WTO commitments in a manner ‘favorable’ to developing country interests.

WTO provisions in general, and those which apply to developing countries in particular, tend to be quite permissive in terms of the trade policies an individual country can pursue—and hence do not tend to constrain these policies in ways that would harm the poor. On the contrary, they are on the whole supportive of trade and foreign direct investment policies that would tend to promote poverty alleviation. Moreover, the availability in the WTO of an effective dispute settlement mechanism and the guarantee of MFN treatment for all its members can be of special importance to developing countries in their dealings with more powerful developed country trading partners. Thus, it is important for all developing countries to be members of the WTO.

At the same time, the permissiveness of the WTO Special and Differential Treatment provisions has been a problem for LDCs. This has enabled developing countries to maintain higher levels of domestic protection, which has harmed their own economies. And, export subsidies—often used to offset the disincentives of protection—are a drain to the budget, and hence are not affordable, and can not be relied upon to provide sustainable, labor intensive export growth that helps alleviate poverty.

*Source:* For more on the WTO, see <http://www.wto.org/>. Hoekman and Kostecki (2001) provide a general introduction; McCulloch, Winters and Cirera (2001) focus on the poverty-related dimensions of many WTO agreements.

## **4 Complementary Policies to a Trade Reform**

Trade liberalization involves reducing discrimination against foreign suppliers of goods and services. This is achieved not simply by eliminating quotas and reducing average tariffs and dispersion across tariffs, but also by strengthening trade-related institutions, in particular customs and standards bodies. In addition, complementary policies are needed to support trade reform.

### **4.1 Macroeconomic and Exchange Rate Policies**

To be sustained and contribute to an efficient allocation of resources, trade liberalization must be supported by a stable macroeconomic environment and a competitive real exchange rate. Trade reform works through the transmission of price signals. These are

concealed in a regime of high and variable inflation. Thus, macro-stability is a key complementary policy.<sup>12</sup>

A competitive real exchange rate is also crucial to create conditions for continued support of liberal trade policies. With an overvalued exchange rate, import competing industries are at a competitive disadvantage, and this generates political pressures for protection that are difficult to withstand in the face of rising trade deficits and declining foreign exchange reserves (Shatz and Tarr, 2001 provide a more general treatment).

Initially, trade liberalization is likely to lead to a trade deficit because the rise in imports tends to occur faster than the export supply response. A depreciation of the real exchange rate will help to restore a balance between exports and imports since it makes imports more expensive and exports are more profitable in domestic currency. Under a flexible exchange rate regime, the real exchange rate will adjust through market forces. Under a fixed exchange rate regime, significant trade reform should be accompanied by a devaluation of the domestic currency. The required depreciation is larger the greater the extent of trade liberalization and the greater the lags in the supply response (see Appendix).

Without recommending any particular type of exchange rate regime, we note that some developing countries are participants in a currency zone, which limits their capacity to devalue—an example is provided by the countries in West and Central Africa who are members of the CFA zone. Due primarily to currency overvaluation, in the CFA zone between 1986 and 1994 there was no economic growth, when other Sub-Saharan African countries were growing at 2.5 percent annually (Clément, 1994). In fact, for some of the CFA countries (e.g., Cameroon, Cote d'Ivoire) the overvaluation induced an output contraction between 1986 and 1994 comparable to the Great Depression in the United States (Shatz and Tarr, 2001). A number of CFA countries also suffered large increases in poverty (Devarajan and Hinkle, 1994). After the devaluation of 1994, growth strongly resumed. Some countries seek to maintain a fixed exchange rate through the establishment of a currency board or some other arrangement (e.g., Argentina and Estonia). In such countries, to contain output losses, trade liberalization may have to proceed at a pace consistent with the feasible rate of real exchange rate depreciation.

## 4.2 Fiscal Revenue and the Design of Tariff Reform

In 1990, collected trade taxes as a percent of GDP averaged 0.6 percent among OECD countries and 4.4 percent among non-OECD countries.<sup>13</sup> Policy makers in low-income countries may be concerned that reform might substantially reduce government revenue, yielding larger fiscal deficits and inducing inflation. While these concerns have some merit, trade reform need not entail diminished revenues. Many countries have implemented successful trade reform programs without significant loss of revenue. For example, in the

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<sup>12</sup> The relative price of tradable to non-tradable (or home) goods,  $P_t/P_h$ , is typically referred to as the real exchange rate (RER) and is used as a measure of the competitiveness of the tradable sector. The reason is that several of the determinants of  $P_h$  (such as wages) affect the production costs of tradables. Oversimplifying for purposes of illustration, suppose a government runs a fiscal deficit and finances it by printing money. The resulting inflation raises prices in the non-tradable sector. If tradable prices do not increase by the same amount, inflation lowers  $P_t/P_h$  and thus the real exchange rate, thereby reducing the competitiveness of the tradable sector. See the Annex.

<sup>13</sup> Trade taxes as a percent of GDP were: 5.3 percent in Africa, 4.4 percent in Asia, and 3.5 percent in the Middle East. Ebrill et al. (1999).

1990s, Ghana, Kenya, Senegal and Malawi implemented trade reforms without a significant loss in revenue as a percent of GDP (Ebrill *et al.*, 1999).

Perhaps the foremost reason why trade reform need not lead to a loss of revenue is that developing countries have traditionally relied heavily on quantitative restrictions of imports. Government revenue increases when quantitative restrictions are converted into tariffs. Reduction of tariffs should start with the highest ones. Also, where tariff rates are very high initially, they will generate little or no revenue. Reductions of the tariffs to more moderate levels will increase imports and thus revenues, as the incentive to smuggle is reduced. Moreover, exemptions often are a significant source of revenue loss and their reduction increases tariff collections. Finally, an exchange rate depreciation, which should accompany significant tariff reduction, will raise the local currency value of imports and thus tariff revenue.

**Box 4. Summary of Revenue Impacts of Trade Liberalization**

<b>Trade Reform</b>	<b>Expected Revenue Impact</b>
Replace NTBs with tariffs	Positive
Eliminate tariff exemptions	Positive
Eliminate trade-related subsidies	Positive
Reduce tariff dispersion	Ambiguous/Positive
Eliminate state trading monopolies	Ambiguous/Positive
Reduce high average tariffs	Ambiguous
Lower maximum tariff	Ambiguous
Reduce moderate or low average tariffs	Negative
Eliminate export taxes	Ambiguous/Negative

*Source:* Sharer *et al.* (1998).

When tariffs rates are already uniform and in the moderate to low range, then further tariff reduction is likely to result in revenue loss. Only in this latter case does revenue represent a genuine problem for trade liberalization. Alternate broad-based and nondiscriminatory revenue sources should be sought, and trade reform sequenced to coincide with the availability of these alternate revenue sources. Such alternative, broad based tax instruments will be more efficient (much less distorting) than trade taxes. For many products, such as alcohol, tobacco and petroleum, collection of taxes on domestic production as well as imports will have very low additional administrative costs, and will reduce the incentives to develop inefficient import-substituting firms. Even very poor countries such as Cambodia have been able to introduce broad-based consumption taxes that reduce dependence on customs duties, and raise much-needed revenues for development expenditures.

**4.3 Labor and Other Factor Markets**

Where labor market flexibility is low, reforms to improve the operation of labor markets should accompany trade reforms in order to enhance labor mobility. For instance, in Peru in the 1980s, a trade reform failed to generate any supply response because of severe labor market rigidities. Labor legislation prohibited firms to shed labor, close plants or even change activities. This led to many bankruptcies, contributed to foreign exchange and financial crises and a failure of the reform (Nogues, 1991).

The poor are often concentrated in the informal sector and reforms which increase labor mobility in the formal sector can have a powerful effect on reducing poverty when combined with trade liberalization by opening up additional jobs in the formal sector for workers previously in the informal sector. This was the case in Panama, for example, see World Bank (1999). The mutually supportive relations between trade, macroeconomic, labor market and other policies may then serve to increase the credibility and payoffs of each.

Property rights for land (and water) are also important in coping with needed adjustments or taking advantage of export opportunities that may be beneficial to the poor. For example, Egypt could produce labor-intensive crops (fruits and vegetables) for export to the EU, as is done in other Mediterranean countries, and the rural poor could gain significantly (Barres and Valdes, 2000). But because of the lack of existence of land (and water) markets, Egypt has not taken advantage of this opportunity and continues to grow traditional crops.

#### 4.4 Competition Policies

In manufacturing, prices paid by poor consumers are affected by competitive conditions in the country. It is possible to increase the competitiveness of markets for manufactured goods in developing countries, that is, reduce the markup over the cost of production by lowering external barriers to international competition as well as by reducing government imposed barriers to entry against *domestic firms*. Both are important in providing goods to poor consumers with low monopoly markups. In small countries an open trade regime is especially crucial, since there are fewer domestic firms contesting the market. In large countries, administrative and legal barriers against domestic entry are relatively more important than in small countries since there are more potential entrants blocked by domestic barriers to entry (Hoekman, Kee and Olarreaga, 2001).

#### Box 5. Rural Poverty, Cotton and Parastatals in West Africa

In most of Francophone Africa, the national parastatal company is the sole authorized purchaser and processor of the farmers' seed cotton, and the sole seller of the joint products of ginning: cotton lint and cotton seed. It also supplies inputs to the farmers, owns and operates all the cotton gins, and provides the transport needed to supply the inputs to the farms, the seed cotton from the farms to the gins, the lint to the ports or to local textile firms, and the seed to local oil mills or to other markets. It is also responsible for the sale of the lint, nearly all of which is exported.

Cotton has proved to be an economically very efficient crop and has made major contributions to the development of rural areas, exports, poverty alleviation and growth. The share of cotton lint exports increased from about 4 percent of world trade in cotton in the mid-1970s to about 15 percent in 1997. However, the absence of any competition in the purchase of seed cotton from farmers has implied that farmers have been paid prices for their seed cotton that tend to be far below competitive levels. In terms of lint equivalent, seed cotton prices in the Francophone African countries have generally been within a range of 40 to 50 percent of the export price of cotton lint, compared to ratios averaging almost 90 percent in India and around 80 percent in Zimbabwe.

Detailed comparative analyses of costs show that only a small part of the low Francophone seed cotton prices can be explained by higher transport and operating costs. More important are high government taxes (including special taxes on parastatal profits and export taxes on cotton lint), and implicit taxes from sale of lint to domestic textile firms at low prices and periodic costly management mistakes and corrupt

practices. Simulations suggest that removing this taxation would generate large percentage increases in seed cotton prices for farmers, varying from 45 percent in Cameroon to 87 percent in Burkina Faso, expand output, and increase real farm incomes. Another problem with parastatals is that they typically impose pan-territorial prices whereby they pay the same price for all locations (and times of the crop year). These subsidies for transport and storage eliminated any incentive for private provision of these services, and resulted in production in socially inefficient locations. The parastatal monopoly also prevented the development of private credit services.

Allowing private firms to provide the services of the parastatal and permitting farmers to contract with private firms can be expected to greatly improve efficiency and have distributional advantages for poor farmers in the long run. However, it is important to pay attention to supporting services and markets (such as credit and transportation) during the transition to a market based system. It is also possible that the elimination of pan-territorial pricing will have a negative effect on poor farmers that are located in isolated regions. As is frequently the case, not all will necessarily gain, pointing to the need for a social safety net.

Source: Pursell (1998).

An important sector in the context of trade reform is distribution. If there are barriers to entry into distribution, those who control this sector may be the primary beneficiaries of trade liberalization, pocketing much of what used to be collected as tariff revenue and not passing the tariff cut on to consumers. In agriculture, parastatal marketing boards often strongly restrict competition for the products of poor farmers and restrain their incomes (Box 5). Elimination of these boards, while paying attention during the transition that key ancillary services like transportation and credit that these parastatals may be providing continue to be supplied, should benefit the poor. But competition among private firms is also important. Thus, exclusive government licenses to the private sector should also be avoided so that poor farmers do not have to pay excessive prices for their inputs or receive monopsonistically depressed prices for their outputs. The prescription applies to import monopolies and exclusive distribution arrangements.

#### **4.5 Foreign Direct Investment (FDI) and Intellectual Property Protection**

FDI is an important channel of technology transfer across national boundaries. Multinational corporations account for a large share of the world's research and development, and more than 80 percent of royalty payments for technology transfers flow from subsidiaries of foreign companies to their parent firms (UNCTAD 1997). Econometric evidence tends to support the view that developing countries receiving FDI perform better in terms of productivity than their counterparts that are not FDI recipients.

What matters from a poverty reduction perspective is whether and to what extent FDI has a positive effect on the incomes (employment) of the poor and on the prices of what they consume. As far as employment is concerned, it is important from a short run viewpoint that FDI involve labor-intensive production and result in the transfer of skills through training. Improvements in communications, transport and information technology, together with global trade policy reforms, have made it much more attractive to companies to engage in so-called outsourcing and processing trade, where the labor-intensive parts of production are located in developing countries. In the 1970s such FDI focused in particular on textiles, more recently it has also included the electronics and auto parts



sectors. Such investment can be an important catalyst for the creation of low skilled employment—as exemplified by Mexico and South-East Asian economies.

Given the importance of low trade costs for such activity, policy makers should avoid offering trade protection to foreign investors, since this will attract the ‘wrong’ type of investment from an employment creation perspective by depriving the host country of the benefits from participation in international production and distribution networks. Protection may also result in losses to the host economy by providing rents to foreign investors at the expense of domestic consumers. Lall and Streeten (1977:172-174) studied some 90 foreign investments, using a cost-benefit methodology, and found that more than 33% *reduced* national income; this was mainly due to excessive tariff protection that allowed high cost firms to produce for the local market at very high prices, even though they could have been imported much more cheaply. Encarnation and Wells (1986) found that between 25-45% of 50 projects studied (depending on analytical assumptions) reduced national income; again the main culprit was high protection.

Intellectual property right protection can be important in attracting FDI in sectors that rely extensively on patent protection, helping to tilt the focus of investment projects toward manufacturing and away from distribution (Smarzynska, 2000). Intellectual property protection is of direct importance to the poor in developing countries, especially for products and sectors that rely heavily on traditional knowledge and culture, including ethno-botanicals, as well as activities such as writing and performing music. The absence of effective protection of intangible assets and intellectual property can have very adverse consequences for the poor that are either producers (e.g., handicrafts) or the beneficiaries of assets that have been built up over time (e.g., traditional designs, plant varieties). The costs of intellectual property rights include the price increasing effect of protection. This can have harmful effects on the poor by preventing access to drugs and keeping prices far above the cost of production. As discussed at greater length by Maskus (2001), intellectual property right protection must be complemented by trade and competition policy instruments that serve to offset the market power granted to right holders.

## **5 Sector Issues**

In many developing countries the manufacturing sector has been most protected as a means of promoting industrialization and longer term development. A great deal of the analysis regarding trade reform in earlier sections focuses implicitly on reforms in that sector. However, trade reforms in agriculture and services provide significant opportunities for employment and incomes of the poor as well as reductions in the costs of their consumption.

### **5.1 The importance of agriculture**

Because the poor in developing countries are often located in rural areas and employed in agriculture, how trade reform affects agriculture will critically affect its overall impact on poverty alleviation. Agricultural importables (mainly staples) are typically protected, while agricultural exportables are often subject to export taxes. Agriculture as a whole has tended to be taxed indirectly through protection of the manufacturing sector, overvaluation of the real exchange rate (Schiff and Valdes, 1992, 2000), and the operation of marketing boards or similar parastatals (see above). Trade reform, which should cover both agriculture and manufacturing, will therefore typically raise agriculture’s domestic terms of trade and help the rural poor. The same is true for improved macroeconomic and fiscal

policies that result in a real exchange rate that is closer to a sustainable equilibrium. In other words, the rural poor will generally benefit from trade reform, even when it includes agriculture.

Some of the rural poor, however, may lose. Foremost among these to consider are those who are employed or produce in sectors that are highly protected, low-productivity sectors. Examples include maize in Mexico, wheat in Morocco, and various import-competing crops in many developing countries. If the mobility of these rural poor is limited, then a reduction in the tariffs in that sector is likely to hurt that sub-group, especially in the short term, as prices of their output fall. Over time these losses can be minimized as farmers change their output mix and produce more of the crops whose prices did not fall. In a study on the Northeast of Brazil, one of the world's poorer regions, switching to more profitable crops after trade liberalization and devaluation greatly reduced negative real income effects for small farmers (Lopez and Romano, 2000). Thus, trade liberalization accompanied by devaluation (see sub-section 4.1) can help dampen the short-term effect on incomes of the rural poor.

The ability to shift to the production of new products (possibly exportables whose price has risen) may depend importantly on necessary complementary reforms. Shifting crops may require restructured land arrangements, additional capital or access to water. If markets for these factors are poorly developed, farmers may be unable to take advantage of new opportunities. Thus, complementary reforms that focus on these markets may be necessary to help poor farmers. Given that poor farmers may be hurt in the short run, compensation policies such as improving rural infrastructure, research and development, and creating educational opportunities for children are important. These options will almost always be better than protection, as only if farmer's returns outside agriculture are increased will poverty be reduced in the longer term. As far as trade reform itself is concerned, one option to consider is to phase down tariffs in the vulnerable sector gradually following a pre-announced schedule. This is what was agreed for the maize sector in the NAFTA negotiations between the US and Mexico. Experience shows that unless a schedule of tariff reductions is pre-announced and actually implemented from the start, reforms with long transition periods (typically over five years) lack credibility and provide lobbyists with time to defeat reform.

**Fluctuating world prices.** The liberalization of a country's agricultural trade policies means not only adjusting to lower or higher general price levels prevailing in international markets, but also to the fluctuations in world prices of agricultural commodities. In many countries, the impact of these fluctuations on the domestic economy is a major motivation for interventions that de-link domestic and international markets. Export and import controls, government controlled parastatals or marketing boards, and variable tariffs all reduce the size of the international market in which the commodity is freely traded and thus increase the sensitivity of international prices to exogenous shocks such as bumper harvests and crop failures. For example, international trade in rice is equivalent to only 5 percent of world production. More important, the extent to which some of the largest producing and consuming countries (e.g. China, India, Indonesia, and Brazil) import or export is subject to discretionary government controls. Policies by these countries aimed at stabilizing domestic prices can have a very large impact on prices in the narrow international market, in turn leading to pressures to maintain or increase border interventions elsewhere. For this reason, all countries have a common interest in reducing the instability of world prices by opening their domestic markets and removing policies which de-link domestic from world markets.

Although policies to open domestic markets, especially in large countries—both developed and developing<sup>14</sup>--have the potential to substantially reduce the amplitude of fluctuations in world commodity prices, these prices are inherently less stable than the world prices of manufactured goods and the prices of services.<sup>15</sup> In any case, most individual small countries cannot on their own have any perceptible effect on the level or volatility of world commodity prices, and need to find the best way to live with the price swings that they must by and large take as a given. Consequently, trade liberalization in any individual country, if fully implemented, will often (but by no means always) mean that domestic commodity prices, including prices at farm level, will become more unstable.<sup>16</sup> Farmers in many countries have repeatedly shown that they can adjust rapidly and efficiently to relative price changes. For there to be an overall welfare improvement from sheltering farmers from price fluctuations, the extra income of the groups that benefit from interventions must outweigh the net economic losses consequent on distorted consumer prices and changes in the government's fiscal position. If all changes in income, including government income, are weighted equally in the decision-making process, the costs of intervening will always exceed the benefits. It is generally better to target the low income groups that are hurt with actions that increase the ability of farmers and workers to switch between crops, complemented with welfare and workfare programs until a reasonable degree of flexibility and responsiveness is achieved.

In considering price stabilizing policies, it is important to recognize that once such policies are introduced, it is very difficult if not impossible to stop the politically powerful from using them to shift the average price. The commodity marketing boards and parastatal monopolies in developing countries discussed previously often stabilized prices at very low levels relative to world prices, implying heavy taxation of small farmers and resource transfers to governments and local processing interests. This may seriously retard the growth of economically efficient rural industries and slow down the contribution that their expansion could make to the alleviation of rural poverty. For import substitutes, the political economy forces generally point in the opposite direction, and intervention originally justified in the name of price stabilization (e.g. price band schemes introduced in Latin America during the 1990s) very often become de facto price support schemes that develop a momentum of their own.

**OECD intervention.** Export subsidies on products such as meat, dairy products and grains, depress prices on world markets, and thus also on the domestic markets of developing countries. Some countries such as Japan maintain very high barriers against imports of wheat, rice and other agricultural commodities. As mentioned, such policies

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<sup>14</sup> For example, if the markets for rice, wheat, sugar, milk products, sugar and cotton were open in China and India, that would greatly expand the size of the world market for these products and reduce the impact of various exogenous shocks (Tyers and Anderson, 1992).

<sup>15</sup> Abstracting from fragmented world markets, commodity price instability is associated with inelastic demand, lags in supply adjustments due to seasonal production, weather conditions etc.

<sup>16</sup> Prices in domestic commodity markets (e.g. for sorghum and maize in inland areas of Africa and South Asia) that are disconnected from world markets by a combination of high domestic and marketing costs and/or restrictive trade policies, may fluctuate more than world prices both within and across seasons. Linking them to world markets by opening imports could increase price stability, e.g., by cutting off price peaks resulting from crop failures. The use of measures to control imports and exports in ways that do not adjust flexibly to domestic market conditions may also lead to higher domestic price instability than in world markets, or worse still, to costly and wasteful accumulations of excess stocks held by government marketing organizations. A significant portion of such stocks often are lost to pests and weather.

contribute to world market price instability, constrain exports and increase import competition. While most of the poorest developing countries produce temperate zone-products such as fruits, nuts and vegetables that do not compete with subsidized and protected meat, milk and grains, for some low-income countries (e.g., meat production in Mali or Burkina Faso), and, of course, for middle income developing countries such as Argentina or Brazil, EU export subsidies are a major factor constraining agricultural exports.

What is the appropriate response to such foreign policies? Insofar as prices are forced downward, consumers tend to gain. The impact of the policies on producers depends on whether farmers compete with subsidized imports, whether the subsidies vary significantly over time, whether farmers are on average net buyers or net sellers of the commodities concerned, the relative importance of subsistence farming, and the relative sizes of the rural and urban poor population. If there is no domestic production of the agricultural products concerned, there is no need for intervention, as subsidized prices are beneficial to consumers. Matters are more complex in instances where there is domestic production of the commodities concerned. It is important to note that households that are net buyers of the products will gain from subsidies, while subsistence farmers will be unaffected. The urban poor will generally gain insofar as the subsidies lower prices. Thus, what matters from a policy point of view is whether the gains to the non-rural poor are larger than the losses incurred by rural households that are net sellers. To answer this question requires collecting information on the number of households that are engaged in subsistence production, those that are net buyers, and those that are net sellers. Another important factor concerns the distribution of the labor force engaged in production in farms that are net sellers. Those that own the land may lose from lower prices, but the extent of such losses are bounded (as they may shift to subsistence farming). While this can imply a severe reduction in real incomes, landless laborers working for net sellers confront the most severe potential loss in that they may lose their source of income without having subsistence farming to fall back on.

In cases of agricultural sectors with significant numbers of households that are net sellers of commodities that are subsidized by OECD countries, it is sometimes argued that higher tariffs on agricultural imports are appropriate. This increases the domestic price, thus helping to offset the effect of the subsidy and allowing domestic producers to compete. This is akin to 'countervailing' the effect of foreign policies. From the viewpoint of efficiency, when subsidies are permanent, such a policy is not desirable as it moves the structure of protection away from uniformity, and distorts producer and consumer choices. Given the long-lasting nature of intervention by high-income countries, countries should regard this as part of the external environment. The implication is that importing country governments should not impose countervailing tariffs.<sup>17</sup> However, with the Uruguay Round, multilateral disciplines were strengthened, and it is clear that there will be significant pressure on the EU and other high-income countries to substantially reduce protection and gradually eliminate export subsidies in the coming decade. Thus, over time

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<sup>17</sup> A key issue is whether the export subsidies are permanent or transitory. If the subsidies are permanent, it will be in the country's interest to ignore the subsidy for policy purposes because the economic costs of protection to the economy outweigh the benefits to domestic producers. If the foreign subsidy is permanent, then the national interest is unaffected by whether the price is low because of foreign comparative advantage or export subsidies. If the subsidies are transitory (and there are capital market or other imperfections), there is a case for temporary protection for those tariff lines subject to competition from subsidized exports so that adjustment costs can be minimized—see below.

the external environment is likely to become less distorted. Insofar as developing countries currently maintain above average tariffs on the relevant agricultural imports, there is then a potential case not to reduce these as much or as rapidly as tariffs on other products as part of an overall trade policy reform.<sup>18</sup> The reason is that liberalization could give rise to inefficient reallocation of resources if there are adjustment costs associated with the downsizing of agricultural production following liberalization and the subsequent expansion as the export subsidies and OECD protection are reduced.

In practice, however, OECD liberalization can be expected to take a long time, witness efforts to do so over the past 30 years. Moreover, it will be impossible to precisely countervail the impact of foreign policies on world prices; the information requirements for such a policy are substantial. Account should also be taken of the risk that protection may become permanent even if the foreign protection and export subsidies come off, and, more fundamentally, that trade intervention is a second best approach to dealing with the problem. The best policy is to push for the phase-out of export subsidies and OECD protection of agriculture in the WTO context, and ensure that any assistance provided to domestic farmers is designed primarily to target domestic poverty concerns. More generally, whether or not foreign countries intervene in agricultural markets should not be the focus of policy. Instead, the focus should be on determining how large is the population that may lose from trade liberalization in the short run, that is, net sellers of protected commodities.

While trade policy is not the appropriate long-term instrument through which to pursue rural poverty reduction objectives, it can play a role in three situations. The first is to deal with temporary import surges that have a significant negative impact on the livelihood of poor farmers. In such cases a special safeguard mechanism can be considered, under which temporary protection can be sought if domestic prices of products that are of importance to the poor in terms of production and employment fall significantly in a short period of time due to imports. Whether these are subsidized does not matter; what matters is that there is a serious detrimental impact on poor farmers. The general design of any such safeguard mechanism should conform to the principles set out in section 3.3 above. The second situation is if the overall policy regime discriminates against agriculture, i.e., policy favors industrial production and/or urban consumers of food. While this can be used as an argument in favor of higher protection for poor farmers in low-income countries, the appropriate policy is instead lowering protection for industry and offsetting any prevailing policy bias against the rural poor. In contexts where this cannot be achieved, or where it is pursued gradually, there may be a case for maintaining higher rates of protection on agricultural commodities on second-best grounds. Third, in situations where complementary policies (safety nets) are inadequate and a significant number of the poor are engaged in production of commodities that are sold domestically, agricultural trade policy reform should be gradual, involving a pre-announced schedule of tariff reductions.

Potential negative impacts of reform in this sector on net sellers can be attenuated by accompanying the trade reform with a devaluation and implementing complementary reforms in markets for land, credit and water to enable farmers to take advantage of the new opportunities, adjust to changed incentives and benefit from the reform. Government has an important role to play in fostering agricultural and rural development, including

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<sup>18</sup> If agriculture import barriers currently are not higher than for manufactures, there is no rationale for raising them given that adjustment will already have taken place.

through encouraging absorption of new technologies, education and providing infrastructure. Such complementary policies are crucial in that they can be critical in addressing the needs of the rural poor. In all cases there is a need for careful analysis of the prevailing situation before reforms are pursued. This should focus on identifying the balance between rural net buyers, rural net sellers, and the urban poor, as well as the importance of subsistence farming.

A final remark. For the least developed countries, a key challenge is meeting the standards and rule of origin requirements imposed under preferential arrangements granting duty-free access. By allowing goods produced in these countries to receive high prices in major export markets, but goods to be imported at world prices, they allow the poorest countries a double benefit. Preferential access provides a positive incentive to produce these products for sale in the highly protected markets of the OECD countries that grant such access. In effect, the preferential access provides protection to LDC producers in the developed country markets that offer preferential access. As these markets are both vastly larger than their own, and offer very inflated prices due to protection, this may allow farmers in LDCs to increase their incomes by producing more of these products for export.<sup>19</sup>

## 5.2 The Role of Services

Services—which include activities such as transport of goods and people, financial services (banking, insurance) telecommunications, distribution, tourism (hotels and restaurants), construction, as well as education and health care, account for a rising portion of GDP, in even in the lowest-income countries. The importance of an efficient service sector goes beyond the contribution of the services sector itself to the balance of payments, because the efficiency of many service sectors is a key determinant of the competitiveness of firms. Key sectors that influence the ability of firms to participate in world trade are telecommunications, transportation, financial services and other business services such as accounting and legal services.

The gains from eliminating barriers to competition in the various business services can be very large and fundamentally effect the country's comparative advantage and pattern of trade (Markusen, Rutherford and Tarr, 2000). As nations reduce barriers to trade in goods, it has become apparent that in many countries, inefficient business services sectors have become the principal barrier to effective integration in world markets. Inefficient provision of trade-support services acts as a tax on exporters of merchandise goods and ultimately on growth and poverty reduction. Establishing policies that encourage competitive and efficient services sectors, such as allowing entry where possible and encouraging foreign direct investment should therefore be a major element of global integration and poverty reduction strategies. In particular, projects that address restructuring and reform of service sectors should take into account the importance of establishing a regulatory environment that is contestable.

Liberalization of services sectors means reduction or elimination of barriers, where barriers tend to take the form of prohibitions, quantitative restrictions and regulations (UNCTAD and World Bank, 1994). For example, such restrictions may prohibit foreign

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<sup>19</sup> Farmers in middle income countries may face different incentives, as they will suffer a decline in demand for their products in the EU because of preferential access provided only to the LDCs.

direct investment in certain sectors, limit the share of ownership of foreign firms in these sectors, limit the number of expatriates that can be employed, or restrict the amount of imports of a particular service. Frequently the restrictions apply to both domestic and foreign suppliers and result in public sector monopolies in the provision of services, e.g. in air and maritime transport (inclusive port services), telecommunications, or financial services. In many such cases, elimination of public sector monopolies may need to be accompanied with opening up of service markets to foreign direct investment (e.g. through relaxing of provisions regarding the right of establishment of foreign firms) because it is the foreign providers that may be able to provide significant improvements in efficiency and cost reductions.

There is evidence of a positive relationship between private competitive provision of telecommunication services and the availability of telephone lines at affordable rates. This is especially true in countries where initial conditions are characterized by a low teledensity or service rationing (long waiting lists for obtaining connections). Simply letting the market work can substantially improve access in an environment where services have been traditionally provided by inefficient public monopolies—even in the poorest countries and among low income consumers.

For many internationally traded goods, the cost of international transportation is higher than the applicable tariff on imports. For a small economy confronting given world prices of traded goods, higher transport costs reduce export prices and increases prices of delivered imports. Hence, exporting industries with higher transport costs must pay lower wages or accept lower returns on capital. Amjadi and Yeats (1995) find that freight rates for Sub-Saharan African countries often are considerably higher than on similar goods originating in other countries and thus have contributed to the region's poor trade performance over the last decades. High transportation costs are due in part to anti-competitive policies, such as cargo reservation schemes maintained by a large number of African countries and international shipping cartels and legislated monopoly providers in both industrialized and developing countries (Francois and Wooton, 2001; Fink and Mattoo, 2001).

#### **Box 6. Liberalizing Trade in Transport Services**

Shipping deregulation in Chile started in 1979 and aimed at dismantling a system based on cargo reservation protection for the national fleet. The core of the reform was eliminating restrictions on foreign shipping companies to supply international transport services. In addition, monopoly rights in cargo loading operations in Chilean seaports were eliminated, allowing the entry of new private operators and the development of a competitive market for cargo handling services. Moreover, the government tripled port capacity by obtaining labor flexibility. It did this by paying the union for the right to use workers not under union contract which allowed it to move from a union-constrained eight hour day to 24 hour cargo handling. This led to a significant cost reduction and an increase in exports, particularly the time-sensitive agricultural exports that are intensive in rural labor. Demand increased especially for female labor involved in picking, sorting, selecting and packing of fruits and vegetables

The new status quo proved beneficial during the 1981-82 economic crisis, as Chile's exporters had "untrammelled access to the international shipping markets" and were able to supply more price-competitive products. Chilean fruit exporters entered into long-term contracts with international shipping enterprises to ensure regular service, guaranteeing rapid transit and certain timing of delivery, essential requirements on the highly competitive export fruit market.

Denial of access to foreign-owned transport companies to domestic inland routes can also be important in cutting off a region to international trade. China provides an example: exporters from inner China typically send goods to ports in a break-bulk form by truck or railway, where the goods are containerized and shipped. Multinational companies, however, require access to container transport from door-to-door. This multimodal transport requirement cannot be met given low inland penetration of containers, so that most export industries locate on the coast and often import raw materials and intermediates from abroad rather than source from mainland China. Lack of competition was a major factor: two state-owned companies (SOEs) had around 80% of the market for freight forwarding and shipping agencies. Although the government allows major foreign shipping lines to establish freight forwarding arms in China, they may only handle parent companies' products. Restrictions on shipping agencies are even more sweeping: government rules bar foreign or joint venture from entering the shipping market, limiting it solely to SOEs.  
*Source: Bennathan(1989) and World Bank (1996).*

The case of Zimbabwe's vegetable exports illustrates the enormous possibilities when transport and related services are efficient. In the early 1990s, farmers near the capital have been supplying fresh vegetables to the London market by picking them, immediately trucking them to the airport, and flying them overnight to London where they are on the shelves ready for sale in the morning. This requires cheap and reliable air transport and modern telecommunications because the shipments are delivered to order (Krugman, 1998). In the Maghreb, Amiot and Salama (1996) estimate that eliminating restrictions on ship registry in Morocco could lead to 25% savings on the maritime transport costs for clothing and footwear. All Algerian and Moroccan ports, as well as the main ports in Tunisia, are operated by inefficient government-owned cargo-handling companies, which charge 30% in excess of the rates that would be quoted by a private independent operator. Licenses required by exporters and importers to charter vessels also create barriers to international trade, since permission to charter is granted only if the national shipping line withdraws. This is estimated to cost an additional 20% over the usual international freight rates.

**Services reform and the poor.** Although the poor spend less of their income on services than the non-poor, significant benefits can accrue to the poor from increased efficiency of services markets. Services such as transport, education, and access to communications and finance are vital determinants of the ability of the poor to find employment and market their production. The incomes of the rural poor are strongly dependent on marketing and transportation costs, and on the efficiency of transportation networks. High transport or marketing costs lower the prices received by poor farmers and raise the prices of food to poor consumers. Competition in these sectors is very important to poverty reduction, as are resources devoted to "trade facilitation" to improve the efficiency of service networks and reduce corruption and related transactions costs.

Recent research based on household surveys found that farmers' access to a public telephone is positively related to the price they receive in district markets for their farm output. Decreasing the distance to a telephone by 10 percent would lead to a 1.6 percent increase in local prices (Larson, 2000). In Bangladesh villages, women entrepreneurs provide pay phone services at a profit, using mobile cellular technology. Even though rural villagers cannot afford a phone individually, they can afford one collectively (Lawson and Meyenn, 2000). A key aspect of services liberalization is that it



often involves the movement of factors of production because the services concerned cannot be traded. Given the structure of factor prices in poor countries, an inflow of capital through FDI would tend to be to the advantage of the unskilled poor—increasing employment opportunities and wages.

Liberalization of services and the resultant competition are likely to lead to lower prices, greater availability and improved quality of services. In so far as the poor are consumers of these services, they are likely to benefit. But there is a twist. Frequently, the prices pre-liberalization are not determined by the market but set administratively, and are kept artificially low for low income end-users. Thus, rural borrowers may pay lower interest rates than urban borrowers, and prices of local telephone calls and public transport may be kept lower than the cost of provision. This structure of prices is often sustained through cross-subsidization within public monopolies or through government financial support. New entrants may focus on the most profitable market segments (“cream-skimming”), such as urban areas, where the cost of service provision may be lower and incomes higher. Privatization could mean the end of government support. The result is that even though the sector becomes more efficient and average prices decline, the prices for low income households may actually increase and/or availability decline.<sup>20</sup>

Universal service or access goals are not contradictory with liberalization of service markets. The handicap of providing services to low income households can in principle also be imposed on new entrants in a non-discriminatory way. Thus, universal service obligations can be part of the license conditions for new entrants into fixed network telephony and transport. But recourse to fiscal instruments has proved more successful than direct regulation—for example, through universal service funds or subsidies for providing services in rural areas. Another effective mechanism is to fund the consumer rather than the provider through vouchers, as has been the case for education and energy services in a number of countries (Mattoo, 2001).

**Assessing services policy and performance.** A careful evaluation of services trade policy requires analysis of the conditions of competition in a particular sector, notably restrictions on entry; ownership limitations, private and foreign; and regulation, especially elements designed to achieve pro-poor outcomes in competitive markets. Relevant questions for policy-makers include: How much greater would the benefits be if privatization were accompanied by the introduction of competition? Are there good reasons to limit entry by policy? What institutional features promote the effectiveness of a sector regulator? What should the regulator regulate? What are the costs and benefits of restrictions on foreign ownership?

In many countries, an assessment of policy and performance in services is frustrated by a dearth of data. Main performance indicators include price and quality variables and measures of access and availability of services to the poor. Detailed templates for an assessment of policy and performance in services in a particular country have recently been developed by the World Bank for three key services sectors.<sup>21</sup> These can be used to benchmark countries against international experience.

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<sup>20</sup> In the case of agricultural exportables, increased domestic transport efficiency to the port will typically raise inland farmgate prices. This could worsen the welfare of low income consumers of that product in inland areas.

<sup>21</sup> They cover telecommunications, air and maritime transport, and financial services and are available at <http://www1.worldbank.org/wbiep/trade/services.html>.

## 6 Coping With Uncertainty: The Role of Safety Nets

One of the most important complementary policies for the poor is an efficient social safety net. It is highly recommended that a program to establish a social safety net be in place independent of the needs related to trade liberalization. The best outcomes for the poor can be expected when as a result of the overall reform process, of which trade is a part, growth accelerates in the economy as a whole. Especially in the short run, however, there are bound to be some effects on some groups of poor who may be incapable of sustaining even short periods with adverse adjustment costs. One needs to be especially careful regarding the effects of any reform on the poor, as they are least able to bear risks because they do not have the savings.

An important issue that confronts all trade policy reforms then relates to the hardship faced by poor workers in import competing activities who lose income following import liberalization. The policy choices broadly defined are: employ general social safety nets; establish safety nets targeted to those who are harmed by the trade reform; and selective limitation of the reforms or intervention in markets for the purpose of limiting the impact of market reforms on the poor.

One type of market intervention is based on the view that opening up to world markets will increase risk because world markets are typically unstable. However, poor countries are also subject to large domestic shocks and it is unclear whether openness to trade increases risk. Government attempts to reduce the risk of trade openness through marketing boards and similar institutions aimed to cushion the impact of international price fluctuations on producers, especially the poor, have often been counterproductive. As discussed above, many of these agencies have imposed significant taxes on the poor. Experience with these institutions reveals the risks for the poor of efforts by governments to limit the scope of market reforms, even when these limitations are intended for their benefit. A fundamental problem in using government interventions that limit market reforms ostensibly for the benefit of the poor is that these interventions are subject to political lobbying. The poor typically lack political power, so that political intervention in market processes will typically result in outcomes that are even worse for the poor (see above). A variety of efforts are underway in many countries to replace parastatals and similar bodies with more efficient, private sector entities.<sup>22</sup> In low-income countries such alternatives may not be a viable option, however. As noted earlier, complementary actions may be called, such as improving and reducing the cost of education to poor households.

Specialized safety nets linked to trade reform have a spotty history. In practice difficult to distinguish workers who are harmed due to trade reform from those who are harmed due to normal turnover or displacement in an economy. The United States has been providing trade adjustment assistance (TAA) to workers displaced by international trade since 1962 (not linked to poverty). The US program provides both monetary compensation (called Trade Readjustment Allowances, TRA) and retraining. In the early years of the program, it was found that income support was typically provided to workers who were not permanently separated from their employers, i.e., the program was not well targeted (Corson and Nicholson, 1981). However, changes in the design and monitoring

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<sup>22</sup> For example, the International Task Force on Commodity Risk Management seeks to establish market-based price insurance schemes that would reduce the price risk farmers (especially the poor) have to shoulder in exporting cash crops.

of the program in 1982 and 1988 have resulted in better targeting (Decker and Corson, 1995).

The results of retraining programs appear to be mixed. When retraining is required, as in the U.S., it may be ineffective. More generally, the effectiveness of retraining programs tends to increase if they are demand driven, so, for example, subsidized apprenticeships in the private sector may work better than government provided training programs.<sup>23</sup> An alternate approach to requiring retraining is to require the participation in a job search program. This appears to increase the likelihood of employment and reduce unemployment benefits among recipients (Johnson and Klepinger, 1991; Decker and Corson, 1995).

Fundamentally, it is difficult to morally justify safety net programs to poor people who are harmed due to trade reform and deny assistance to other poor people who suffer equivalent harm from fluctuations such as technological displacement or price changes due to domestic demand shifts. Consequently, it is best to employ general, country-wide, safety nets to deal with problems linked to trade reform, rather than establish special safety net programs for trade related problems. As the main need for the poor during a difficult transition period is likely to be food, one approach is a time limited food subsidy and distribution program. Targeting a food subsidy, however, is difficult and where it has been done, it has been subject to abuse.<sup>24</sup> An alternative is an untargeted subsidy on inferior goods, as has been pursued in Egypt (Adams, 2000), although Egypt's program has been permanent, not temporary.

Direct income support tends to be the most efficient type of social safety net, provided it can be administratively arranged. A problem is that it is very hard to identify who actually needs the money and even harder to get it to all those who need it. One approach, which was employed successfully in Jordan, is to provide a money payment to all households initially. The program was subsequently narrowed to middle and low-income families and finally, to only low-income families. Because distinguishing the poor from the non-poor may be difficult, workfare programs may be more generally applicable, and have been proven effective under certain circumstances (Ravallion, 1999), as individuals can self-identify for these programs. The chapter in this Sourcebook on social protection provides more guidance on safety nets.

In general, as trade reforms are undertaken, the groups of poor which may be adversely affected need to be identified as accurately as possible and provisions should be made for their enrollment in whatever safety net programs are available for as long as necessary. Clearly safety nets are needed to support the poor during a period of transition which may vary in duration and severity depending on their age, skills, mobility and other similar factors. If there are no general safety nets available, they should be installed, not because trade reform demands them, but because they should be an essential component of a sustainable poverty reduction strategy. A practical problem is that some poor countries may not be able to afford a full-fledged safety net. For the design of trade policy reform this strengthens the need both for up front analysis of where the poor are located in terms of production (income) and consumption, assessing which groups may be

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<sup>23</sup> O'Leary (1995) discusses the measurement of the effectiveness of labor market programs in Hungary and Poland.

<sup>24</sup> Subsidies to consumption of essential commodities will often result in a transfer of income to the middle and upper classes since the wealthy buy more in absolute amounts of essential commodities.

seriously detrimentally affected, and determining what types of complementary reforms would best offset these potential losses.

## **7 Trade Policy Reform: Guidelines For Poverty Alleviation<sup>25</sup>**

### **7.1 General Analytical Framework**

As discussed above and in the Appendix, in tracing through the impact of trade liberalization on the poor, it is important to consider both the pattern of expenditures and sources of incomes of the poor. However, what matters most in the short run is the impact on incomes. The effect of trade reform on poverty in the longer term hinges very much on the growth process—which in turn will depend on a variety of complementary policies and institutions. In low income countries, the key complementary policies/institutions that need to be analyzed fall into the following major areas: (a) macro-economic, and especially exchange rate policy; (b) the operation of the market for labor, since the poor are often concentrated in the informal sector; (c) the operation of the markets for agriculture—which is both a major source of income and accounts for a large portion of the household expenditures of the poor; (d) access of the poor to trade related services—for example, credit, marketing, transportation; and (e) access to safety nets. There are of course other issues, such as governance, which are important here as well as in other reform efforts. Tools are being developed by the World Bank that can assist policymakers in identifying the impact of trade liberalization on the poor.<sup>26</sup> What follows provides a “checklist” of questions and issues that should be considered in the design and pursuit of trade reform.

### **7.2 What is a ‘Liberal’ Trade Regime?**

The basic elements of a good trade policy regime involve predictability, transparency, and uniformity. The following bullets describe in a nutshell what constitutes a liberal trade policy regime. These provide a benchmark against which to judge the prevailing trade regime and provide guidance for the direction of reforms.

- No licensing, or other approvals, except for health, safety and environmental reasons, and automatic licensing used for statistical purposes; no other QRs.
- Low and uniform tariffs. If the tariff is not uniform, it should have little dispersion, with only a small number of bands. A few sectors with very high tariffs should be especially avoided.
- If tariffs are important for revenue generation, uniformity implies that the overall level of the tariff should be such as to generate the revenue required. However, some products—such as alcohol and tobacco products—may be subjected to high duties to raise revenue, as long as equivalent excise taxes are imposed on domestic production.
- An efficient customs clearance process with little red tape, that ensures tariff-free access to intermediate imports for exporters.
- Only one instrument of contingent protection—a safeguard provision. No anti-dumping.

<sup>25</sup> A more detailed presentation of these guidelines may be found in Michalopoulos (2001).

<sup>26</sup> For a synthesis of available methods see the proceedings from a October 2000 conference “Poverty and the International Economy”, available at: <http://www1.worldbank.org/wbiep/trade/povertyconf.html>. Tools will be posted on this site as they become available.

- Contestable service markets—measures to ensure competition prevails, there is no discrimination against foreign suppliers that seek to establish a presence in the market, and that appropriate regulation is in place.

### 7.3 Is Trade Reform Needed?

A number of questions are relevant in determining whether trade reform should be a priority and whether this will benefit the majority of the poor:

- **What is the impact of status quo trade policies on the poor?** It is important to determine the effect on the poor of the existing pattern of protection/subsidization. Such effects may be positive or negative, and affect particular products consumed by the poor or the incomes of a significant number of the poor, whether country-wide or in a particular region. Taxes or supports for important food staples or inputs to agriculture, in particular, should be identified and their incidence examined. In those cases where the structure of protection is not beneficial to the poor there is a prima facie case for reform. In those cases where some of the poor benefit, an assessment should be made of the relative magnitude of the potential losses and the economy-wide gains from reform.
- **Are there non-tariff barriers** for reasons other than for health, safety and the environment? To the extent that significant non-tariff barriers are present, there is again a prima facie case of a need for reform—starting with conversion to tariffs. This reform is likely to benefit the poor more than the non-poor since license recipients typically collect rents, are unlikely to be poor (almost by definition) and the competition for licenses wastes resources that can be used productively.
- **What is the average tariff and how dispersed is it?** The more dispersion, the greater the difference in treatment of different sectors and segments of society is likely to be, and the greater the urgency for reform. Dispersion often generated by exemptions and tariff escalation will lead to high effective rates of protection and is likely to entail significant inefficiencies.
- **Is there discrimination against agriculture?** The overall policy stance affecting agriculture should be determined, starting with an assessment of the 'effective' rate of protection for this sector compared to manufacturing—see Schiff and Valdes (1992) for a description of a methodology to do this. The importance of agriculture lies in the fact that the rural poor are likely to account for a large share of the poor.
- **How well do critical service markets function?** Do the poor have access to important ancillary services such as transport? Do policies discriminate against foreign suppliers and lead to high cost, low quality domestic supply? Is entry possible in labor-intensive sectors such as tourism or back-office services? Does competition prevail in key 'backbone' sectors such as transport, finance and communications? Is appropriate pro-competitive regulation in place?
- **How efficient is customs?** How long does it take to clear a container or air freight shipment? How does this compare to neighboring countries and to best practice? How large are 'unofficial' trade facilitation payments? Is there a functioning drawback and temporary admission mechanism?

### 7.4 Getting There

The overall analysis of the trade regime should yield a preliminary judgment on the desirability of trade reform. Analysis of both the impact of the status quo policy set and the likely effect of alternative reforms on the poor is important. The tools to undertake such an

analysis can be constructed for most economies; the basic requirements include detailed data on imports and exports, the trade barriers that apply to those goods, household survey information on the consumption pattern of the poor and the sources of their income, and data on the basic structure of the economy (ideally an input-output table or social accounting matrix). The basic elements of a framework for the analysis that is required is laid out in the Appendix—practical tools to undertake such analyses are being developed by the World Bank and will be posed on [www.worldbank.org/trade](http://www.worldbank.org/trade) as they become available.<sup>27</sup>

This judgment should be then reviewed in the light of the potential short-term effects of trade reform on the poor. If there are possible negative effects, it is important to identify the relevant products and sectors early on, in order to help design arrangements for dealing with adverse impacts of the reform and develop strategies for developing consensus in their support.

Strong government commitment to the reform is critical. The government should attempt to explain the desirability for reform and obtain the support from some parts of civil society. Obtaining a broad consensus may be a difficult task. The benefits from reform are likely to be dispersed, uncertain and spread over time; whereas the private costs of sectors that will be facing increased competition from imports will be obvious, near term and likely to be concentrated in powerful political groups.

It might appear tempting to design a pro-poor trade reform by identifying sectors that are important to the poor—either on the consumption side or the income side—and singling out these sectors for differentiated cuts in protection. If, for instance, many poor people produce maize, as in Mexico, it might seem sensible to exclude this product from a tariff reduction. There are at least two problems with this approach. One is fundamental and the other relates to political economy. The fundamental problem is that trade policy is a single instrument, and a fundamental principle of economic policy formulation is that a single instrument can not be expected to address multiple targets. The political economy problem is that, once a highly differentiated trade regime is adopted, it is essentially impossible to stop special interests building a case that their sector deserves special treatment for one reason or another. Returning to the example of maize, if we decide to maintain or raise protection, we are likely to find that there is another important group of poor people for whom maize is an important expenditure item.

A better approach is to focus on developing two different sets of instruments—one, trade policy, focused on providing the incentives appropriate for efficient production and use of goods and services, and another, distributional policy, focused on alleviating poverty. With this assignment of instruments, trade policy can be designed using the simple, comprehensible, guidelines for trade policy formulation. A set of distributional instruments will necessarily have a much wider range of dimensions, including investments in expanding access to education, the provision of safety nets, and a range of infrastructure investments needed to allow people in poorer regions access to the markets and other amenities enjoyed by relatively advantaged people.

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<sup>27</sup> On this website the reader may find the initial efforts which include Harrison, Rutherford and Tarr (2001) and other papers from the Stockholm conference on Poverty and the International Economy.

## 7.5 Complementary Policies

Trade policy reform and institutional strengthening must be implemented in the context of a variety of complementary policies. Some of these are general and some are focused on making the trade policy reform more likely to benefit the poor.

**Macro-economic stabilization** and a competitive exchange rate are essential to support greater integration into the world markets. Exchange rate depreciation in the beginning of major trade reform programs will facilitate adjustment. Great care must be taken to avoid real exchange rate appreciation at a time of import liberalization. As this is largely determined by macroeconomic and fiscal policies, it is important that these are managed to be consistent with the trade reform.

**Markets.** If markets are not competitive or are missing, trade reforms may not benefit the poor. Critical obstacles to the operation of market signals must be identified. Questions that should be posed include:

- In agriculture, are prices passed on to farmers, or are there government or private intermediaries which make large profits in the sale of farm products or farm inputs?
- More generally, is the reform likely to destroy existing markets that are significant for the poor? Will it allow poor consumer to obtain new goods? (For further discussion, see Winters, 2000, 2001).
- Are there serious impediments of various kinds (legal, cultural, transportation) to labor mobility? Labor market restrictions, such as prohibitions on firing of workers, often result in an informal labor market sector, with the poor concentrated in the informal sector. Reduction in the restraints in the labor market, especially combined with trade reform, can result in an expansion of the formal sector. This can have a strong impact on poverty reduction since the poor will move from the informal to the formal sector with the expansion of demand in the formal sector.
- Are there serious financing obstacles to participation in trade? In the long run, developing an effective financial system is a key to development. In the short run, trade-focused instruments such as the use of back-to-back letters of credit may allow some of the most pressing obstacles to trade to be alleviated.
- Are there serious obstacles in setting up a business? Competition may be impeded because it is difficult to obtain a license to start a new business or to make an investment. Or foreign investment may be impeded. The reduction in barriers to entry, especially those imposed by governments at various levels, can be expected to improve competition and allow entrepreneurs to sell new cheaper imports to the poor or to provide services necessary to bring goods to market. The latter is particularly important in cases where reform affects entities that provide ancillary services to the poor and may cease to do so after reform occurs. An example would be the provision of transport, storage and distribution services to farmers by a marketing board. If there are barriers to entry into such service activities, or entry is unlikely to occur because the market cannot sustain operations, continued government involvement may be necessary.
- Are there transport obstacles to trade? High transport costs make it difficult to engage in trade. Landlocked economies that are far away from markets may have little that they can influence, both because of the absence of direct links and the difficulties of establishing transit arrangements but sometimes there are government policies or institutions that can be modified which would lower transport costs. Here again a key test should be whether entry is feasible.

- In those instances where analysis suggests that the market will not supply the needs of the poor or those located in outlying regions, there may be a need for universal service regulation. Experience suggests that explicit subsidies to achieve such objectives can be efficient.
- Are there serious trade obstacles in entering major external markets or in competition from abroad? Most low income developing countries face relatively low traditional trade barriers in external markets, given a variety of preference schemes; but there are specific problems related to sanitary and phytosanitary controls in many markets, the threat of contingent protection and competition from subsidized exports in third markets.

**Trade Related Institutions.** Success of trade policy reforms involves a variety of institutions both public and private. On the government side, an effective and non-corrupt Customs Authority is critical to the success of reforms. Other institutions to which particular attention needs to be paid in order to ensure that trade reforms benefit the poor include marketing and export finance. Both are necessary for export expansion. In order for the poor to benefit, it may be useful to establish organizations such as co-operatives which can put together large enough shipments from individual producers to supply foreign markets; and to be able to obtain financing linked to their exports—which individual poor farmers can not. There is a lot of international experience on these issues, including through the International Trade Centre and UNCTAD in Geneva. Bilateral donors and multilateral development banks can provide assistance in the design of such programs, as well as financing.

**Agriculture and the Rural Poor.** Key issues where complementary actions may be required for poor farmers include the availability and cost of education for children; research and development; and infrastructure, especially transport and communications. Unless the opportunity costs of farm residents can be raised, they will stay trapped in poverty.

## 7.6 Timing and Sequencing

Existing interest groups, often entrenched elites benefiting from the status quo, may oppose reform. And if it is agreed, there will be pressures to postpone adjustment as long as possible. Recognizing that this is the likely environment in which trade reforms are usually proposed, it is nonetheless, extremely important to investigate in advance the impact of reforms on specific groups of the poor and to design programs to address them. In such a case, the timing of the implementation of trade reforms needs to be closely linked to the establishment of the programs that deal with their impact on the poor. Some points worth noting about sequencing are the following:

- If a reform is preannounced to be implemented over a few years and it is a *credible* reform, then normal market adjustment and attrition can be used to eliminate or greatly reduce adjustment costs. However, this may come at the cost of the threat of reversal of the trade reforms, as entrenched interests will be granted time to mobilize opposition. A staged reform that is scheduled to take more than five years is not likely to be credible unless it is anchored in WTO commitments or a far-reaching regional trade agreement.
- It is important, as noted earlier, to address non-tariff barriers and high tariff peaks earlier rather than later.
- It is also important to reduce tariffs across the board during each stage of a gradual reform. If instead a target is set based on the tariff average, the tendency will be to cut



tariffs only where they cause no immediate difficulty and leave all the adjustment to last.

- Broad trade reforms frequently meet with much less political resistance than cuts in protection to individual sectors. Broad reforms help the winners from reform recognize their potential gains, and tend to reduce the costs even for industries that lose protection on their output.
- Waiting for some important infrastructure project to be completed, such as a port facility or a road, is not usually a good reason to delay reforms.

Summing up, not everything will be perfect at the start, but some minimum, especially macro-economic stability and a competitive exchange rate, should be in place. The best outcomes for the poor can be expected when, as a result of the overall reform process, of which trade reform is a part, growth accelerates in the economy as a whole. That said, it must be recognized that the poor are least able to bear risks, and that in the short run there will be losses for some groups. Analysis of the status quo and the likely impact of reform on the poor is therefore very important. General safety nets may not exist or be inadequate in many low-income countries. In such situations reforms should not be postponed, but rather should be implemented gradually, following a pre-announced schedule, and complemented by actions to minimize adverse consequences to the poorest in society. In many cases this can be done by directly targeting trade policies that are currently clearly detrimental to the interests of the poor, and ensuring that the reform process also considers the need for action in ancillary areas such as service markets.

## Appendix. Trade Reform and the Poor: A Simple Framework

In order to provide a schematic overview of the various possible effects of a trade policy reform on the poor, it is useful to distinguish between three types of sectors: those producing importable or import-substitute goods (M), exportable goods (X) and non-tradable or home goods (H), as well as two factors of production, labor and capital. We assume here that the only asset of the poor consists of labor, while the asset owned by the non-poor is capital. The effects of trade policy reform on the poor depend on the consumption and production of the poor in these three sectors. The effects also differ in the short and long run. In the short run we assume that the factors of production are immobile, while they are mobile in the long run.

### A.1 Trade Reform and Relative Prices

We assume that the country concerned is small—it has no power to affect world prices of traded goods—and that labor markets function well in the sense that that nominal and real wages are flexible. Domestic prices of M ( $P_m$ ) and X ( $P_x$ ) depend on their world price and on policy variables such as the exchange rate and import tariffs. On the other hand, the price of H ( $P_h$ ) is determined fundamentally by domestic supply and demand. Allocation of resources depends on these three prices. In the long run, resource allocation depends on relative prices only, such as  $P_x/P_m$  and  $P_x/P_h$ .<sup>28</sup>

Trade liberalization (a reduction in tariffs) raises  $P_x/P_m$ , and labor and capital have an incentive to move from M to X. Whether  $P_m$  falls or  $P_x$  rises makes an enormous difference in the short run and is likely to determine the success of the reform. This is where complementary policies play a crucial role, including exchange rate policy.

Suppose the nominal exchange rate (ER) remains unchanged following a tariff reduction. Then  $P_m$  falls while  $P_x$  remains unchanged, and labor and capital in sector M are hurt in the short run. The groups that are hurt are likely to lobby for a policy reversal. Also, though in the long run both imports and exports increase with a tariff reduction, imports tend to increase faster than exports, with a likely deficit in the balance of trade that may be unsustainable. Both the pressure from short-term losers and the balance of trade problem may result in a failure of the reform. This outcome can be avoided or its effects are mitigated by depreciation of the domestic currency. This raises the price of importables relative to non-tradables, and helps dampen both the increase in import demand and the decline of labor and capital's nominal income in sector M. On the other hand, labor and capital in sector X benefit from the devaluation since  $P_x$  increases.<sup>29</sup>

Thus, a policy package of tariff reduction and currency depreciation should make it easier for the factors of production in sector M in the short run and during the transition period, and should dampen the resistance to the reform. In countries with a flexible or floating exchange rate policy, the lower tariff will raise the demand for imports and for foreign exchange. This will raise the price of foreign exchange or lower the value of the domestic currency. In other words, the exchange rate will depreciate (more units of

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<sup>28</sup> With three nominal prices, there are only two independent relative prices. For instance, choosing  $P_x/P_m$  and  $P_x/P_h$ , the third relative price ( $P_m/P_h$ ) is obtained by dividing  $P_x/P_h$  by  $P_x/P_m$ .

<sup>29</sup> A devaluation has no impact on the relative price  $P_x/P_m$  because both prices increase in the same proportion.

domestic currency per unit of foreign currency). This is similar to a devaluation except that it is determined by the market and not by the monetary authorities.<sup>30</sup>

The effect of trade reform on the poor also depends on the second relative price  $P_x/P_h$ . That relative price depends not only on policy but also on consumer reaction to the policy since it is determined by supply and demand.  $P_x/P_h$  also rises following a tariff reduction, though less than  $P_x/P_m$ .

When the value of the nominal exchange rate cannot be changed, a tariff reduction has no impact on  $P_x$  but lowers  $P_m$ . This leads to a shift in consumption from H and X to M, and thus to a reduction in  $P_h$  (though less than the reduction in  $P_m$ ). This implies an increase in  $P_x/P_h$ . With a full devaluation equivalent to the tariff reduction,  $P_m$  remains unchanged and  $P_x$  rises by the magnitude of the depreciation, shifting consumption from X to M and H, raising  $P_h$ .  $P_x/P_h$  rises by the exact same amount as in the absence of devaluation. Finally, with flexible exchange rates, the depreciation is less than the reduction in the tariff, so  $P_m$  falls, while  $P_x$  rises. Consumption shifts from X to H and M, and from H to M, so the net effect on the demand for H is ambiguous, as is the effect on  $P_h$ . Note, however, that  $P_x/P_h$  rises exactly as in the other two cases.

## A.2 Effects on real income in the short run

The impact of trade reform on the poor in the short run will critically depend on their location in terms of consumption and production (income), in particular whether they are employed in tradable or nontradable activities. There are three cases to consider that indicate the types of effects that may arise:

i) Poor employed in the exportable sector. The relative price of sector X increases. Thus, in the short run, as factors are not mobile across sectors, the wage rate of labor employed in X increases. On the consumption side, labor (and the poor, by assumption) would gain as long as they consume either some M or some H or both (since their prices fall). Thus, labor's real income must improve; and the higher the proportion the poor spend on H and M, the larger the gains. Thus, the real income of labor in X must rise, or remain unchanged in the unlikely circumstance that the poor spend their entire income on the exportable X.

ii) Poor employed in the importable sector. If, on the other hand, the poor produce in the importable sector, a tariff reduction would lead to a decline in the wage of the poor (labor) employed in the importable sector. How much they would lose then would depend on the consumption effect: if they spend all their income on importables, the income and consumption effects would cancel out and the net effect of trade liberalization on their real income is zero. However, if they also consume X and H, they will lose. The expected result is that the poor lose in the short run, but their loss is smaller than the decline in their wages, because of the gains from the effect of trade liberalization on the prices of things they consume.

iii) Poor produce only in the non-tradable sector. With the decline in the price of H, the wage rate in that sector also declines by about the same percentage. On the other

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<sup>30</sup> This section employs a stylized and simple framework that abstracts from the complexities which, in practice, are often important. For example, the existence of unemployment, the presence of intermediates products etc.

hand, labor in H also benefits from the lower cost of consuming M and H. It is possible that the impact on the real income of the poor rises because the cost of the consumption bundle falls more than their wages. In general, the impact on the real income of labor in H is ambiguous and depends on the shares of M, X and H in the consumption basket, and on the response of the price of H to trade liberalization. The larger the share of M in the consumption basket of the poor, the greater the likelihood that they will gain. They must gain if they only consume M, they must lose if they only consume X, and they are unaffected if they only consume H.

These results are summarized in the matrix below. Each cell in the matrix represents the "location" of the poor in terms of production and consumption. The first sign represents the effect of trade liberalization on the income of the poor, i.e. the return to their assets (labor). The second sign represents the effect on their real income due to changes in the cost of their consumption basket. Thus a "+" after the "/" sign means that the cost of their consumption basket has fallen following trade liberalization. The sign in parenthesis gives the net effect of changes in their nominal income and cost of their consumption baskets on their real-income in different "locations". To summarize, the best outcome is when the poor are employed primarily in the exportable sector X and consume importable goods M. And the worst outcome occurs if the poor are primarily employed in sector M and consume primarily exportable goods X.

**Table 1: Location of the poor and effects of trade liberalization in the short-run**

		Consumption			Total <sup>a</sup>
		M	X	H	
Production	M	-/+(0)	-/-(-)	-/+(-)	-/+(-)
	X	+/(+)	+/- (0)	+/(+)	+/(+)
	H	-/(+)	-/-(-)	-/+(0)	-/+(?)
Total <sup>b</sup>		?/+(+)	?/-(-)	?/+(?)	

<sup>a</sup> This column gives the effects for the poor that receive their income from production in only one sector, but their consumption basket includes products from the three sectors.

<sup>b</sup> This row gives the effects for the poor that consume products from only one sector, but receive their income from the three sectors.

Although the discussion has focused on trade reform involving tariffs, in practice reforms often involve the abolition of quantitative restrictions (QRs) such as import licenses. As discussed above, due to rent-seeking, shifting from QRs to tariffs could significantly help the poor.

### A.3 Effects in the long-run

In the long run, labor and capital are mobile across sectors. Then, trade liberalization results in a contraction of sector M and an expansion of sector X. If, as is likely for most low income developing countries, M is on average capital intensive while X is relatively labor intensive, then, in the new output configuration results in an increased demand for labor and a higher nominal wage rate. As the prices of M and H fall, labor's real income rises as well. Consequently, while in the short run some labor employed in M loses from trade liberalization and the impact on labor in H is ambiguous, when factors are mobile, labor in both sectors gain. Of course, for this to apply to all the poor, labor markets need to be integrated. If they are segmented, then some poor could lose, especially if they are

employed in the import competing sector and are unable to move. In order to ensure that the poor are better off following trade liberalization, the conditions affecting the functioning of the labor market are therefore critical.

In the analysis presented above, it is assumed that all factors are fully employed and changes in trade policy are reflected in changes in relative factor prices. In practice, and for many of the countries for which PRSPs are being prepared, there may be a large supply of unskilled labor in the subsistence sector that can be employed at a fixed real wage in the modern sector. Trade reform may have a positive impact in this case, not through increase in the wages of the unskilled workers but rather by reducing the amount of unemployed or underemployed in the subsistence sector and inducing an expansion of the output of the modern sector. Indeed, following the Indian trade reform in 1991, manufacturing employment increased faster while wages increased slower than before the reform (Winters, 2000). In most cases, one can expect a lasting trade policy reform to have a mixture of quantity and price effects on the labor markets. But no matter what the situation, labor mobility is essential in order ensure movement of workers from the contracting and expanding sectors.

#### **A.4 Sector-specific issues**

The above framework is highly stylized and abstracts from many factors that are important in determining the impact of reform on the poor. Such factors include the existence of imperfect competition and inter-sectoral dependencies. For example, although the agricultural sector is generally made up of small and competitive farms, this is typically not the case for marketing and distribution services. In a number of LDCs, marketing is organized by public agencies or parastatals, who usually fix producer prices at levels below world prices and do not always change them in response to changes in world prices or in exchange rates. For instance, in some of the countries where the devaluation from 50 to 100 CFA Francs to the French Franc took place, farm prices did not at first increase by the full amount of the devaluation, while the prices of their imported inputs often did, and some of the products farmers consume did as well. This may have had a negative impact on the real income of farmers in the short run. Thus, though the framework developed above is useful in order to understand the likely first-order impacts of trade reform on the real income of the poor, the specifics of each case need to be taken into account.

To continue with the agricultural example, an issue to take into account is the degree to which farmers consume their own output. The greater the share of own consumption, the smaller the impact of the reform on the real income of the farmers. If farmers consume exactly what they produce, then the real income effect of trade reform on them is nil. If farmers are net buyers, it is often argued that in that case farmers lose from an increase in the price of the product they produce. This may well be the case, but one must also consider that in order to be net buyers, they need to obtain additional income. If this additional income is obtained by working on other farms, real income of these farmers need not decline given that nominal rural wages will tend to increase with the price of farm products (or increase with trade reform in the long run).

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- Note: a number of these papers as well as many others dealing with trade policy issues can be downloaded from [www.worldbank.org/trade](http://www.worldbank.org/trade).
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