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DTI ECONOMICS PAPER NO. 10

Liberalisation and  
Globalisation:  
Maximising the Benefits  
of International Trade and  
Investment

JULY 2004



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9. **The Benefits from Competition – some Illustrative UK Cases**, Professor Stephen Davies, Heather Coles, Matthew Olczak, Christopher Pike and Christopher Wilson (Centre for Competition Policy, University of East Anglia), July 2004

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While their help has been invaluable any mistakes in the document are our own. The paper draws heavily on the vast and rich literature on trade and investment. Efforts have been made to ensure that sources are correctly cited. We apologise for any omissions.

# Foreword

This DTI economics paper is the analytical accompaniment to the White Paper on trade and investment. It offers an introduction to the analysis and evidence available on many aspects of trade and investment. Many of the issues are complex, with a huge literature, and they deserve more detailed treatment than is possible here. DTI economists, working with colleagues in several other government departments, intend to produce more analysis on some of the most important issues. This will either be published or made available on the internet.

A powerful message from this paper is that there are large potential gains to producers and consumers worldwide from further liberalisation of trade and investment. These gains accrue from imports as well as exports, outward investment as well as inward, demonstrating the irrationality of mercantilism. Trade and investment reforms can be good for the UK and good for the rest of the world too - it isn't a zero sum game.

This is not a theoretical debate. The Doha Development Round of WTO negotiations is a real attempt to ensure that developing countries as well as the developed gain from further liberalisation. The analysis provided in this paper helps to explain some of the complex issues under discussion and the imperative of making progress.

The DTI's mission is to achieve prosperity for all. Liberalisation of international trade and investment can make a real contribution to greater prosperity for more of the world's population. However trade liberalisation alone cannot overcome severe economic problems. Increasingly there is consensus amongst economists that trade liberalisation should be an important part of a suite of carefully timed complementary economic and development policies. Without the right supporting policies, trade and investment reform may not deliver sustainable benefits. These policies are invariably desirable in their own right and some of them have been covered by previous DTI economics papers.

Transition following liberalisation may be difficult and may have distributional consequences but the long term benefits are dramatic. The challenge now is to address the issues raised in this paper, and to carry forward the good intentions of the global community into practical measures that will benefit the lives of people in both the developing and the developed world.



A handwritten signature in black ink, appearing to read 'Vicky Pryce', written in a cursive style.

**Vicky Pryce**

Chief Economic Adviser and Director General, Economics. DTI

# Executive Summary

Trade and investment liberalisation offers great benefits to producers and consumers in developed and developing countries. However for many developing countries to unlock these benefits, liberalisation has to be part of a suite of policies. The necessary complementary policies will vary between countries, but all need stable macroeconomic conditions and the rule of law. Many other policies are desirable, including predictable regulatory and fiscal regimes.

Liberalisation leads to changes in the patterns of production and employment. This offers significant adjustment challenges. The UK experience is that while certain communities have undergone very painful consequences from economic restructuring, in particular from the loss of traditional manufacturing jobs, the overall effect on employment has been positive. Flexibility in the labour market and transferable skills have and do make adjustment quicker and less painful.

Liberalisation does have a differential impact on different groups in society. This will affect the distribution of income. Evidence suggests that liberalisation is generally beneficial for the poor. Protectionism also has a differential impact and can often benefit the better off at the expense of the poor.

The evidence does not suggest that labour and environmental standards are eroded by liberalisation, although there may be short term detriments that need to be addressed. While countries increasingly recognise the benefits of liberalising their own trade and investment regime, the multilateral system plays an important role in promoting a liberal trading environment. Multilateral negotiations are likely to deliver an outcome which provides wider and deeper liberalisation than bilateral trade agreements.

Governments have a positive role to play in making the system work better. At a national level they can help correct market failures, but they should avoid the temptation to intervene to favour some sectors as this is invariably at the expense of other sectors or consumers and has a poor record of success.

There are many gains from a successful completion of the Doha round<sup>1</sup>, for example from further liberalisation of trade in agriculture and services and from trade facilitation measures. Trade and investment liberalisation, however, will not be completed by the Doha round; there are many benefits still to be unlocked by a range of measures, particularly removing non-tariff barriers to trade.

New challenges to free trade continue to emerge, for example the growing use of trade defence measures such as anti-dumping and safeguard measures, which are rarely justified by predatory pricing or other forms of market abuse. It is a continuing challenge for Governments to meet society's concerns for adequate product standards and security needs in a way that does not unduly restrict or undermine the benefits of international trade and investment.

<sup>1</sup> The current round of WTO trade negotiations

# Introduction

The starting point for this paper is that international trade and investment can bring dynamic benefits from enhanced competition, innovation, and skill transfer etc., in addition to the traditional static gains from trade. This subject matter is covered in great depth by the academic literature. Here we refer to this literature but do not set out to repeat it. Instead, the paper focuses on the implications of the phenomenon of globalisation of trade and investment and liberalisation, the adjustment process that removes artificial barriers to trade and investment. The paper looks at their implications for the UK and the rest of the world.

Chapter 1 provides a brief history of protection and where the drive for multilateral trade liberalisation came from. It also assesses whether globalisation is as widespread as is sometimes suggested. The case for liberalisation is assessed in Chapter 2. Key issues such as the costs of protection and the infant industry argument are examined. The importance of flanking measures and assessing mobility in a wide range of factor markets is emphasised. Some of the challenges posed by adjustment are addressed in Chapter 3. Evidence from the UK's shift towards the service sector is presented to demonstrate that large-scale structural change is possible; the offshoring of services is assessed, as is the need to understand and mitigate environmental challenges. Adjustment sometimes has a distributional impact. Some aspects of this including income distribution, poverty, gender, labour standards and fiscal adjustment are assessed in Chapter 4.

Chapter 5 focuses on UK trade policy in the Doha Development Round (DDA). This is the first trade round that focuses directly on products of particular interest to developing countries. Progress on agriculture is a key element of the round offering potential benefits to producers in developing countries and consumers around the world. This paper suggests that the DDA proposals offer a useful but not final step in the liberalisation process. There are lots more benefits still to be had from removing remaining tariff and non-tariff barriers to trade.

The UK is a relatively open economy that has benefited from earlier phases of trade liberalisation and from both inward and outward investment. Chapter 6 looks at whether there is an economically rational case for intervention by the government to enable the UK to gain even more from it. This section argues that intervention is only likely to be beneficial where it corrects a market failure or address externalities. Chapter 7 is forward looking, assessing some of the many challenges that will still exist in trade policy after the Doha round.

# Part 1: Principles

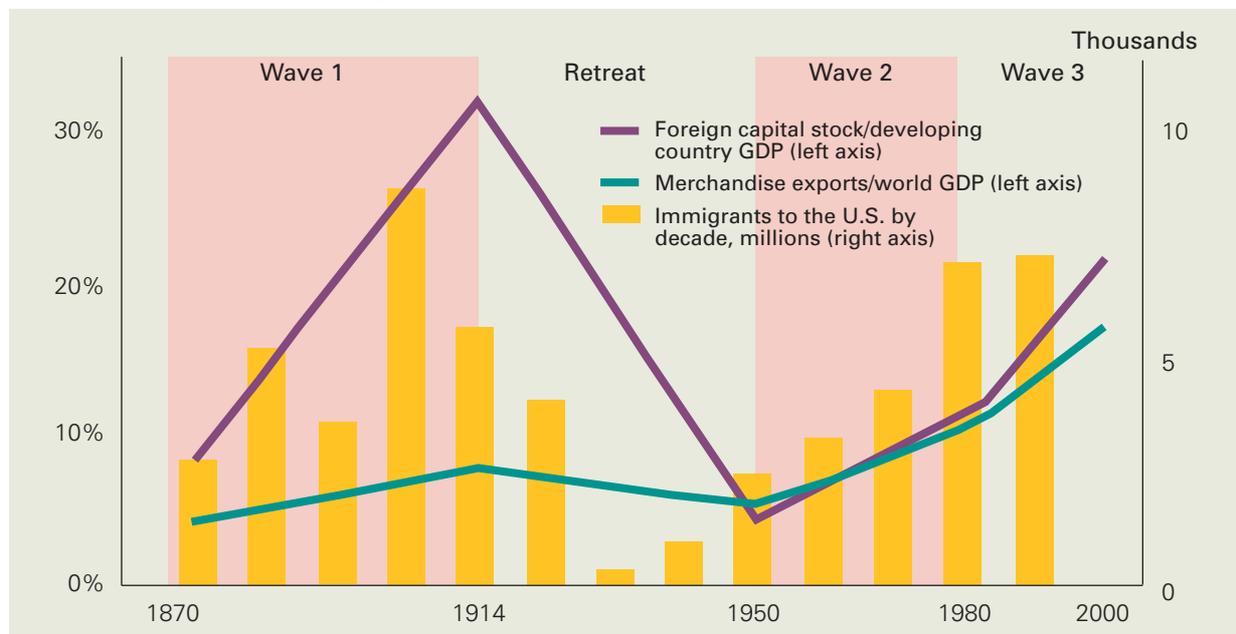
Part 1 of this paper makes the economic case for trade and investment liberalisation, addresses some of the most common counter-arguments and discusses some of the more important adjustment pressures and distributional issues related to globalisation.

# Chapter 1: Liberalisation and Globalisation – An Overview

## Waves of Globalisation

**1.1** This paper is concerned with trade and investment liberalisation. Any liberalisation in today's world takes place against the background of a "globalising" world. There is no standard definition of what is meant by globalisation. The working definition used here is a marked increase in the movement across national boundaries of goods/services, investment, people and information. The result of this process is that economic agents in many parts of the world are more affected than before by events in other parts of the world. By reducing government-imposed barriers, trade and investment liberalisation can facilitate globalisation, but it is not the only driver.

**Chart 1.1 Three waves of globalisation**

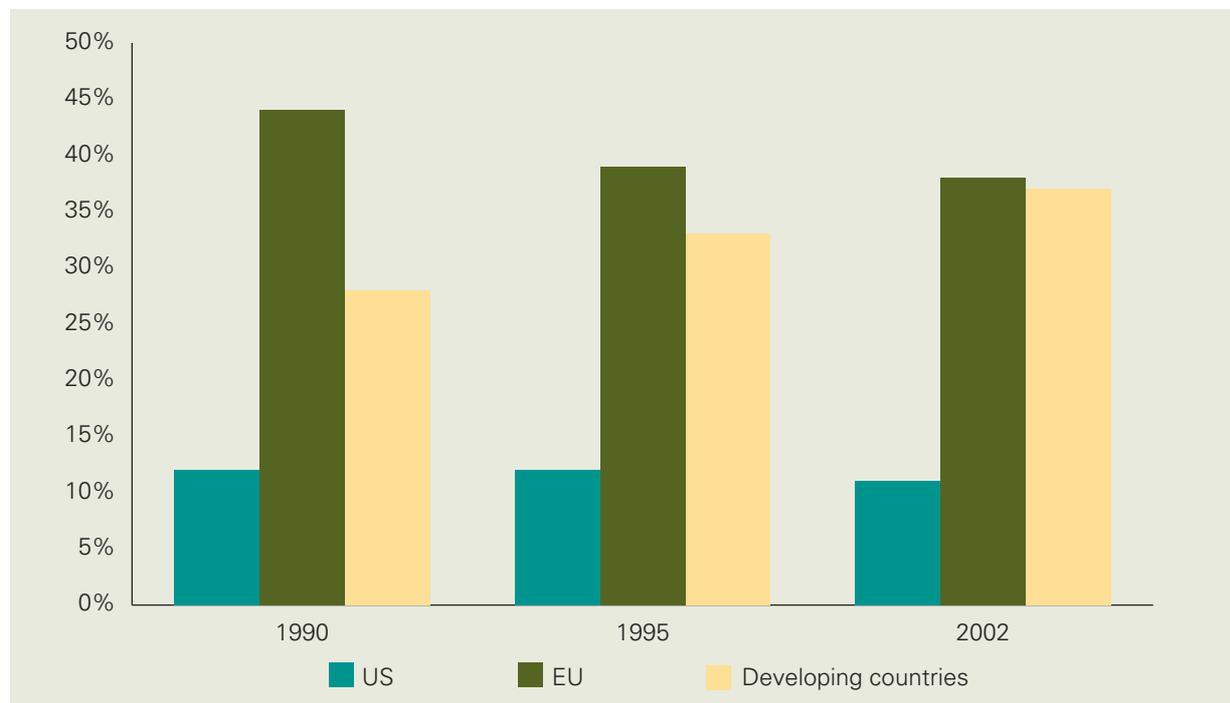


Source: World Bank

**1.2** The first wave of globalisation began around 1870. The ratio of merchandise exports to world GDP increased steadily over this period. The ratio of foreign capital stock to developing country GDP increased even more markedly. Advances in transport, such as the steamship, made long-distance migration much more feasible. Historians contend that migration in this period was far more substantial than it is today. It is estimated that in the 19th century 10% of the world's population may have migrated, whereas about 3% currently move across borders for more than a year. Between 1870 and 1914, migration raised the New World labour force by a third and lowered the European labour force by an eighth<sup>2</sup>. And the ability to transmit information quickly increased. The first transatlantic telegraph was laid in 1866, and by the end of the century telegraphs covered the world.

### **What is the difference today?**

**1.3** Some have suggested that the new globalisation is no more than a repeat of that prior to 1914. However, the composition of trade is somewhat different from that which prevailed before 1914. Broadly, much trade prior to 1914 consisted of the sale of commodities by developing countries to developed ones, with the sale of manufactures by developed countries in return. One characteristic of modern trade has been the growing role of developing countries in the production of manufactures, which was traditionally the preserve of developed countries. The share of manufactured goods in developing countries' exports has risen from about 25% to over 80% in the last twenty years, and developing countries have markedly increased their share of world merchandise trade. This emergence of some – but by no means all – developing countries as major participants in international trade in manufactures and increasingly in services presents both challenges and opportunities for developed countries.

**Chart 1.2 Changing shares in total world merchandise trade, selected regions**

Source: IMF Direction of Trade (2003)

**1.4** Another difference in the pattern of globalisation today has been the growth of intra-industry trade – that is sales between countries of very similar products, for example cars. It is estimated that intra-industry trade in OECD countries is 60-70% of total trade for sophisticated manufactured products and 40% for simpler manufactured products<sup>3</sup>. A related aspect is the fact that a single product may now be the result of economic activity in a number of countries. A car may be made from parts manufactured in 40 different countries. Even the provision of a service may involve activities in more than one country. For example, financial services companies may locate their back office facilities in a country other than that where the service is finally delivered. The specific issue of the offshoring of certain services is considered in Chapter 3.

**1.5** The information technology revolution has undoubtedly facilitated such developments. It has brought great benefits, but, arguably, it has also led to a greater sense of economic insecurity for some people and fuelled anti-globalisation sentiments. In many activities, technology matters, and technological capability has spread. Many countries have access to similar pools of knowledge and multinationals, if they choose, can take scarce knowledge to a variety of destinations. The comfortable buffer of country specific specialisation has been partially eroded<sup>4</sup>.

**1.6** The fundamental message of this paper is that trade and investment liberalisation, if underpinned by sound policies, can help to promote economic growth and welfare. But the characteristics of modern globalisation do lead some to wonder how developed

<sup>3</sup> OECD Economic Outlook 2002. Sophisticated manufactured products include chemical, machinery and transport equipment. Simpler manufactured products include food products.

<sup>4</sup> Bhagwati 2004

and developing country economies will adapt and evolve. Yet economies do adapt to change, and there is a role for Government in adopting policies to assist the process. These issues are considered in Chapter 3.

## Limits of globalisation

**1.7** The process of globalisation needs to be placed in perspective. To some, there are no limits to globalisation. According to this scenario, trade liberalisation and IT reinforce each other: liberalisation provides the opportunity to producers to locate anywhere and yet retain access to their markets; information networks provide easy means by which customers can purchase, and producers can coordinate production, on a global scale. “Globalisation” suggests a world in which any and all goods and services could suddenly be delivered from China or Patagonia, sweeping away great rafts of domestic jobs. In this world there is no hiding place, distance ceases to matter and price differences are rapidly competed away. Proximity to the market no longer offers natural protection. Any footloose activity will henceforth be located wherever in the world unit delivered costs are lowest, and the production of any product, or service, could go the way of footwear, cutlery and tableware, to low-wage economies.

**1.8** The vast majority of economic exchange however, still takes place within national boundaries. International trade is just a fraction of total trade, so that 80% of what the world produces is still traded and consumed within the country of production. And international trade is itself, to a great degree, “local trade”. Thus, despite the “globalisation” rhetoric, nations continue to conduct most of their trade with their neighbours. “Gravity models” of trade, which predict that the volume of trade between two trading partners is positively related to the partners’ economic mass and negatively related to the distance that separates them, remain good predictors of trade flows. Proximity to related industries and discriminating consumers still appear to play a role in determining whether an industry is successful or not. Industrial clusters exist and appear to contribute to industrial competitiveness<sup>5</sup>.

**1.9** Transport costs remain important in explaining the pattern of trade. Unit transport costs are not negligible, particularly for heavy products. The cost of shipping hot-rolled steel from a coastal location in the Far East to the UK is more than 10% of the price of such products in the UK market<sup>6</sup>. The increasing demands for just-in-time delivery and for nimble responses to changes in fashion favour localisation. In the clothing industry, for example, although much of the EU’s production is now out-sourced from low-wage countries, the countries in Eastern Europe, which can offer quicker delivery, are gaining ground at the expense of those in the Far East. The importance of such costs in the trade of poorer countries, especially landlocked countries and remote island states, are even greater. They contribute to the marginalisation of such countries in world trade.

<sup>5</sup> Porter 1990

<sup>6</sup> Source: CRU International, Report commissioned for the DTI

It is estimated that freight costs as a percentage of imports are close to 20% for land-locked countries in Africa and 11% for Africa as a whole, compared to less than 5% in developed countries<sup>7</sup>.

**1.10** Chapter 2 examines the links between openness to trade and investment in an economy and that economy's productivity, and thus its growth. Exposure to domestic competition is an important part of the process. Productivity and growth may also increase through exports. Some of the rhetoric about globalisation implies that the growth rates of our manufacturing industries are largely determined by their abilities to compete in the world; that industries that have increased their trade balance – a good indicator of their competitiveness – would have grown fastest. But this under-emphasises the role of the domestic market. As Chart 1.3 indicates, there appears to be very little correlation between a UK manufacturing industry's rate of growth and the change in its trade balance. In contrast, there is a striking correlation between an industry's rate of growth and the rate of growth of its domestic market – see Chart 1.4.

**Chart 1.3 – Changes in UK industry's sales & changes in their trade balances: 1990–1998**



Source: DTI

**Chart 1.4 – Changes in UK industry’s sales & in the market for their products: 1990–1998**



Source: DTI

**1.11** There are therefore limits to globalisation. Chapter 7 examines many of the significant barriers to the movement of goods and investment that would remain even if tariffs and investment restraints were abolished overnight. Indeed recent trends in trade and investment show a general decline in trade growth in recent years. There is also a mixed picture at a regional level. Some countries, notably in Africa, remain effectively marginalised in terms of world trade and investment.

## A Bit of History

**1.12** The broad message of the following chapters is that, on the whole, open economies are good for growth, and for the welfare of those who live in them. The evidence to support this proposition, however, is often open to challenge. It is worth noting one period of recent history – the retreat from globalisation that began with the First World War and continued throughout the interwar period. This was largely attributable to policy choices made by governments. A League of Nations report<sup>8</sup> on commercial policy in the interwar years concluded that “never before in history were trade barriers raised so rapidly or discrimination so greatly practiced”. The report continued that “trade was consistently regarded as a form of warfare, as a vast game of beggar-my-neighbour, rather than as a co-operative activity from the extension of which all stood to benefit”. Tariff barriers reached extreme levels when the US enacted the Smoot-Hawley Tariff Act in 1930. Under this, average US tariffs rose from 38% to 50%.

8 League of Nations 1942

The USA's trading partners responded and retaliatory tariffs were imposed in an almost universal fashion. Tariff rates for the major powers were generally around 50%.

**1.13** Naturally, world trade collapsed. Trade volumes as a percentage of GDP fell from 22% in 1913 to 9%. Foreign direct investment and migration also contracted. Per capita world GDP growth fell to less than 1% a year – compared to nearly 8% in the “golden age” of 1950-73.

**1.14** The need to contain sudden protectionist surges that have a negative impact on global welfare inspired the foundation of the GATT (later WTO) in 1947. It should always be remembered that the aim of the GATT was not, and is not, freer trade per se, but only as a contributor to economic welfare for all. As the Preamble of the GATT states, the objective is “raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand”.

**1.15** Since the creation of the GATT, there have been eight rounds of trade negotiations. The earlier rounds were primarily concerned with reducing the tariffs on goods, and the reductions were largely confined to developed countries. Agriculture and services were subjected to WTO disciplines only in the last completed round (the Uruguay Round). It would be fair to say that the prime value of these agreements was to bring agriculture and services within the scope of future negotiations rather than leading to deep liberalisation in these areas. Agriculture remains much more protected than manufacturing. Chapter 5 looks at the considerable potential gains from further liberalisation in these areas. Foreign investment is partially covered by the agreement on services and by that on TRIMS (trade-related investment measures) but there is as yet no general investment agreement in the WTO. The arguments for and against such an agreement are also considered in Chapter 5.

**1.16** Since the foundation of the GATT, there has been a steady rise in the world exports to GDP ratio. The upsurge in trade is a very prominent feature of the “new globalisation”. Trade is now 20% of world GDP. Foreign investment and migration have also increased in the post-war period, but have not yet reached the levels that prevailed before 1914. And in recent years the revolution in information technology has substantially lowered the costs and increased the speed by which information can be transmitted across borders.

**1.17** Two conclusions may be drawn. International economic activity is positively related to income growth. And it is generally accepted that liberalisation through the GATT/WTO has played an important role in stimulating that activity<sup>9</sup>.

<sup>9</sup> Although Rose (2004) raises the question of whether membership of the WTO necessarily increases a country's external trade.

# Chapter 2: The Case for Liberalisation

## **Chapter outline**

- Trade and economic growth; theory and evidence
- The costs of trade protection
- Is protection necessary for development? The Infant Industry argument
- Investment and growth
  - FDI
  - Outward investment
- Migration; its effect on developed and developing countries
- Complementary policies; the macro and microeconomic policies needed to maximise the gains from liberalisation

This chapter examines the relationship between trade, investment and migration and economic growth. The relationship between trade and productivity, economic reform and growth is examined in more detail in a recent HMT/DTI publication<sup>10</sup>. This chapter examines the theory and the evidence. It concludes that, on balance, the evidence suggests that there are positive effects on growth from more open regimes. This conclusion is based not only on the evidence comparing the macro-economic performance of open and less open economies, but also on assessment of the outcome of attempts to protect industries. But – particularly for developing countries – increased openness needs to be part of a package of reforms if the full benefits to growth are to be realised. The chapter also looks at the complementary supply-side reforms that can maximise the benefits of liberalisation.

## **The Relationship between Trade Openness and Growth**

*“If there were an Economist’s Creed, it would surely contain the affirmations “I believe in the Principle of Comparative Advantage” and “I believe in Free Trade”.”*  
Paul Krugman<sup>11</sup>

**2.1** Ricardo put forward the principle of comparative advantage two centuries ago, and it still remains at the core of arguments for trade liberalisation. The fundamental point is that trade allows each country to specialise in the production of those goods and services that it can produce most efficiently (i.e. those where it has a comparative advantage). Trade barriers mean that countries produce more of goods that could be

<sup>10</sup> DTI-HMT 2004

<sup>11</sup> Krugman 1987

produced more efficiently elsewhere, and less of goods that they produce efficiently. By lowering barriers so that countries may exploit their own specialisations, world output will increase and each country can raise its overall consumption and welfare. Theory predicts there will be overall gains to the country but there will also be distributional issues, especially in the short run, which help explain the resistance to trade liberalisation and also explain how this resistance can still be compatible with the belief that openness will improve welfare in the long-run.

**2.2** Pursuing the principle of comparative advantage raises productivity, partly by reallocating resources to their most productive uses, and partly by enhancing the processes (competition and innovation) that drive economic growth. Countries that gain access to foreign markets may gain from exploiting economies of scale that further reduce their costs. Open markets encourage innovation, both because greater foreign competition makes that more necessary, and because larger markets make the rewards from innovation more profitable. Greater competition also drives the least competitive firms out of markets, and reduces prices to consumers. Trade, like investment, is also an important mechanism by which countries can have access to new technologies. Moreover, the pace of structural change is likely to be faster in open economies, so that they can better move from declining to expanding industries. Closed economies are more likely to have inefficient, out-of-date production methods. They will be less productive and thus less wealthy.

**2.3** Openness in an economy can also stimulate growth through less obvious mechanisms. It is argued that trade liberalisation and growth are linked via the effect on other policies and institutions<sup>12</sup>. One of the most important of these links may well be the effect on corruption. There is evidence that corruption flourishes more in closed economies, and that more corruption in turn reduces investment and growth<sup>13</sup>. Chile is cited as a good example of a country that opened its economy and transformed its economic performance and its public administrative standards<sup>14</sup>.

**2.4** Competitive industries are better able to succeed on world markets. It is fair to say that most of the available evidence suggests that trade liberalisation has had a significant impact on export performance<sup>15</sup>. This supports the view that a country's own trade regime is as, if not more, important for its export performance as those of its trading partners. Or, in other words, it confirms the familiar economic relationship that "a tax on imports is a tax on exports".

### ***The evidence***

**2.5** The empirical literature on how far trade openness stimulates growth is vast, and at times has proved controversial. Despite the strength of the theoretical case in favour of

<sup>12</sup> Krueger 1978, 1990

<sup>13</sup> Ales and Di Tella, 1997, 1999

<sup>14</sup> Winters 2004

<sup>15</sup> For example, Michaely et al 1991, Greenaway 1992, Rodrik 1998

trade liberalisation, and the fact that many studies have found a positive *association* between a liberal trade policy, or at least an outward-oriented trade policy, and economic growth, empirical researchers have had considerable difficulty in establishing a consistently *significant causal* relationship<sup>16</sup>. Part of this failure almost certainly reflects difficulties in defining and measuring liberalisation, and other difficulties or inadequacies in modelling its relationship with growth. The current debate centres on how much and under what conditions trade liberalisation can increase growth, especially in developing countries.

**2.6** One generally agreed conclusion is that it is not automatic that increased openness will lead to higher sustained growth. Openness is not a sufficient condition for growth. Particularly in developing countries, it is likely that other reforms will be required for the benefits of openness to be captured. The sort of complementary policies that may be needed are outlined below.

**2.7** Overall, the balance of evidence certainly favours the conclusion that trade liberalisation has a positive impact on growth. And there is a definite lack of evidence suggesting it impedes growth. The evidence takes three basic forms.

**2.8** One is detailed individual country studies. In the 1960s and 1970s, several full-length studies of the trade and industrialisation strategies of over a dozen major developing countries – including India, Ghana, Egypt, South Korea, the Philippines, Chile, Brazil and Mexico – were done for the OECD and the National Bureau of Economic Research. Although there are familiar difficulties in generalising from specific case studies, these strongly suggested that increased openness translated into higher growth<sup>17</sup>.

**2.9** A second form of evidence is available from general equilibrium modelling. A number of studies have used this approach in an attempt to capture and quantify the complex economic effects of trade liberalisation initiatives such as the Uruguay and Doha rounds. All such studies agree that liberalisation through previous WTO rounds is likely to have produced substantial benefits, although there are significant differences in the estimates of the magnitude. This reflects, in part, different assumptions underlying the economic model used in the analysis, different interpretations of the liberalisation packages agreed and differences in the base year in which the agreement is assumed to be implemented.

**2.10** None of these studies takes account of transitional adjustment costs that are likely to be incurred following trade liberalisation, as resources move from contracting to expanding sectors of the economy. But nor do they take account of the permanent benefits arising from other important elements of multilateral rounds, such as the increased certainty resulting from the binding of tariff barriers, the liberalisation of some non-tariff barriers or

<sup>16</sup> Greenaway et al 1998, Harrison and Revenga 1995, Edwards 1998

<sup>17</sup> Bagwhati 2004

strengthened procedures for resolving trade disputes. More detail on these studies can be found in the joint HMT/DTI paper on Trade and the Global Economy<sup>18</sup>.

**2.11** A third form of evidence involves cross-country regressions. There has been a considerable amount of cross-country regression work that shows that overall there is a strong positive relationship between trade and growth in developing countries. Sachs and Warner, using simple summary measures of openness and growth, concluded that annual GDP growth in open countries was two percentage points higher than in closed economies<sup>19</sup>. This positive relationship between openness and the growth rate has been confirmed by a number of other studies<sup>20</sup>. Recently, Dollar and Kray divide a sample of 73 developing countries into “globalisers” and “non-globalisers” and find that in each case the average growth per capita has been higher for the globalising group<sup>21</sup>. However, one thing that comes out very strongly from the work that has been done, both in terms of theory and in terms of actual country work, is that there is no a priori relationship and any correlation very much depends on country circumstances. The precise effect of liberalisation will vary between countries.

**2.12** Even the empirical evidence suggesting that openness promotes growth is vulnerable to the criticism that the effects of openness have not been isolated from those of other reforms undertaken prior to or with trade liberalisation<sup>22</sup>. The results of the numerous studies that relate trade policy variables to growth rates have been disputed. Criticism of these studies, notably by Rodriguez and Rodrik (2001) relates to both econometric factors and also the concern that “indicators of openness” used by researchers are problematic, as measures of trade barriers are highly correlated with other sources of poor economic performance.<sup>23</sup>

**2.13** In this, the argument is related to the more general critique of the empirical growth literature<sup>24</sup>: policies correlated with growth (trade openness, macro stability, rule of law, the institutional setting) are all highly correlated among themselves. When all of these policies are included in regression analyses it can be difficult to identify the separate effects of different policies<sup>25</sup>. Equally it is easy to misattribute the effects of omitted policy to trade<sup>26</sup>. Recent work<sup>27</sup> studying 24 developing countries found that around two-thirds had increased growth after moving from being closed to open, but a third saw growth decline – often because political and macroeconomic instability undermined economic performance.<sup>28</sup>

18 DTI/HM Treasury 2004

19 Sachs and Warner 1995

20 For a review of a large number of studies, see Lewer and Van Den Berg 2003

21 Dollar and Kray 2004

22 Berg and Krueger 2003

23 Prowse 2002, 2003

24 Levine and Renelt 1992

25 Sala-i-Martin 1997

26 Dollar and Kraay 2002

27 Wacziarg and Welch 2003

28 Prowse 2002, 2003

**2.14** While this debate may represent an econometric challenge, arguably “it is not a policy problem”. It needs to be recognised that while no country has developed successfully by turning its back on international trade and long-term capital flows, equally no country has developed simply by opening itself to foreign trade and investment<sup>29</sup>.

**2.15** What the evidence does highlight is the need to place trade reform in the broader context of a country’s development strategy and identify necessary complementary policies and appropriate sequencing to ensure success. Openness has important positive spillovers on other aspects of reform, so that the correlation of trade with other reform policies only speaks to the advantages of having a comprehensive trade agenda as a key component of the reform process. This does not imply that ‘one size fits all’ or to deny that adjustment costs and measures to safeguard the interest of poor households must be considered in the design of policies. Critically important is to look at ‘behind the border’ measures, which take into account the fundamental factors associated with providing poor people with access to the opportunities created by trade. It is necessary to understand and address the impacts of policy reform on the poor and vulnerable in society and explicitly to take actions to facilitate adjustment. Determining the appropriate trade policy stance and associated complementary policies for a country is consequently of major importance in the design of development and poverty-reduction strategies.<sup>30</sup>

**2.16** One related consideration is the impact of increased openness on macro-economic variables. Adverse movements in these might force governments to adopt policies that restricted growth. There is, in fact, little evidence to suggest that there are significant adjustment costs in this respect e.g. for the current account or fiscal deficit. Although there is some evidence of short-term output declines (“J-curve effects”), any losses are likely to be short-lived<sup>31</sup>. In the majority of cases, output and exports continue to grow before, during and after the liberalisation episode and there is no deterioration in fiscal or current account balances<sup>32</sup>. This is not to deny that there have been cases where adverse movements in macro-economic variables have undermined attempts at trade reform. However, successful reforms have shown that these problems can be overcome.

## The Costs of Protection Barriers to Taxpayers and Consumers

*“While the burden remains on our backs  
Let the shout for repeal ne’er relax  
Till, like Jericho’s wall, Protection shall fall,  
And give us our loaf without tax.”*

Ballad of the National Anti-Corn Law League, 1845

29 Malhotra 2003, Prowse 2002, 2003

30 Prowse 2002, 2003

31 Greenaway, Morgan and Wright 1998

32 Michaely, Papageorgiou and Choski eds 1991

**2.17** Tariffs, non-tariff barriers and other forms of protection serve as a tax on domestic consumers. Moreover, they are very often a regressive form of taxation, hurting the poorest consumers far more than the better off. In the EU for instance, the nature of existing protection means that the heaviest taxes tend to fall on the necessities of life such as food, clothing and footwear.

**2.18** The (primary) intended effect of a tariff is to reduce the supply of certain imported produce and thereby to increase domestic demand for more expensive, domestically produced goods. As such, the tariff is a tax on domestic consumers and effects a redistribution of income from consumers to domestic producers (and also from other domestic producers who use the imported goods in their production). Tariffs reduce supply and raise prices directly because of the higher costs of domestic suppliers, but they will also increase prices indirectly where the domestic sector is characterised by imperfect competition; where tariffs reduce external competitive pressure then the market power of domestic firms will be enhanced, potentially allowing monopolistic pricing. It is estimated, for example, that the recent tariff and other barriers placed on imports of steel into the US increased the price of every car produced there by an average of \$100<sup>33</sup>. In addition, tariffs reduce consumer choice in the short-run and may inhibit the development of new products in the longer run.

**2.19** Although the recent past has been a period of generally falling tariffs, they are still maintained by the EU on a wide variety of products. In addition, the presence of non-tariff barriers (NTBs) such as quotas, technical standards, rules of origin, anti-dumping measures and the like raises prices in the same way, sometimes considerably. It is estimated that the average level of protection in the EU as a result of all these types of measure is equivalent to a tariff level of around 12%<sup>34</sup>. In particular, the EU, like the United States, has its highest tariff rates, actual and effective, on the products on which the poorest people spend relatively more of their income such as food and clothing. The tax effect of the tariff is therefore far greater as a proportion of income on low earners than on high earners. Table 2.1 illustrates the levels of protection applied to various sectors within the EU.

**2.20** Analysis in the US, which has a similar tariff structure to the EU, shows that someone on a salary of \$25,000 could expect to pay double the amount of tariff as a proportion of their income as someone earning \$100,000, 1.2% against 0.6%. For someone earning as little as \$15,000, tariffs could represent an income tax of nearly 2%<sup>35</sup>.

33 Rollo 2003

34 Messerlin 2003

35 Gresser 2002

**Table 2.1 EC protection, selected products**

	Average MFN rate %	Maximum rate %	Non-Tariff Barrier %	Anti-dumping %	Overall %
Cereals	14.0	15.2	5.0		19.0
Meat	11.2	12.1	64.8		76.0
Dairy products	9.7	10.3	100.3		110.0
Other agriculture	8.9	179.7	11.2	5.3	20.0
Food products	19.5	236.4	5.0		24.5
Tobacco	47.3	81.9			47.3
Clothing	11.6	13.0	19.0		30.6
Footwear	7.4	17.0		17.5	8.9

Source: Messerlin, *The Real Cost of European Protection*, 2003

**2.21** Of course, tariffs contribute to government revenue and can thereby be used to fund social programmes which help the poor, although there will obviously be efficiency losses in such a circular redistribution. For developed countries, however, the contribution of tariffs to overall government revenues, is modest. In the UK, tariffs are worth £2 billion, equivalent to only around 0.5% of the total tax take. (Developing countries tend to be more reliant on tariffs for revenue and the position for them is discussed in more detail in Chapter 4). In developed countries, the greatest transfer takes place not between consumers and government, but between consumers and domestic or (particularly when quantitative restrictions are used to restrict imports) foreign producers. Thus, while tariff revenue for the EU as a whole is around 0.5% of GDP, the overall cost of protection falling on EU consumers is estimated as 7% of EU GDP<sup>36</sup>. The difference is essentially a transfer payment from consumers to domestic or foreign producers in the protected sectors.

**2.22** Cumulatively, this adds significant costs to the household budget. In the UK, the Consumers' Association has estimated that the cost of the Common Agricultural Policy alone (including subsidies as well as import tariffs) costs each family in the UK around £16 per week in tax and higher food prices<sup>37</sup>.

**2.23** In developed countries, one of the primary political objectives of maintaining tariff barriers is to try to protect vulnerable low-skill jobs. But tariffs have proven ineffective at protecting domestic jobs. Since 1997 UK employment in textiles manufacturing has fallen by 45%, in clothing manufacture by nearly 60%, and in footwear manufacturing by around 50%. In Europe as a whole, it is estimated that tariff protection has saved around 3% of the jobs supposedly protected, adding up to around 220,000 euros for every job saved<sup>38</sup>.

<sup>36</sup> Messerlin 2003

<sup>37</sup> Consumers' Association press release 11/12/2001 <http://www.which.net/media/pr/dec01/general/capscrap.html>

<sup>38</sup> Messerlin 2003

**2.24** Tariffs and other protective measures are therefore unambiguously harmful to consumers, raising prices and reducing choice. The structure of tariffs in the EU and in other developed countries is especially burdensome for poorer people as consumers since higher prices fall on those products on which they spend proportionately more of their income. Moreover, they are a highly inefficient mechanism for preserving jobs in the protected sectors, and potentially destroy jobs in other sectors. The following section looks in more detail at the experience of “infant industry” protection, which is, in economic theory, the most reputable justification for protection.

## Is Protection Necessary for Development? The Infant Industry Argument<sup>39</sup>

**2.25** For over 200 years<sup>40</sup> it has been argued that “infant industries” need protection: how else could an industrialising country hope to match the unit costs of more established foreign rivals? The essentials of the argument were guardedly endorsed by John Stuart Mill<sup>41</sup>, provided that protection is eventually removed. In today’s language, there are first-mover advantages because industries learn-by-doing; unit costs typically decline in real terms as a result of production experience. A survey of 92 empirical studies<sup>42</sup> into so-called progress ratios, or experience curves, indicate that unit manufacturing costs typically fall by between 70% and 90% with each doubling of cumulative output<sup>43</sup>. Protection affords the infant industry an opportunity to progress down its experience curve and eliminate its cost disadvantage.

**2.26** The infant industry argument is recognised by the GATT and the WTO. Article XVIII of the GATT legitimates a wide range of government actions to help protect and encourage infant industries<sup>44</sup>. Today’s supporters of the infant industry case wish to distance themselves from the failures of import-substitution strategies and emphasise export-promotion, claiming that export-targeted subsidies played a key role in the economic development of the Asian Tigers. They fret about the restrictions imposed by Article 3 of the Agreement on Subsidy and Countervailing Measures (ASCM), which prohibits subsidies dependent upon “export performance” or “the use of domestic over imported goods” to be paid to firms (except for agricultural products)<sup>45</sup>.

39 See also, DTI White Paper on Trade and Investment 2004, p.72-74

40 Hamilton, 1791 and List 1841

41 John Stuart Mill, *Principles of Political Economy* (1848, Book 3), in Robson, ed. (1965, pp.918-19). “The superiority of one country over another in a branch of production often arises only from having begun it sooner”. “But it cannot be expected that individuals should, at their own risk, or rather to their certain loss, introduce a new manufacture, and bear the burden of carrying it on until the producers have been educated up to the level of those with whom the processes are traditional. A protecting duty, continued for a reasonable time, might sometimes be the least inconvenient mode in which the nation can tax itself for the support of such an experiment”.

42 Ghemawat 1985

43 A learning curve is conventionally said to have a slope of x per cent if it declines by x per cent when cumulative output doubles.

44 According to the 1995 edition of the GATT Analytical Index, Articles XVIII A and C have been invoked a total sixteen times by countries such as Cuba, Haiti, India, Sri Lanka, Suriname, Indonesia and Korea.

45 Subsidies are permitted for R&D but not for production (although Least Developed Countries and other developing countries with a per capita income of less than \$1,000 are specifically exempted from the restrictions imposed by the ASCM).

**2.27** Some proponents of the infant industry case make much of the point that today's developed countries urge developing countries to reduce their tariffs but they themselves developed via protection<sup>46</sup>. The more relevant historical question is the counterfactual: would the USA and Germany – the two most commonly cited historical examples – have fared better if they had instead adopted less protective measures? If so, is it sensible for today's less developed countries to replicate the pioneering routes to economic development when, with the benefit of empirical research, protection can now be seen as a mistake?

### ***Analysis***

**2.28** The first question with which the argument needs to be confronted is: what is the alleged "market failure" which infant industry protection seeks to remedy? It cannot be an information failure because, if it is so obvious that an infant industry could eventually become internationally competitive, what is preventing would-be producers from financing it? Is it a question of externalities and, if so, why is tariff protection the appropriate instrument to deal with them? One possibility is that there are dynamic economies of scale which are external to the firm but internal to the industry as, for example, if a pioneering firm trains its employees, and then loses them to free riders. A tariff would do nothing to solve this problem, which needs to be addressed either by the public provision of training or by training grants and levies. As a matter of empirics, it not at all clear that there are such economies. By applying modern econometric techniques to learning-by-doing spillovers over seven generations of dynamic random access memory (DRAM) semiconductors, Irwin and Klenow<sup>47</sup> concluded that firms learn three times more from an additional unit of their own cumulative production than from that of another firm, and that learning spills over just as much between firms of different countries as between firms within a given country. These findings, although based on only one sector, provide no support for the spillover argument for infant industry protection.

**2.29** There are then some practical questions about the necessary conditions for the infant industry to catch up. The established foreign industries are not likely to stand still, but continue to learn themselves. As the Box indicates, the protected infant industry can expect to find itself chasing a receding target.

46 Chang 2002

47 Irwin and Klenow 1991

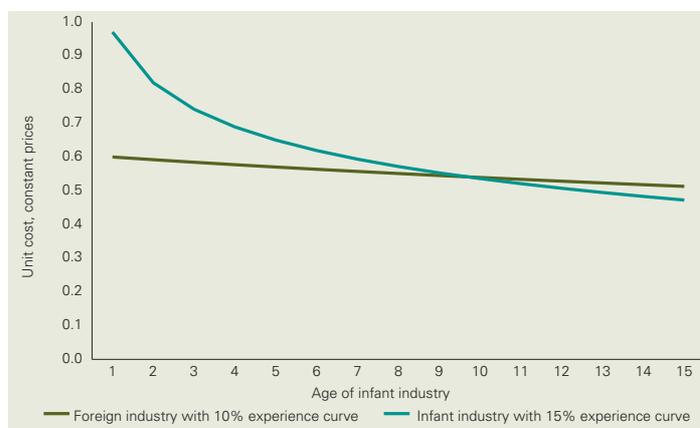
### Box 2.1: Catching up by learning-by-doing

Suppose that an established foreign industry enjoys a 40% unit cost advantage over the infant industry. The infant industry might hope to close the gap by:

- learning faster than the foreign competitor, achieving greater reductions in unit cost with each increase in cumulative volume – see Figure 1A<sup>48</sup>
- growing faster than its foreign competitor, perhaps because it can exploit a large and expanding domestic market – see Figure 1B.

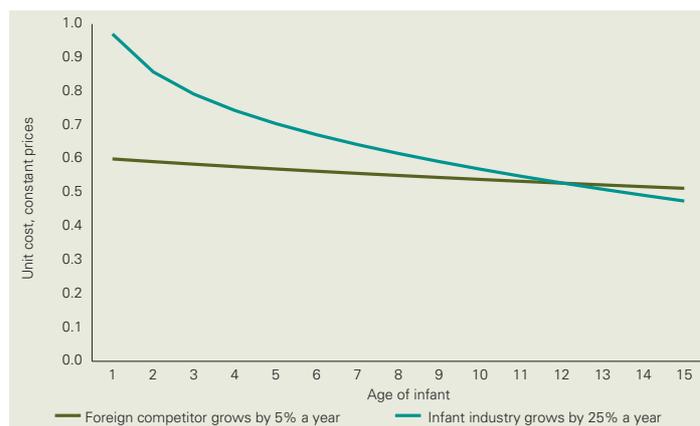
#### Figure 1A Catching up by faster learning-by-doing.

Infant and foreign industry grow at same annual rate (5%)



Source: DTI

#### Figure 1B Catching up through faster growth. Infant and foreign industry follow the same 10% experience curve.



Source: DTI

In each case the infant catches up with the foreign industry in fifteen years: a slightly faster rate of learning (Figure 1A) is as potent as a very much faster rate of growth (Figure 1B).

<sup>48</sup> Both the foreign and the infant industry produce one unit in their first year, but the foreign industry starts 10 years before the infant. Unit cost in any year is modelled as a function of cumulative volume up to and including that year:  $\text{unit cost}_t = CV_t^\alpha$ . If unit cost falls by 10% with each doubling of cumulative volume,  $\alpha = -0.152$  i.e.  $1 - 2^{-0.152} = 0.1$ .

**2.30** Another consideration is whether experience curves are reliable predictors of industries' unit costs. The slopes of experience curves vary widely from product to product. They are steeper in industries with standardised product ranges and complex, labour-intensive production processes such as airframe assembly or machine tool businesses. There are instances of organisational "forgetting"<sup>49</sup>. The relevant dimension of cumulative experience is not always obvious: is it an individual product or is it a family of products that share common processes (economies of scope apply also to learning). Greater variation is reported across organisations producing the same product (e.g. within shipbuilding programmes) than within organisations producing different products. The variety of these outcomes reminds us that business is not conducted according to some manual: it is more akin to a series of experiments.

**2.31** Learning is often confused with other factors, such as economies of scale and exogenous technological change. One of the most famous examples of learning-by-doing occurred in the US's Emergency Shipbuilding Program in World War II. Labour productivity increased by over 40% a year for three years, reducing the production time of a Liberty Ship from six months to just 30 days by 1943. For fifty years the economics profession attributed this all to learning. A re-examination of the evidence<sup>50</sup> indicates that about half of these productivity gains were due to increased capital investment. Some gains were also due to new methods, including new welding machines that were developed outside the industry, and declining quality.

**2.32** Reviewing the value of experience curves as a basis for business strategy, Ghemawat noted that they can lead to expensive mistakes, even by those well placed to understand them<sup>51</sup>. Companies can bet on the wrong technology, only to discover that their learning advantage has been wiped out. With huge plants and massive cumulative volumes, integrated steel producers found themselves unable to compete on cost with the new electric-arc mini-mills. Watching and waiting, rather than accumulating the "wrong" experience, may sometimes prove the better strategy. Waging a price war on the basis of experience curves can prove ruinous; if rivals are determined to ride down their curves, alternative strategies might be more productive, but these alternatives usually involve producing premium products (e.g. General Motors' response to the Model T Ford, Intel's reliance on innovation to escape competition from TI and National Semiconductor) – precisely the market segments in which developing countries are least likely to be competitive.

**2.33** How is it, then, that some new industries are able to take off in developing countries, without protection? One reason is that they enjoy factor cost advantages that offset their learning disadvantages. Another is that in some industries, there is little learning

49 Argote and Epple 1990

50 Thompson 2002

51 Ghemawat 1985, "Douglas Aircraft fixed prices for prices for the DC-9 on the basis of an 85% experience curve. When the estimated cost reductions failed to materialise, its losses forced Douglas into acquisition by the McDonnell Company" (page 144). "Monsanto, which tried to rush down the experience curve by investing aggressively in large facilities such as the UK Seal Sands complex, lost money because the expected cost advantage did not materialise" (p 146)

involved; in others, learning is embodied in the capital equipment, and can hence be bought of-the-shelf.

**2.34** Finally, the infant industry argument encounters two problems of political economy. The first is to do with information. The infant industry argument involves “picking winners”. It is far from obvious that any government – in developed or developing countries – has the knowledge or ability to select either the right industries or the appropriate degree of protection. The learning benefits are distant and difficult to measure. The likely outcome is that protection is secured by the most effective lobby rather than by the most “deserving” industry.

**2.35** The second political economy problem is to do with what is termed “time inconsistency”. Once habituated to protection, and confident that it will remain, firms lose their competitive edge. As Tornell<sup>52</sup> observed, “If authorities capitulate to protectionist pressures in the present, they are unlikely to resist them in the future, in the event that the targeted firm would not have adapted”. So when the time comes to discontinue protection, this is no longer the optimal policy, because the firm has yet to become competitive.

### ***How have infants fared?***

**2.36** Studies of the experience of protected industries suggest that protection has not, in general, succeeded. A review of these found only one case of an industry that achieved international competitiveness, sixteen years after its birth<sup>53</sup>. The reviewers commented that “none of the studies makes comparisons with established firms”. A study on behalf of UNCTAD<sup>54</sup> remarked that “There has also been a plethora of studies which show that industrialisation behind protective walls has often extended beyond reasonable grounds of infancy and has led to efficiency and welfare losses, and entrenched vested interests.”

**2.37** Few studies have compared infants’ competitiveness with that of their established competitors, which is a very relevant comparison. Fewer still have attempted to construct the alternative, no-protection scenario. Head’s study of the 19th century U.S. steel rail industry<sup>55</sup> is an exception, modelling US consumers’ choices as between American and British steel rails (which were not perfect substitutes), the roles of learning-by-doing, changing resource endowments, and tariff protection in the emergence of this industry, in order to simulate the no-protection scenario. Head estimated that, despite strong learning effects, the steel rail tariff was damaging to rail users, even in the long run. The tariff’s overall effect on welfare was positive but fairly small. The protected industry learned-by-doing at a lower rate than the British industry, suggesting that protection relieved some of the pressure on the protected industry to drive down unit costs<sup>56</sup>.

52 Tornell 1994

53 Bell, Ross-Larson and Westphal 1984

54 Bora, Lloyd and Pangesti 2000

55 Head 1994

56 The coefficients on cumulative volume for the US and British industries were – 0.186 and –0.275 respectively.

Moreover, it is unlikely that the protected industry would have colluded, as it did from 1887, and raised prices in the way it did, in the absence of protection.

**2.38** The Spanish steel industry is an interesting case: it was accorded infant industry protection in the first third of the 20th century, with tariffs of 50-200% on iron and 50% on steel<sup>57</sup>. Sheltered from foreign competition, the Spanish steel firms established price agreements to ensure that they were not troubled by internal competition either. After 30 years of protection the industry's exports had dwindled to zero. Scale is important in steel production: in this period the industry increased its average plant size nearly threefold, from 24,000 tons/year to 66,000 tons/year. But the foreign firms increased their average plant size tenfold, from 50,000 tons/year to 500,000 tons/year.

**2.39** The growth of an infant industry is not itself proof that the policy has succeeded; the costs of stimulating this growth may exceed the benefits. Until 1990 the Brazilian government strongly protected its microcomputer industry. A detailed analysis<sup>58</sup> concluded that the cost of the protection to Brazilian consumers was nearly 20% of domestic expenditure on microcomputers, and that the industry, despite high growth, fell behind technically by between three and five years. On the other hand, Danish subsidies for wind-generated electricity are a persuasive instance of a successful infant industry strategy. The four Danish windmill suppliers moved down their learning curve between 1983 and 1998 and by the late 1990s were exporting about three-quarters of their production<sup>59</sup>. But the questions remain of how would they have fared in the alternative, policy-off scenario and in what sense was the Danish windmill industry itself protected? Wind-generated electricity is the protected industry, not the windmills; it was open to the Danish generators to buy windmills from any other EU country, free of tariffs. Why have other countries' subsidies to wind power not given rise to successful windmill industries?

## **Conclusions**

**2.40** It is understandable that developing countries should seize on learning-by-doing as a basis for strategy. Learning-by-doing is a potent and well-documented phenomenon: it is used as a basis for business strategy, with varying success, and it underpins endogenous growth theory. However, as noted above, the issues here are whether the infant can learn *at a faster rate* than established producers. Moreover, can it do so within a protective cocoon that exerts little or no pressure to perform, noting that governments cannot credibly commit to terminating it. There have been successful infants (e.g. the South Korean steel industry) but most appear to have failed. Although the infant industry protection seeks to remedy alleged *market* failures (i.e. spillovers within the protected industry), there is little evidence of these spillovers, and if there *were* any there are better remedies than tariffs. The more probable outcome is a *government*

57 Fraile 1991

58 Luzio and Greenstein 1995

59 Drud Hansen, Jensen and Stroker 2003

failure: when even those closest to the industry concerned have difficulty predicting rates of learning-by-doing, central planners, with only the slimmest acquaintance with production processes, will be even less able to do so.

## **The Relationship Between Investment Liberalisation and Growth<sup>60</sup>**

**2.41** Foreign direct investment (FDI) can have a significant impact on growth in the host economy, by transferring technology, skills, managerial know-how, and innovation, by providing access to international markets, and by stimulating domestic investment and competition and enabling capital formation that would not otherwise have been possible<sup>61</sup>.

**2.42** FDI will also have important compositional effects on the host economy due to the fact that foreign firms often have higher levels of productivity<sup>62</sup> (FDI typically involves higher costs and risk and so may be adopted by more productive firms<sup>63</sup>) and engage in more trade than domestic firms in developing countries. However, FDI may also crowd out domestic investment, holding back the development of domestic industries, although the evidence for this is mixed.

**2.43** The impact of FDI on developing countries appears to be stronger for those which are more advanced, suggesting that host countries need to acquire a minimum level of investment or educational infrastructure to reap the full potential benefits<sup>64</sup>. The impact of FDI will also vary according to the motivations and characteristics of both investors and local firms and according to the prevailing levels of competition, international integration and the ease with which the economy is able to adjust.

**2.44** The link between FDI and trade is one of the main factors contributing to increased growth for developing countries. FDI and trade can be alternative strategies that multinational enterprises (hereafter 'MNEs') use to enter markets. For example, the existence of trade barriers may force firms to access the market through investment rather than exports. But FDI and trade can also be complementary. A MNE may prefer to start by trading and, if this proves successful, invest. Generally, countries that are open to trade will find it easier to attract FDI as openness to trade allows investors to purchase imported inputs cheaply and to sell products outside the host country more easily.

**2.45** FDI is itself likely to impact on trade flows. As mentioned above, one of the key benefits that developing countries can hope to derive from FDI is in further integration into the world economy, which is likely to result in both more imports and more exports:

60 See OECD 2002 (3) for a fuller analysis

61 Blomstrom et al 1992, Borzenstein et al 1995

62 Bannock et al forthcoming 2005

63 Melitz 2002

64 Blomstrom et al 1992, Borzenstein et al 1995

- Exports may be increased, inter alia, if the investment enables the host country, which was previously financially constrained, to make better use of their natural resource endowment or geographical location. Also, at least one study<sup>65</sup> concludes that FDI can provide an important boost to exports, both because foreign enterprises tend to be more trade-oriented than domestic enterprises, and because they provide positive informational spillovers to domestically-owned exporters.
- Imports may increase as a result of increased number of imported inputs and other factors of production.
- Countries may attempt to encourage inward FDI by establishing export processing zones (hereafter 'EPZs'<sup>66</sup>). However these may be expensive to maintain, and create an uneven playing field between domestic and foreign enterprises.

**2.46** Some studies show that MNEs<sup>67</sup> are increasingly vertically integrated, and that there has been an increase in the level of imports of input and intermediate level goods. Other studies<sup>68</sup> indicate that horizontal integration is more common<sup>69</sup> and do not show an increase in intra-firm imports. The increase in outsourcing has also been noted. Overall, the pattern is that FDI tends to lead to an increase in imports in the short term, which is gradually reduced as the local companies acquire the skills to serve as subcontractors to the entrant MNEs.

**2.47** Another consequence may be an impact on the international liquidity of the host country if considerable amounts of profits, interest and royalties are remitted to the parent companies abroad. This can result in negative effects to the balance of payments. The evidence on this is limited. There have been estimates<sup>70</sup> that remittance and other payments in Malaysia rose from \$2bn to \$5bn between 1990 and 1995, exceeding new capital inflows of FDI. By contrast, in China new FDI inflows were over 3.5 times the size of profit remittance in 1995<sup>70</sup>. However, these figures give no indication of the size of reinvested profits. If the share of profits that are reinvested depends on the profitability of the original investment, this underscores the importance of facilitative government policies to establish and maintain an attractive investment climate.

65 Aitken et al 1994

66 Export-processing zones are a trade-related investment policy that may assist in attracting FDI. They generally involve unlimited duty free imports of inputs and capital goods for production, reduced administrative and regulatory burdens, flexibility in labour standards, tax concessions, better communications and infrastructure and openness to domestic and foreign owned enterprises.

67 Hanson 2002

68 Brainard 1997, Ekholm 1998

69 Vertical integration occurs when an enterprise has ownership/control of either its suppliers (backward integration) or its distributors (forward integration). Horizontal integration occurs if an enterprise has this relationship with other enterprises at the same point in the supply chain as itself, such as competitors or companies producing complementary products.

70 UNCTAD 1997

## ***FDI and technology transfers***

**2.48** Technology transfers may be the most important channel for positive externalities from FDI in host countries. They are considered by civil society as one of the key contributions of FDI<sup>71</sup>. Whether MNEs facilitate these spillovers, and whether developing countries are able to take advantage of them, are key to whether or not developing countries benefit from FDI. In China, the government has encouraged domestic firms to improve their own industrial efficiency through technology transfer, co-operation in joint ventures, and (more recently) controlled levels of competition. However, not all FDI, especially into developed economies, will necessarily be by firms with superior knowledge or technology<sup>72</sup>. Investors may be seeking market access, to evade trade or regulatory barriers, or may be seeking to learn from local clusters<sup>73</sup>. In such cases technology transfers may flow the other way, from local firms to inward investors.

**2.49** Technology transfer can take place via the following channels:

- a) Vertical linkages with suppliers or purchasers, where MNEs provide technical assistance, training and information to raise the efficiency of the suppliers, and the quality of their products. They may also assist in purchasing raw materials and other inputs that widen the range of intermediate goods, and in setting up modernised production facilities. There is strong evidence<sup>74</sup> that this does occur in developing countries, in particular where there are backward linkages between MNEs and local suppliers. The important caveat here is that the technology transferred must be relevant to the host country business sector outside of the original firm.
- b) Horizontal linkages with competing or complementary companies in the same industry. These take place via either demonstration or competition effects. Demonstration effects involve the imitation of a technology by a local firm after it has been adopted by an MNE. A positive externality occurs in cases where adoption of a new technology is considered risky, as it has not been used by local firms before. If it is shown by the MNE to be effective then the risk associated with the investment is reduced. The competition effect is likely to be most beneficial if the domestic market was previously characterised by high entry barriers.

Studies<sup>75</sup> have found mixed results in the case of horizontal linkages in developing countries, which could be due to MNEs' efforts to avoid knowledge leaking to their competitors. More recent studies<sup>76</sup> indicate that horizontal spillovers may be more important between enterprises in unrelated sectors, which supports this view<sup>77</sup>.

71 CUTS "Investment for Development – Civil Society Perceptions", case study for WDR 2005, funded by DFID. Technology, management and capital are perceived to be the key contributions.

72 Dunning 2000

73 Driffield and Love 2001

74 For example see Lall 1980 and Watanabe 1983

75 For example see Saggi 2000 and Aitken and Harrison 1999

76 Kugler 2000

77 For more details, see OECD 2002 (3)

- c) Migration of skilled labour from MNEs to domestic companies, which takes with it the skills and knowledge acquired. The evidence for this is mixed. Results from various different studies show significant levels of migration of skilled labour from MNEs to domestic firms occurred in Latin America, South Korea, Taiwan and Bangladesh. By contrast only small numbers migrated in this fashion in Kenya, Mexico, and Venezuela. This may be explained partly by the finding that in the latter two countries the wages paid by MNEs were significantly higher than those paid by domestic firms.<sup>78</sup>

**2.50** A further significant point is that the level of technology in the host country in relation to that of the MNE is important to the amount of technology that can be gained from spillovers. If the “technology gap”, both in absolute and relative terms, between domestic and foreign enterprises is too wide then the domestic enterprises are less able to absorb the potential benefits described.

### ***The effect of FDI on human capital enhancement***

**2.51** The economic benefits of improved human capital are increased productivity – partly through increasing its ability to absorb new technology and process innovations – and increased motivation and commitment.

**2.52** The benefits to human capital enhancement brought by FDI come from two sources:

- a) The direct contribution made by MNEs to employees and to other enterprises in the host country. This occurs through training of employees and spillover effects such as demonstration effects and the migration of skilled labour.
- b) The indirect contribution from improvement of the enabling environment by governments (in terms of education, labour standards and other human capital formation) made in order to attract more FDI. This contribution is vital both in itself, and also as it enables increased absorption of spillovers generated by MNEs.

**2.53** The evidence shows that a significantly larger impact is made to human capital by governments than directly by MNEs. However, the contribution of MNEs is found to be positive: they are found to provide more training and other capital upgrading activities (including labour training and skill acquisition and through the introduction of alternative management practices and organisational arrangements) than domestic enterprises. The evidence for migration of skilled labour from MNEs to domestic firms has been discussed in the previous section.

<sup>78</sup> For example see Bloom 1992 and Katz 1987

**2.54** Human capital levels and spillovers are closely interrelated with technology transfers. Evidence suggests that more technologically advanced economies are likely to experience more human capital spillovers, and that economies with a high component of human capital will gain more technology spillovers.

### ***The effect of FDI on competition***

**2.55** FDI may have a significant influence on the competitive situation in host country markets. On one hand, by allowing the entry of globally efficient new firms into the domestic market, FDI may increase the number of players in the market (but not if entry takes place through a merger or acquisition) and hence increase the intensity of competition for business.

**2.56** However, it is also possible that FDI may be detrimental to competition, if large and powerful MNEs are able to exploit their position and use anti-competitive practices to increase concentration by driving small, local competitors out of the market and prevent new entry<sup>79</sup>. This risk is exacerbated if the host country constitutes a separate geographical market, the barriers to entry are high, the host country is small, the entrant has an important market position and if the host country competition policy regime is weak or is weakly enforced.

**2.57** Some casualties among the domestic competitors may be expected: the movement of labour and capital from less to more productive activities is in fact central to realising the benefits of FDI. The fact that the MNE enters the market at all suggests that it has some advantage over domestic competitors, e.g. through size, technical efficiency, brand etc.<sup>80</sup>, which makes FDI worthwhile despite the costs of relocation.

**2.58** The ability of MNEs to drive competitors out of the market may be greater in developing countries, where domestic competitors may be relatively backward technologically and lacking capital, making them particularly vulnerable to competition. However, this is not necessarily detrimental to the economy if it reflects greater efficiency or a higher minimum efficient scale (MES). (Some of the new technologies that MNEs introduce may be expected to increase the MES, if for example they lead to greater mechanisation etc.) In addition, over time, if domestic entrepreneurs are able to learn from the MNE, they may be able to re-enter and compete more effectively, resulting in a reduction in concentration in the long run<sup>81</sup>.

**2.59** Market concentration has increased worldwide since the beginning of the 1990's due to the number of mergers and acquisitions that have taken place. While high market concentration does not necessarily imply a lack of competition or contestability, high

<sup>79</sup> Different types of FDI will have different impacts on concentration. For example, FDI that is used solely to take advantage of low labour costs and to produce products mainly for export will have little impact on host country product markets compared to FDI that is used specifically to access the host country market.

<sup>80</sup> Dunning 2000

<sup>81</sup> Clearly this depends on the extent to which the MNC's competitive advantage is replicable. A domestic competitor may be able to copy a particular technology, but it won't be able to copy a brand name.

concentration and a large market share may make it easier for firms to undertake anti-competitive practices<sup>82</sup>, especially where entry barriers exist through brand dominance, intensive and extensive advertising, high investments, and control over distribution systems etc.

**2.60** This discussion shows that the existence of effective competition policy and law are desirable to prevent and tackle anti-competitive practices, and to ensure that a healthy degree of competition remains. This also suggests that countries with effective competition policy may derive greater benefit from FDI than countries without, a belief that is shared by civil society<sup>83</sup>. Supporting this, there is evidence to suggest that competition authorities can facilitate FDI entry in a way that is in the interests of, and maximises the benefits to, the host country<sup>84</sup>.

**2.61** Another way of ensuring a competitive outcome is to expand the relevant market by increasing the host economy's openness to international trade. Here the emphasis should be on protecting competition and hence consumers, rather than incumbents, which could lead to inefficiency in the long run.

### ***The effect of FDI on enterprise development***<sup>85</sup>

**2.62** FDI has the potential to spur enterprise restructuring in the host economy. The direct impact of FDI on the acquired host country enterprise will be, for example, efforts made by the MNE to raise efficiency and reduce costs and in the development of new activities. This leads to changes in management and corporate governance. MNEs will introduce their own company policies, reporting systems and principles of information disclosure on acquired enterprises. To the extent that foreign corporate practices are superior to those prevailing in the host economy, this may boost corporate efficiency.

**2.63** Evidence points to a significant improvement in economic efficiency in the enterprises acquired by MNEs, although the degree varies across countries and sectors. The strongest evidence of this happening is in industries where there are economies of scale.

**2.64** Studies also show that the migration of foreign managers can be an important source of improvement in an enterprise, but that country specific competencies can also be an asset for managers in subsidiaries. The optimal solution appears to be a mix of local and foreign management.

**2.65** Foreign participation in the privatisation of government-owned enterprises is a specific example of the potential success of FDI in contributing to the restructuring of an enterprise. Many of the experiences so far have come from the transition economies of

82 UNCTAD 1997

83 CUTS "Investment for Development – Civil Society Perceptions", case study for WDR 2005, funded by DFID.

84 CUTS "7 Up Comparative Competition project", funded by DFID.

85 See OECD 2002(3) for more details.

Central and Eastern Europe, and have been largely positive. There have been political controversies, however, as efficiency gains have come at the cost of job losses. Moreover, some of the value of FDI in privatisation schemes may reflect the fact that few domestic strategic investors have sufficient access to finance. Where it has happened, domestic investment has had an equally positive effect.

**2.66** Additional efficiency gains may occur in related enterprises through demonstration effects and other spillover channels similar to those of technology and human capital, as discussed earlier. The extra competition from the presence of the MNE should act as a spur for local firms to innovate. FDI may also provide a stimulus to small and medium size enterprise (hereafter "SME") development, generally through its impact on increased business linkages in the local economy.

### ***Outward investment***

**2.67** The above demonstrates why inward investment is generally accepted as being economically beneficial to host countries. What is less universally accepted is that outward investment can also bring benefits. Clearly it can be expected to generate benefits in the host countries, for the reasons discussed earlier. It would also be expected to create value for the investing companies, as otherwise they wouldn't invest. However, its impact on the home county is less clear-cut and difficult to evaluate. If overseas investment substitutes for home investment there can be a short-term loss in output. Yet, competitive, innovative companies are vital for the long run prosperity of any country. With outward investment expected to improve the competitiveness of a country's companies, it may be a necessary step for long-run prosperity. However, in the short term it can cause disruption and there can be adjustment costs.

**2.68** Outward investment can be made for a variety of reasons. Typically it can be undertaken to maximise profits from firm specific advantages whose benefits can be internalised and (to some extent) protected<sup>86</sup>. But it can be driven by the desire to access a large market, especially if there are significant trade or regulatory barriers, or even to try to access local technology or advantages (when firms seek to invest in and learn from successful overseas clusters). Overseas investment can also help firms diversify their operations and hence lower their risks.

**2.69** As there are larger risks and costs associated with overseas investment than trade, the opportunities and profits need to be larger to compensate. Indeed it is possible that only the most productive firms are likely to seek to invest overseas<sup>87</sup>. This suggests that firms can be split between those serving only their domestic market, those that export and those that invest overseas based on their performance. Due to higher costs and risks of entering overseas markets and the greater costs of investing than exporting, there is self-selection with the weakest firms concentrating on their domestic market and

86 Dunning 2000

87 Melitz 2002

the strongest investing overseas. Home production, exporting and outward investment thus emerge as complementary activities rather than direct substitutes.

**2.70** The home country benefits from the increased competitiveness and growth of its companies, who will be better placed to benefit from the opportunities offered from globalisation. There can be short-term costs, if as a result of overseas investment, production is shifted overseas. But attempts to prevent outward investment are likely to be counterproductive. Blocking outward investment may preserve jobs in the short run but is likely to leave home companies weaker. As their long-term competitiveness declines, the jobs that have been “protected” are likely to disappear.

**2.71** UK firms have been significant users of overseas investment. The UK is the world’s second largest overseas investor after the USA, with the stock of UK investment reaching over £630 billion by the end of 2003.

## Migration

**2.72** Any analysis of the increased economic flows between countries needs to cover not only trade but also the increased movements of labour across international borders that are associated with closer economic integration. The DTI Strategy (2003) highlights social change, including shifting migration patterns, as one of the challenges ahead for the UK economy. This section highlights the potential benefits arising from the freedom of movement of people, and considers some of the fears about migration. The impact of migration into the UK is considered before discussing two significant impacts of migration to the UK on the developing world: brain drain and remittances. The focus is on managed migration, not on illegal migration or asylum.

**2.73** Basic economic theory suggests that labour, in the absence of barriers to mobility, will move to where it is most productive, i.e. with employers willing to pay wages equal to the marginal product of labour, labour will maximize its income by moving to where its marginal product is greatest. Migrants move across borders voluntarily in the expectation of improving their future welfare.

**2.74** International labour flows are far from a perfect market, since there are numerous barriers to the movement of labour. Some of these barriers are unavoidable and, of course, there are government-imposed restrictions on labour flows.

**2.75** Nevertheless, government restrictions permitting, labour will migrate when there are differentials in wages and other factors that affect quality of life such as healthcare, education, and political and economic freedom. Evidence from the US shows that legal migrants from Mexico earn on average over 60% more than they would if they continued to work in Mexico<sup>88</sup>. However, because migration is costly it is rarely an

option for the very poorest. Migration rates will initially increase with income, as the option to move becomes affordable, and then fall away as the income differentials between the labour-exporting country and the destination are closed<sup>89</sup>.

**2.76** From the perspective of the host country, selective inward migration has been encouraged by recruitment drives by developed countries and by changes to developed country immigration procedures to facilitate the inflow of migrants with desirable skills. This is illustrated, for example, by the UK work permit system, the US visa system and by Mode 4<sup>90</sup> of GATS, the General Agreement on Trade in Services. Migration into the UK has increased in recent years as the barriers to migration have fallen, for example with the spread of global transport networks, falling transport costs and hugely increased flows of information. The number of inward migrants has risen from 179,000 in 1993 to 418,000 in 2002 (excluding returning UK citizens). It is notable that the net migration pattern for the UK and other major developed countries has varied both over time and between countries.

#### **Industrial Country Net Immigration (average per year, as a % of labour force)**

	<b>1870 – 1913</b>	<b>1914 – 1949</b>	<b>1950 – 1973</b>	<b>1974 – 1987</b>
Australia	0.96	0.74	2.06	1.14
France	0.11	- 0.03	0.75	0.11
Germany	- 0.48	- 0.08	1.12	0.26
Japan	n.a.	0.02	- 0.01	- 0.02
<b>UK</b>	<b>- 0.97</b>	<b>- 0.24</b>	<b>- 0.10</b>	<b>0.00</b>
USA	1.38	0.35	0.47	0.51

Source: Obstfeld and Rogoff 1996

**2.77** It seems reasonable to conclude that in the presence of significant push and pull factors, there will continue to be significant labour flows in the absence of further government imposed barriers to migration.

#### ***Impact of migration on the UK***

**2.78** This section looks at the overall impact of labour flows into the UK and does not consider the impact of individual entry schemes. The aggregate impact of labour inflows on the UK economy is considered, but it is recognised that the impact may be more marked if migration becomes focused on certain regions or groups within society. It should also be noted that many migrants come to the UK for reasons other than to work. For example, around 175,000 overseas (non-EU) students were studying in the UK in 2002-03<sup>91</sup>. Others come as refugees or for family reunions.

<sup>89</sup> Bhagwati 2004

<sup>90</sup> Under Mode 4 a person resident in one country can deliver a service in another country, provided that they are transferring within the company, performing a specified contract, or visiting as a business visitor, in all cases for a limited period and provided the person is suitably qualified.

<sup>91</sup> British Council, cited in the Times Online 22 January 2004

**2.79 Reducing skill shortages and improving growth.** Migrant flows currently play a significant role in meeting the skills needs of a number of sectors. The primary aim of the work permit system is to fulfil the needs of UK employers, by enabling them to recruit labour from overseas if they can demonstrate that they are unable to find suitable resident labour.

**2.80** By alleviating skills shortages, inflows of labour can help relax constraints on growth within the economy. HMT figures suggest that 0.4 percentage points of overall trend growth of 2.75% result from inward migration<sup>92</sup>. In addition, migrants may be a source of entrepreneurial activity that would not otherwise have occurred. Research published by the Home Office<sup>93</sup> estimates that a 1% increase in the population through migration is associated with an increase in GDP of between 1.25% and 1.5%.

**2.81 Impact on the UK labour market.** Many people believe that increased labour flows into the UK have reduced employment and wages for the existing UK labour force. For example Dustmann<sup>94</sup>, quoting data from the European Social Survey 2003, points out that approximately one in three UK residents believe that immigration brings down wages. In fact there is little evidence to suggest that it does.

**2.82 Impact on employment.** These concerns arise in part from the lump of labour fallacy – the belief that there are only so many jobs to go round and that by ‘giving’ a job to a migrant it is lost to a native worker thus increasing unemployment. This lump of labour argument is now discredited. Not only will migrants add to the level of demand in the economy but also in a flexible labour market such as that of the UK, the existing labour force will be able to find alternative employment. Recent research<sup>95</sup> using UK Labour Force Survey data found that migration did not have an adverse impact on the employment rate of the existing workforce.

**2.83** Although there may be some negative externalities from migrants, for example, increasing pressure on housing and other infrastructure, any negative labour market impact is mitigated by the fact that migrants are often entrepreneurial, establishing new businesses and thus generating employment. For example, foreign born people in employment in the UK are more likely than their UK-born counterparts to be self-employed (14% compared with 11%)<sup>96</sup>.

**2.84 Impact on wages.** Economic theory suggests that those in direct labour market competition with migrants face lower wages. However, recent research for the UK fails to find a significant negative link between migration and wages<sup>97</sup>. Where migrants work in sectors with skill shortages, employment will rise, but not enough to reduce wages.

92 Trend Growth, HM Treasury April 2002

93 Glover et al 2001

94 Dustmann et al 2003

95 Dustmann et al 2003

96 Dustmann et al 2002

97 Dustmann et al 2003

In addition, migration may allow a change in the structure of output, i.e. migration of workers into a sector allows that sector to expand, relative to other sectors, allowing both wages and employment to increase.

**2.85 Fiscal impact.** An additional argument put forward against migration is that migrants represent a drag on the fiscal resources of the UK. Managed migration schemes are focused on allowing entry to migrants with employable skills. Once in employment migrants are likely to make a net positive contribution to the UK fiscal position.

### ***Migration and developing countries***

**2.86** Although migration will generally benefit the individuals involved and their immediate family, its wider developmental impact is less clear-cut. Two issues are considered here, the risk of 'brain drain' damaging developing countries and the positive impact of remittances flows back to developing countries.

#### ***Brain drain***

**2.87** A major concern about migration and its impact on development is the 'brain drain'. The World Bank defines brain drain as when 10% or more of a country's tertiary-educated population migrate. The effect of the brain drain is to augment the human capital stock of already developed countries while reducing that in the developing world. As the accumulation of human capital is a crucial driver of growth, brain drains could have significant negative consequences. The losses incurred by developing countries are increased when they have borne the education and training costs of the migrants.

**2.88** There is evidence that the brain drain does exist, at least for some countries. Overall average years of education of migrants from developing countries are around double that of the population in their home country as a whole. For example, the average years of schooling of a Bangladeshi migrant to the US is 14 years while the average for the Bangladeshi population as a whole is just under 6 years<sup>98</sup>. Of those with a high level of education around 20% have emigrated from India, Ghana, Uganda and Sierra Leone, around 60% from Gambia, 70% from Jamaica and over 80% from Guyana<sup>99</sup>.

**2.89** There are particular concerns about the migration of healthcare professionals from developing countries to the UK<sup>100</sup>. Developing countries tend to be under-provided with healthcare, in particular in rural areas, and the migration of doctors and nurses can have a negative impact on the health of the population and thereby on productivity, employment and so on. According to the General Medical Council, around 40% of the UK's 193,000 doctors are from outside the EU, most of them from India. Indeed, the

98 Ghose 2002

99 Ghose 2002

100 See DTI White Paper on Trade and Investment 2004, p.43 for a summary of the NHS ethical recruitment policy

60,000 UK doctors of Indian origin are equivalent to around 12% of the total stock of doctors in India<sup>101</sup>.

**2.90** But the brain drain may have some positive impact on developing countries. The possibility of migration of skilled workers to developed countries acts as a signal to other people to invest in their own and their children's education. The positive effect of the additional investment in education can outweigh the losses from the brain drain. Some economies, including India, China and Brazil, would actually experience a net benefit from increased outward migration<sup>101</sup>.

**2.91** In addition, the loss of skills in the developing country may only be temporary with the migrant returning to the developing country having added to their skills.

### ***Remittances and return migration***

**2.92** Remittances are the transfer of funds from migrants working in another country to family or friends in their country of origin. Remittances are generally recognised as a positive factor in poverty alleviation. They can give a significant boost to the living standards of the households and families directly affected, with knock-on benefits to the local and wider economy through the channels of consumption and investment.

**2.93** The scale of remittances dwarfs that of official donor aid and is second only to FDI as a source of external funding. The World Bank<sup>102</sup> estimates that remittances to developing countries were over \$70 billion in 2001, although experts believe that when informal channels of funds transfers are included the figure may double. The countries receiving the largest volume of remittances in absolute terms were India and Mexico, each with around \$10 billion. Remittances to Jamaica and El Salvador in 2001 were equivalent to around 14% of GDP and for Jordan around 23% of GDP.

**2.94** Research in Mexico<sup>103</sup> and the Caribbean<sup>104</sup> illustrates the importance of remittances in enabling further investment and business creation with entrepreneurs establishing new enterprises with funds remitted. Similar patterns have been witnessed in Asia.

**2.95** Remittances form part of a wider network of benefits that may completely or partially offset brain drain effects – return migration, technology, knowledge and skills transfers and spillovers.

101 Commander et al 2003

102 World Bank Global Development Finance Report 2003

103 Woodruff and Zenteno 2001

104 Diaz-Briquets S and Weintraub S 1991 cited in Connell and Brown 2002

## **Conclusion**

**2.96** The evidence suggests that the economic fears of migration have not been borne out. Migrants can benefit the UK economy and do not generate large falls in employment or wages for the existing UK labour force. Provided care is taken to ensure that a brain drain effect does not harm developing countries, migration need not harm the source country, but more work is needed on particular sectors and regions that are vulnerable to the brain drain issue.

## **Complementary Policies<sup>105</sup>**

**2.97** An extremely important conclusion from the literature is that trade liberalisation should also be accompanied by sound complementary policies. These flanking measures are necessary to ensure that greater openness provides the intended boost to productivity and investment and that it generates sustainable economic benefits. Complementary policies are also needed to mitigate and to reduce the costs of adjustment<sup>106</sup>.

**2.98** All countries engaged in trade reform will face different issues and priorities when considering what complementary policies are appropriate to them. All countries need a strong macroeconomic framework, and sound regulatory, institutional and governance policies<sup>107</sup>. Priorities for reform will vary. For example, in some developing countries, dealing with corruption and enhancing the stability, quality and credibility of political and economic governance may be top priorities, whereas other countries may need to focus on their physical infrastructure or fiscal reform.

**2.99** For the poor in developing countries to capture benefits from trade it is important that, in addition to policy reforms of the sort mentioned above, there are the right supply-side policies in place, both at national and local levels, which will enable people to respond to the opportunities that arise<sup>108</sup>. Some key areas of reform may include:

<sup>105</sup> See also DTI White Paper on Trade and Investment 2004, p.71-72

<sup>106</sup> Prowse 2002

<sup>107</sup> World Bank 2000; Dollar and Kray 2001

<sup>108</sup> McCulloch et al 2001

- i) *Investment in transport and communication infrastructures.* It has been estimated that transport costs amount to 15% of the total value of exports from sub-Saharan Africa<sup>109</sup>, more for landlocked countries<sup>110</sup>, and have been a major factor in the decline in that region's share of world trade. Decent transport networks are important not only for the movement of goods but also people; they are vital where labour mobility is needed as the economy adjusts<sup>111</sup>. Poor infrastructure in rural areas is one of the reasons that India has so far been unable to benefit fully from the potential huge positive impact of trade liberalisation on employment growth and poverty reduction. Sound and affordable communications are also necessary for the proper functioning of markets, all of which rely on information flows to operate effectively.
- ii) Other measures to avoid export bottlenecks, such as more efficient customs administration and the ability to meet the product standards demanded in developed countries<sup>112</sup>.
- iii) *Investment in human capital.* Taking full advantage of the opportunities offered by liberalisation requires a healthy population and an educated and skilled workforce. Basic primary level education, for example, has a powerful impact on economic growth and on overall welfare<sup>113</sup>. In some societies women have only restricted access to education. Lack of access to sanitation, clean water and basic healthcare, in addition to their devastating effect on morbidity and life expectancy, undermine the whole process of economic growth.
- iv) *Broadening access to finance and credit.* Difficulties in accessing financial markets and credit facilities can constrain people from taking the opportunities presented by trade openness. This is often a particular problem for the poor, especially women<sup>114</sup>.
- v) Measures to offset the effects on government revenues of any loss of customs duties (see Chapter 4).
- vi) Adequate social safety nets may also be required, to help labour adjustment and mitigate the potentially disruptive political consequences of reform.

**2.100** This highlights the need to design and implement trade reform within a broader development context and thereby integrate trade policies into national development plans and poverty reduction strategies. These should highlight how international trade could help achieve economic growth and poverty reduction objectives, and outline the policies needed to facilitate this in practice.

109 Amjadi and Yeats 1995

110 UNCTAD 1999

111 DFID 2002

112 Jordan and Wood 2000

113 DTI-HMT 2004

114 DFID 2002

**2.101** Such policies, supported by significant additional international aid flows for investment in physical, human and institutional capital, would help ease capacity constraints and help manage change. Decisions on the pace of reform depend heavily on a country's own economic and political circumstances. In poor countries as elsewhere, trade reform and other domestic reforms are not alternatives, but are strongly complementary.

**2.102** Developed countries need complementary policies too, in order to make the most of trade liberalisation. As noted above, they are likely to already have many of the basic policy frameworks which may be absent in less developed countries and they will also be better able to finance a broader and deeper set of policies to manage adjustment. For example, other enabling policies operating at the national and regional levels may include policies that enhance labour market flexibility, initiatives to help displaced workers back into employment, effective social safety nets, investment in education, skills and R&D, and sophisticated transport and communication networks. Complementary measures in R&D and in education and skills, in particular as they apply to the UK, are discussed below.

### ***R&D and innovation***

**2.103** Research and development and innovation, as key drivers of productivity and competitiveness<sup>115</sup>, have become ever more important for countries competing in the global economy. The UK has a long-standing strength in the generation of new ideas with a science base among the most productive and high quality in the world<sup>116</sup>. However, because of market failures, investment in innovation and research may be suboptimal and may provide a case for government intervention. Market failures affecting innovation include externalities, public goods and uncertainty<sup>117</sup>. Analysis shows that government interventions to correct these market failures, if properly designed and targeted, deliver wider economic benefits in addition to those that accrue to beneficiary firms<sup>118</sup>.

### ***Human capital and skills***

**2.104** International competition occurs at all technological and skill levels, but may particularly affect those with the lowest skills. This makes the enhancement of human capital crucial for developed as well as developing countries. Higher skill levels allow workers to generate new ideas and adapt to the changing economic environment<sup>119</sup> which may result from liberalisation.

<sup>115</sup> See DTI 2003 (2) and (3) for more details on the drivers of productivity

<sup>116</sup> DTI 2000

<sup>117</sup> See DTI 2003 (2)

<sup>118</sup> DTI 2003 (2)

<sup>119</sup> DFES 2003(2)

**2.105** Looking specifically at the UK, educational performance is mixed. On the positive side, the UK does well relative to other European countries in terms of numbers of university graduates generally<sup>120</sup> and of scientists and engineers in particular<sup>121</sup>. But there are weaknesses<sup>122</sup>. Around five million adults were functionally illiterate in 1999, reading less well than the average 11 year old<sup>123</sup>. The UK also has fewer people with vocational skills compared with either France or Germany<sup>124</sup>.

**2.106** As education may be subject to market failures, government intervention may be necessary. Government can direct policies that focus on improving the skills of people before they enter the workforce and also adopt policies to increase and improve participation in education. In addition to funding core education, there is also scope for government to address the market failures associated with skills training for those already in employment. For instance, there may be information asymmetries, whereby firms are unaware of how useful training is likely to be for their staff or how to obtain it. This is likely to be particularly acute for low-skilled workers in small firms<sup>125</sup>.

120 DTI 2003 (3)

121 The UK possesses 1620 science graduates per 100,000 in the youth (ages 25-34) labour force compared to 2063 in France, 835 in Germany and 1098 in the US. OECD 2002 (1)

122 DFES 2003 (1)

123 Moser 1999

124 See DTI 2003 (3)

125 HMT 2004

# Chapter 3: Adjustment

“Free Trade, one of the greatest blessings which a government can confer on a people, is in almost every country unpopular”

Lord Macaulay, 1824

## **Chapter outline**

- Liberalisation and employment; the effect on the UK
- Increasing tradability of services; the case of offshoring
- Tariff reductions and their consequences for developing country government revenues
- Liberalisation and the environment

**3.1** Chapter 2 examined the arguments for liberalisation. This chapter looks at some of the adjustment challenges posed by liberalisation and globalisation. It looks primarily at evidence from the UK. Because factors like liberalisation, globalisation and technical progress change relative prices they are likely to place very powerful pressures on economies to adjust or suffer the consequences of not doing so. In the short term the adjustment process is likely to be painful for some people affected and highly beneficial to others. Chapter 4 looks at some of the distributional issues this generates.

- In the 1970s and 1980s several eminent economists<sup>126</sup> suggested that the decline of some traditional sectors of the UK economy would lead to the UK becoming a poorer country. The first part of the chapter looks at the challenge the UK economy has faced over the last quarter century and how it has responded.

**3.2** The increased disaggregation and tradability of services is posing a new set of challenges, this time affecting white-collar jobs. In the US it has led some to argue that the benefits of free trade no longer hold. This chapter argues that they are wrong. A recurrent issue in this section of the document is coping with change in the economy, but why not plan to pre-empt the change? Nobody can reliably predict the future, many attempts to do so now look risible. 1950s projections of life in the year 2000 often involved everyone having their own helicopter but didn't envisage the internet. For this reason most attempts to plan or manage the future have failed to predict a critical event and have ended in disaster. The British government has its share of such projects – Concorde, a technological tour de force was an economic disaster, because its planners didn't conceive of a sharp increase in oil prices or stronger attention to environmental standards.

## Does Liberalisation Destroy or Create Jobs? The UK Experience

**3.3** The economy's structure is changing all the time. In the process there are job gains and losses<sup>127</sup>. Table 3.1 ranks the UK's sectors according to the growth in their employment over the last quarter of a century. Massive numbers of jobs have been created in real estate, computer-related services, hotels and restaurants, health and social work, education, wholesaling and retailing. The largest job losses have occurred in manufacturing, which lost 3.4 million jobs in this period – nearly half the jobs it provided in 1978. Employment increased in only one manufacturing sector – Publishing, printing and recorded media.

**3.4** It is evident that globalisation has had a hand here: manufacturing is the sector which is most exposed to the impacts of globalisation and, within manufacturing, the largest percentage losses occurred in industries in which the UK was most vulnerable to competition from developing countries – textiles, clothing and footwear. But trade is only part of the story. Other powerful forces are also reflected in this table: shifts in demand (for example, towards private home ownership, personal pensions, health, education, and eating out); the fact that many of the activities which manufacturing performed for itself in 1978 are now outsourced, and recorded as services; and the fact that the opportunities to increase labour productivity, by substituting capital for labour, are higher in manufacturing than in services (e.g. there are fewer people making cars, but more people selling and servicing them). The most significant feature of the table is its last row: despite the job losses in many sectors, the economy as a whole has created more jobs than it has lost. This does not mean that all individuals have benefited; clearly, some have lost out but, on balance, the population as a whole has benefited.

127 The UK has experienced a rise of 1.9 million people in work since spring 1997. There are now over 28 million people in employment and the employment rate is close to its record high. Furthermore, while the downturns of the 1970s, 1980s and 1990s were characterised by substantial rises in unemployment, joblessness in the UK has not risen during the recent global economic slowdown.

**Table 3.1 Changes in employment, by sector, over 25 years**

Description	Employment (000s)		Change
	June 1978	June 2003	
Real estate, renting machinery, computer activities	1,783	3,964	122%
Hotels and restaurants	1,082	1,818	68%
Health and social work	1,700	2,854	68%
Other service activities	907	1,318	45%
Education	1,592	2,240	41%
Financial intermediation, insurance, pension funding	757	1,050	39%
Wholesaling and retailing	3,631	4,451	23%
Publishing, printing and recorded media	323	347	7%
Transport and communications	1,597	1,547	-3%
Public administration and defence; social security	1,667	1,477	-11%
Construction	1,373	1,144	-17%
Furniture; manufacturing n.e.s, recycling	249	200	-20%
Wood and of products of wood and cork	104	82	-21%
Rubber and plastic products	277	216	-22%
Food products; beverages and tobacco	715	467	-35%
Agriculture, hunting and forestry, fishing	418	234	-44%
Petroleum products, nuclear fuel, and chemicals	450	249	-45%
Electrical equipment	740	389	-47%
Pulp, paper and paper products	174	90	-48%
Manufacturing	6,922	3,501	-49%
Machinery and equipment	672	327	-51%
Fabricated metal products	758	356	-53%
Electricity, gas and water supply	292	133	-54%
Other non-metallic mineral products	285	127	-55%
Transport equipment	860	361	-58%
Metals	375	94	-75%
Textiles and clothing	814	180	-78%
Mining and quarrying	383	71	-81%
Footwear and leather goods	124	15	-88%
<b>Total</b>	<b>24,102</b>	<b>25,802</b>	<b>7%</b>

Source: Office for National Statistics

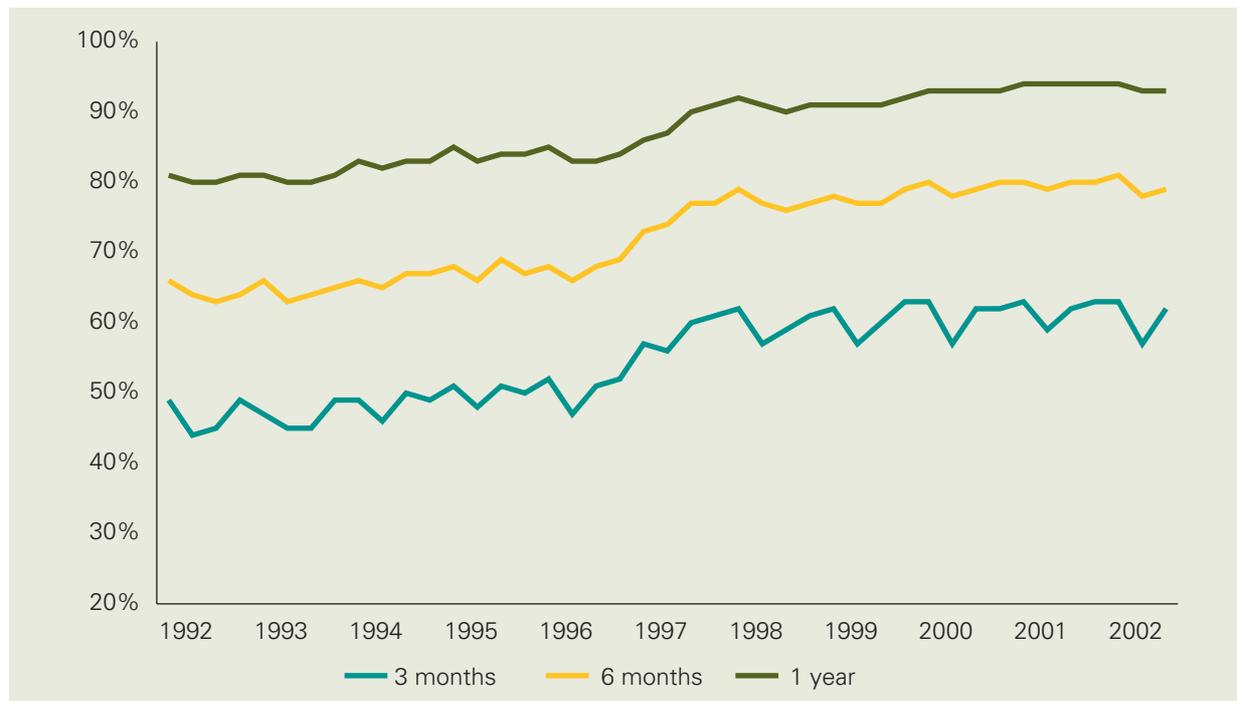
## Labour market adjustment

### 3.5 How does the labour market cope with structural changes of these magnitudes?

Local labour markets have demonstrated an impressive capacity to digest those who become available for work. About 25% of claimants move off the unemployment register each month. In other words, the “stock turn” – annual flows onto and off the register as a multiple of the number of claimants at any particular time – is about three. Most of those registering as claimants move off the register again within six months. Chart 3.1 shows the national picture. In recent years:

- 60% move off the register within three months.
- 80% move off the register within six months<sup>128</sup>.

**Chart 3.1 Transitions from unemployment: proportions of people receiving Job Seeker’s Allowance who leave the register within a given period**



Source: Department for Work and Pensions

**3.6 Not all of these off-flows go into jobs – some leave for non-work destinations** e.g. other benefits, education/training, or leave the labour force earlier than they would otherwise have done so – but most do: 68% of men and 77% of women are re-employed within a year<sup>129</sup>. Another feature of the labour market is that the number of people who move off the unemployment register each quarter tends to rise significantly when more people move onto it. If on-flows onto the register increase by 100, off-flows in the same

<sup>128</sup> The proportion of those registered as unemployed who move off the register within six months tends to be lower when the rate of unemployment is high, and higher when participation rates are high.

<sup>129</sup> Boheim and Taylor 2000

quarter increase by between 36 and 44. This is one of the ways in which the economy is able to adjust to the effects of trade.

**3.7** One possible explanation is the “matching” problem: employers and employees are looking respectively for people and jobs that are right for them. It is not easy for employers to judge the quality of potential employees. One indicator of employee quality is whether or not the person concerned has held down a job for an extended period. If, in any quarter, more such people become available, employers are more likely to recruit<sup>130</sup>.

**3.8** What determines the number of people flowing off the unemployment register each quarter? Quarterly variations in off-flows were examined in three regions (Yorkshire & Humberside, the North East, and Wales) over the 15-year period 1988-2003. They could be explained partly by variations in regional economic activity (as reflected in the CBI’s data on the proportion of companies in each region reporting that they are operating at below capacity), and partly by the number of people flowing onto the unemployment register in the same quarter, and sometimes also in the previous quarter.

**Table 3.2 Regressions results: regional labour markets**

- Dependent variable: quarterly off-flows from the unemployment register;  
59 observations: Q3 1988 – Q1 2003

Explanatory variables	Yorkshire & Humberside	Wales	North East
Constant	24,386 (3.78)	15,870 (2.83)	24,170 (4.92)
Economic activity <sup>c</sup>	289 (3.67)	98 (2.11)	117 (3.10)
On-flows $t$	0.359 (4.72)	0.364 (5.20)	0.445 (4.63)
On-flows $t-1$	0.217 (2.60)	0.195 (2.43)	–
Adjusted R <sup>2</sup>	0.562	0.389	0.412
DW-statistic (p-statistic)	1.55 (0.083)	1.51 (0.067)	1.61 (0.19)

<sup>a</sup> Data on off- and on-flows were obtained from the ONS NOMIS database.

<sup>b</sup>  $t$  ratios in parentheses, based on heteroscedasticity-adjusted standard errors.

<sup>c</sup> Measured by the proportion of companies in each region reporting full-capacity working, CBI/Business Strategies, Regional Trends Survey.

Source: DTI

<sup>130</sup> This is consistent with research into the reasons why unemployment is higher today than it was in the 1950s and 1960s.

Nickell (1998) concluded that “by the 1980s either employers find it harder to get the workers they want from the unemployed pool or the unemployed are much less enamoured of the work they are offered”. Neither side of the labour market much likes all that it is offered.

**3.9** But while evidence suggests that displaced workers will be able to find new employment fairly quickly it has been argued that there will be a strong downward pressure on the wages of those affected. This argument is based on their previous job having a significant economic rent element. Whilst this was clearly the case for some industrial and manufacturing jobs where workers had very specific skills with little or no transfer value, such as cutting coal or operating a furnace, the same is less likely to be the case in the service sector. Evidence from the US<sup>131</sup>, where data are more comprehensive, suggests that workers may re-enter the labour market at higher or lower wages depending on their personal circumstances, skills, etc.

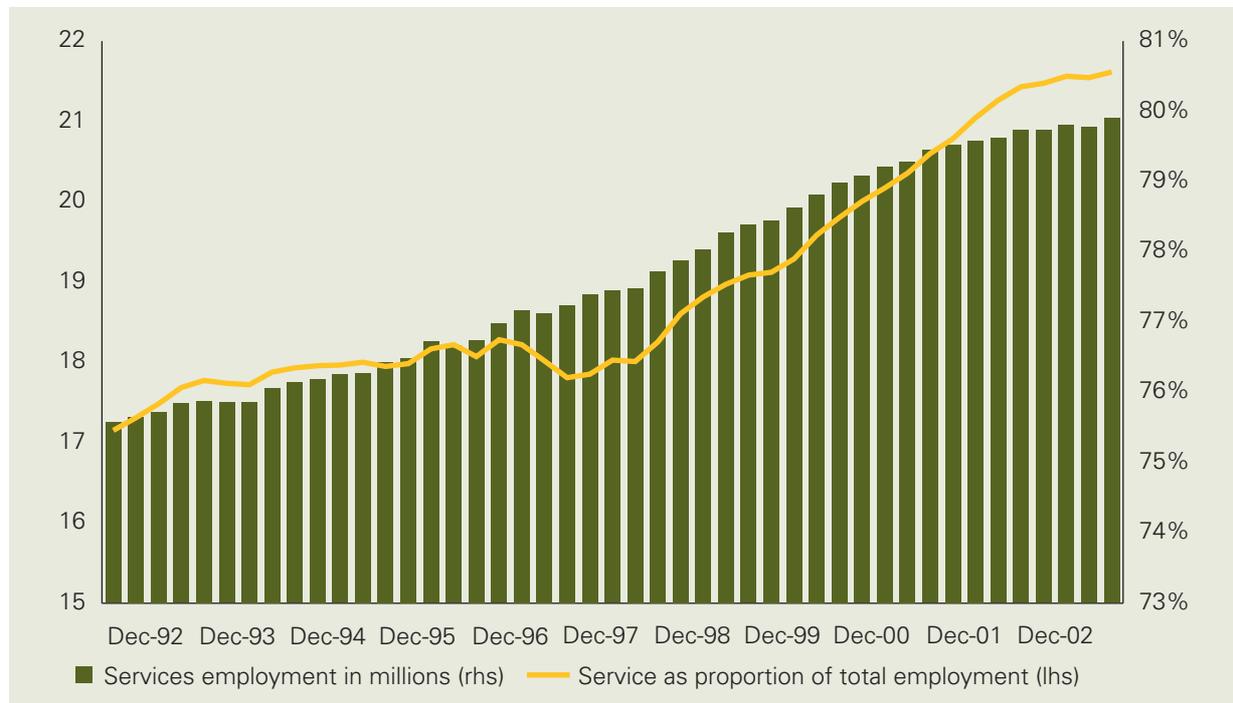
### ***Role of services in the UK economy***

**3.10** A key feature of the UK's adjustment to structural change has been the growth of the service sector. The services sector in the UK contributes over 70% of GDP and accounts for 8 out of every 10 jobs. Employment in the services sector has increased by nearly 3.5 million in the last ten years, and by over 2 million since 1997 alone, and has been a key feature in the UK's successful recent record of job creation (Chart 3.2). The employment level is now at an all time high and the employment rate of nearly 75% is the highest of the major European economies.

**3.11** The growth in service sector employment has been an important factor in providing new employment opportunities, more than offsetting the decline of manufacturing employment. Employment in computer related activities – for example hardware and software creation, consultancy, and data processing – has grown enormously since 1997, increasing by two thirds to more than half a million. Consultancy employment has grown by nearly 40%, now making up a quarter of a million jobs, and there has been similar performance in the accounting sector. The financial services sector overall has maintained its role as a mainstay of the economy with employment in excess of one million. Other service sector employment success stories include the media, hotels and restaurants, food retailers, research and development and real estate activities. The service sector is a vital component of all the regional economies of the UK. Private sector services employment has grown in all but one of the regions since 1997 and is especially important to London and the South East.

**3.12** The service sector is becoming more internationalised and increasingly exposed to international competition. Service exports are worth nearly £90 billion annually, making the UK the world's second largest exporter of services. Service imports are over £75 billion a year. International competition in services and the UK's successful participation in the global economy are creating employment opportunities in the UK, but also bringing new challenges. These issues are discussed in greater depth in the next section on offshoring.

**Chart 3.2 Recent employment growth<sup>a</sup> in the UK service sector, levels and rates**



Source: National Statistics  
<sup>a</sup>employee jobs (ie excludes self-employed)

## Increased Global Tradability of Services or “Offshoring”

**3.13** Comparative advantage was traditionally seen in terms of whole industries locating in particular areas. But, for some time, international disaggregation of production has been a key feature of globalisation. Initially this occurred in manufacturing but it is spreading to some services where it is possible to split up the various processes of production and locate them around the globe in such a way as to take full advantage of differing cost bases, skills and technical specialisations.

**3.14** Most services cannot be fragmented in this way because they are produced and consumed locally; activities such as haircuts, restaurant meals, and dentistry require that production and consumption are co-located. Whilst activities may be subject to competition from overseas firms setting up operations in the host country it is unlikely that any but a minority of service activities can be supplied from abroad or offshored. The World Bank has estimated that between 12% and 16% of service sector jobs have what they refer to as ‘disaggregation potential’<sup>132</sup> while the International Labour Organisation has suggested that 5% may be contestable by low-wage economies<sup>133</sup>. Of course, any such estimates are made without any firm knowledge of future technological developments or the likely pattern of development of employment within the service sector.

<sup>132</sup> World Bank 1995

<sup>133</sup> International Labour Organisation (ILO) 2001

**3.15** The kinds of service sector activities that might face international competition depend partly on the technical feasibility of offshoring. Technological developments and related investments in infrastructure, market liberalisation and the pressure of competition have significantly increased the speed and reduced the cost of communication (for example, Table 3.3) and thereby, in some instances, reduced the need for co-location, or face to face contact, between consumers and producers of services.

**Table 3.3 Falling communication costs between India and the US and UK<sup>134</sup>**

Peak ISD call rates from India (Rupees per minute)	To US	To UK
	Pre-January 2001	60
January 2001 – July 2002	48.8	40
July 2002 – October 2003	24	24
October 2003	9.9	7.6

Source: HSBC

**3.16** This means that some areas of the service sector that had previously been considered non-tradable are now starting to face international competition. This phenomenon applies to trade between developed countries but also between developed and developing economies. Activities such as data processing and analysis, IT services such as software development, research and development and various ‘back office’ functions can now, in many cases, be performed on the other side of the world and then exported, often simultaneously, to the UK. While technological change, and the corresponding expansion of access to lower cost inputs, has undoubtedly been the main driver of services offshoring, innovations in business processes have also been a major push factor and significant investments in human capital in developing countries have acted as a pull. Of course, lower labour costs and technical possibility do not necessarily imply that offshoring will be practical, desirable or economically attractive. As will be discussed below, offshoring also involves many risk factors. And, in spite of offshoring potential, some firms may regard some activities as better conducted closer to the home market, for example where a degree of local knowledge is important to service quality.

**3.17** International trade is, at the level of the economy as a whole, a win-win game and trade in services is no exception. The opportunity to trade provided by globalisation allows producers to produce the goods and services they are relatively good at and allows consumers to buy from providers who offer them the best deal. How the gains from trade are distributed – or redistributed – thereafter is largely a political question, but is obviously crucial in how trade liberalisation and globalisation impact on people’s lives. Recently<sup>135</sup>, notably in the US, it has been argued that offshoring of services invalidates Ricardo’s analysis of comparative advantage and the gains from trade.

<sup>134</sup> HSBC 2003

<sup>135</sup> Exporting jobs is not free trade New York Times editorial 7 January 2004

They suggest that modern day factor mobility – in this case capital, technology and ideas – means that mutual gains from trade can no longer be assumed and that, with offshoring, some countries win and others lose forever. They are mistaken. Offshoring illustrates comparative advantage rather well. The natural concern that they highlight is about the distribution of the gains from trade, but Ricardo's theory refers to the long run and assumes full employment. In the short run there will be winners, losers and adjustment costs. In the long-run displaced labour and other resources are redeployed, complementing the short-run consumer gains from lower prices.

### ***The decision to offshore***

**3.18** The US, the UK and India have so far been at the forefront of the offshoring phenomenon. The commonality of the English language is often cited as the main reason for this and it is clearly a vital factor, at least in those activities that involve regular interactions between service suppliers and customers. Financial services, which are often intensive users of IT, have been early adopters of off shoring. This may be because the sector is relatively highly developed in the US and UK and is one that has traditionally been very open to business and management innovations. However, although less widespread than in the US and UK, outsourcing of services, which enables offshoring, is also becoming a more of a consideration for firms located in France, Germany and the rest of Europe. German firms, for instance, have outsourced to Eastern Europe and Lufthansa, the national airline, has opened a call centre in South Africa. French firms have outsourced to North Africa and Latin America offers ample opportunities for Spanish and Portuguese firms<sup>136</sup>.

**3.19** A recent publication has ranked offshore destinations by attractiveness according to an index comprising people skills and availability, business environment and financial structure<sup>137</sup>. India came top, a result of low costs and well-developed human capital. China was ranked second, for similar reasons, although it lagged India in terms of experience and language. Other strong performers were Malaysia, the Czech Republic, Singapore and the Philippines.

**3.20** As in the globalisation of manufactured goods, costs, and in particular labour costs, are the main driver behind the decision to offshore activities<sup>138</sup> whether this is done with a third-party contract, partnership or in-house arrangements (offshore insourcing). McKinsey<sup>139</sup> suggest that hourly wages for IT workers in India are around a tenth of their counterparts in the US. Similarly an Indian IT programmer will earn around £4,200 against an average of £34,000 for someone performing a similar role in the UK<sup>140</sup>. Overall, PWC estimate that firms relocating to India can save between 65% and 85% on wages, depending on whereabouts in the UK they are moving from. Firms can also enjoy similar

<sup>136</sup> TUC 2004

<sup>137</sup> AT Kearney 2004

<sup>138</sup> For example, McKinsey 2003, Deloitte Research 2003

<sup>139</sup> McKinsey 2003

<sup>140</sup> PWC 2004

savings on property and capital by offshoring to India; property prices in Bangalore are only 17% of those in London's West End and half of those in Sheffield. GlaxoSmithKline expect a total saving of 35% from their IT budget from the offshoring of its entire global IT operations<sup>141</sup>. Once additional telecoms and management costs are added, these savings fall, but to a still very significant 45-55%. When this is compared to survey evidence from the World Bank<sup>142</sup>, that offshoring will be an attractive and viable option when cost savings are in the order of 30-40% or more, it is evident that there is a compelling case for the offshore option. However, this is a very high margin to make a move worthwhile, suggesting significant barriers and risks.

**3.21** Cost is not the only issue. Skill shortages in the UK, particularly in areas such as IT where demand was driven by preparations for Y2K, have also been an important motivating factor for firms in looking to perform functions offshore. This can be compared to the large and growing supply of well motivated, highly qualified potential employees in other countries. This may even enable outsourcing firms to use higher skilled labour than is available economically in the UK.

**3.22** Firms may also look to offshoring for improvements in processes and other efficiency gains, for example in economies of scale for international companies bringing together activities in one location. This can enable them to realise a truly global business model rather than running connected but separate firms in many markets. Offshoring can also allow firms to increase revenues, where lower costs enable them to pursue more marginal activities or where offshoring gives access to new markets abroad.

**3.23** It is not only the commonality of the English language that singles out the UK and US to lead the way in offshoring. The OECD<sup>143</sup> has ranked the US and the UK as having the least restrictive employment protection legislation (EPL) regimes, for example in terms of the statutory costs and procedural inconvenience of individual and collective redundancies, the regulation of temporary contracts, and so on.

**3.24** On the other side of the balance for firms are the risk factors associated with offshoring their business activities. KPMG<sup>144</sup> have summarised the risks (Chart 3.3) as falling into three categories, commercial risk, financial risk and political risk, with the importance of any factor varying for each company or organisation. A key division in the offshoring debate in the UK has been in the way that firms view the impact of offshoring on their customers; some firms have decided that the risks to service quality and thereby customer retention are not justified by the potential cost savings while others have insisted that cost savings and enhanced service quality will only benefit customers. Security and data protection are additional potential risk areas<sup>145</sup>.

141 Matto and Wunsch 2004

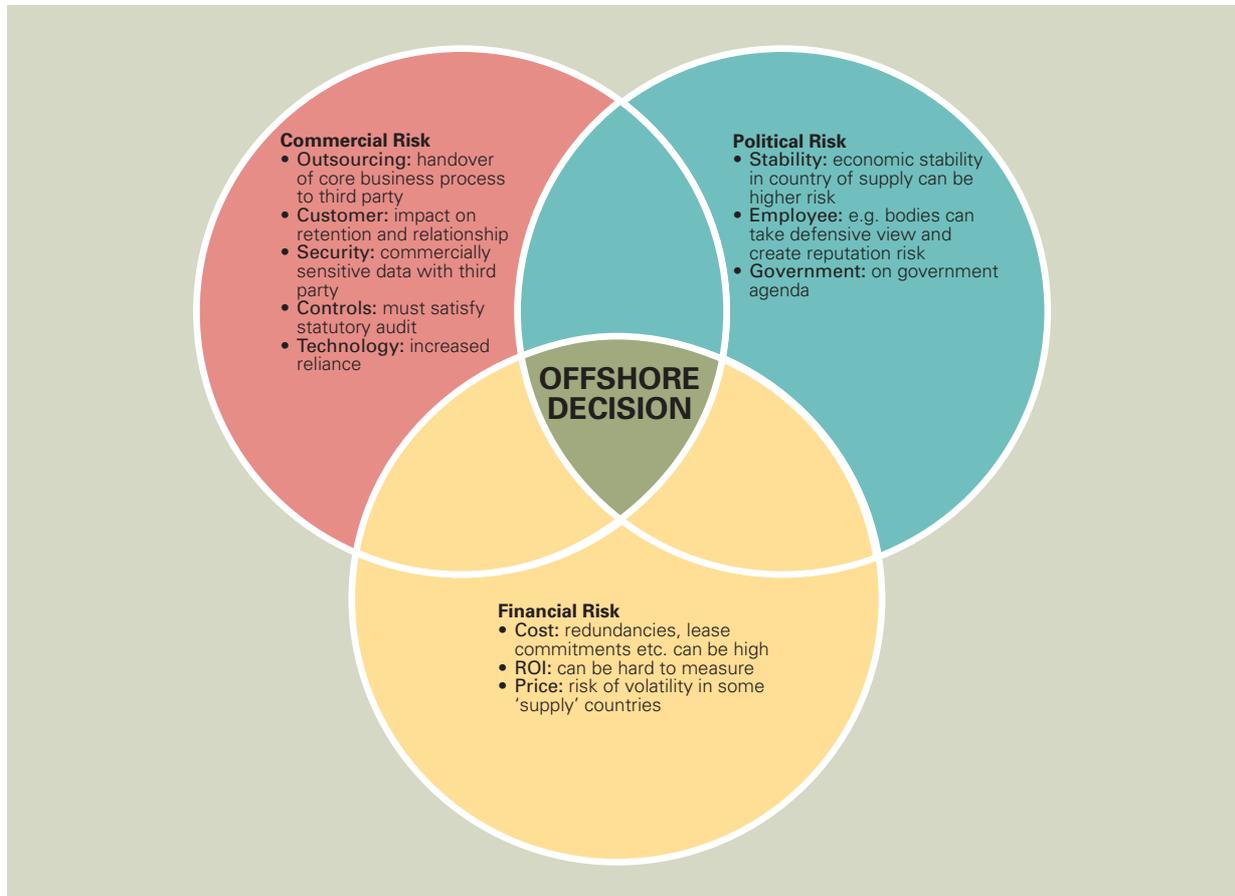
142 World Bank 1995

143 OECD 1999

144 KPMG 2004

145 Ernst & Young, quoted in Financial Times 6 April 2004

**Chart 3.3 Risk factors in the offshoring decision**



Source: KPMG 2004

### ***Long-run gain for the UK?***

**3.25** The UK has traditionally been an open economy at least in terms of trade in goods and this will now be extended to services with the lowering of technological and other barriers. Offshoring is an innovative business process that can drive down costs and drive up productivity. Some cost savings will be passed on directly to consumers as lower prices. In an international context, a lower cost base will enable UK firms to become more competitive in world markets. Where firms choose not to pass on all the cost savings to consumers, they will enjoy higher profits that can be passed on to shareholders, two thirds of whom are UK institutions or individuals<sup>146</sup>, or reinvested. Over the long term, overseas outsourcing, whether of manufacturing production or of service sector activities, allows UK companies to remain competitive, ensuring that the UK economy continues to generate new and sustainable jobs and new business opportunities in the global economy.

**3.26** Recent studies which focus on the US<sup>147</sup> have argued the case for the benefits of offshoring along a broader front. They argue that investment in IT hardware through the 1990s resulted in a productivity boom. Now, with the globalisation of IT services, there will follow a second wave of productivity growth. The diffusion of imported software and services will make IT cheaper and more accessible, broadening and deepening its use particularly in smaller and medium sized firms. Some IT jobs will go abroad, but the greater use of IT across the whole economy will also lead to higher demand for people with IT skills to use the imported products and services and IT employment will actually grow rather than contract. Lower costs and productivity enhancements will also lead, it is argued, to a second round of macroeconomic benefits such as lower inflation, lower interest rates, higher exports and higher real wages.

### ***But possibly a challenging short-run transition***

**3.27** On the downside, offshoring will result in short term, transitional job losses, although quantifying this is extremely difficult. Troika Research<sup>148</sup> estimates 100,000 UK financial services posts will be offshored by 2010, other estimates have suggested more than 200,000 jobs in all sectors. Although these numbers sound large they are still very small when compared to the normal churn of job loss and job creation which is constantly ongoing in the labour market and they do not account for job gains, as a result of offshoring specifically or liberalisation and globalisation more generally. However there is a strong probability that they will tend to be unevenly distributed, hitting low skill “commodity services” hardest. There is some evidence that these tend to be in poorer regions of the UK. To date where people are unfortunate enough to lose their jobs, DWP research has shown that most are re-employed relatively quickly (Chart 3.1). Of new benefit claimants, around 60% will have left unemployment within 3 months and around 80% within 6 months.

**3.28** In addition to the possible negative labour market effects, there are also possible risks both for the health of firms engaged in offshoring and possibly for customers too. The productivity benefits of offshoring have been highlighted above, but it is possible that productivity and organisational performance could also be negatively affected. For example, in offshoring business functions to an overseas third party, firms risk losing skills and knowledge – their intellectual assets – such as business specific knowledge and knowledge about culture and customers as well as the loss of competitive advantage where previously exclusive processes, technologies or skills are passed offshore. Firms may also lose managerial control over non-core but crucial activities or damage productivity because of the negative impact on the morale of onshore survivors. These factors may be behind some recent findings that appear to show that firms engaged in offshoring have not enjoyed significant benefits in either productivity or profits<sup>149</sup>.

147 Mann 2004

148 Troika Research press release November 2003 <http://www.troika-uk.com/news.htm>

149 Görg and Hanley 2004, Görg and Stephan 2002

**3.29** Gartner, a consultancy, have also warned that offshoring represents a threat to the development of future talent as specific skills are lost to the onshore firm<sup>150</sup>. The real or perceived insecurity of such jobs may also serve as a deterrent to people from entering higher education in subject areas like IT which would only serve to undermine those sectors further and create more skill shortages.

### ***Offshoring benefits for developing countries?***

**3.30** The rapid growth in offshoring that has relied so heavily on relatively cheap but highly educated and IT-literate labour offers great opportunities for some of the world's poorer countries.

**3.31** Although a growing number of developing countries are involved in the provision of offshored business services, the market is dominated by one player, India. And there is no question that India desperately needs the opportunity that service exports may offer. While the very poor will not benefit directly, increasing incomes for the country as a whole will strengthen overall economic activity and increase the scope for income re-distribution.

**3.32** When it comes to the export of service activities, India enjoys a number of distinct advantages over other developing countries, advantages that have allowed it to capture around 80% of the world's services offshoring market<sup>151</sup>. Moreover that market is growing and, on some counts, predicted to be worth nearly \$600 billion by 2005<sup>152</sup> – more even than India's current total GDP of around \$510 billion<sup>153</sup>. India has a great advantage in having over 50 million English speakers<sup>154</sup> giving it a head start in breaking into the US and UK markets. In addition to the language factor and wage-differentials, India's education system has been highly successful in producing well-qualified people-graduations are currently running in excess of 2 million a year including around 100,000 in IT related subjects<sup>155</sup>. Estimates from the Indian offshore services sector suggest that offshoring employs around 100,000 people directly,<sup>156</sup> with this figure expected to grow significantly.

**3.33** Offshoring is a dynamic process – to lower their costs, Indian IT services firms are themselves sending work offshore, to even cheaper places such as China. In 1999, a study by the National Association of Software and Services Companies (NASSCOM), a leading Indian IT industry group, estimated that the cost of employing top software engineers in India could be the same as in America in 15 years' time. Others predict that equalisation could happen much earlier<sup>157</sup>.

150 Diane Morello, Gartner Vice-President and Research Director in CIO.com article August 2003, <http://www2.cio.com/analyst/report1647.html>

151 Le Monde quoted in UNCTAD 2003

152 Goldman Sachs, quoted in UNCTAD 2003

153 World Bank World Development Indicators 2004

154 Matoo & Wunsch 2004

155 IMF 2003

156 Wipro quoted in UNCTAD

157 The Economist, The new geography of the IT industry, July 17 2003.

**3.34** Other developing countries including South Africa, Jamaica and Malaysia offer potential competition. The South African President Thabo Mbeki described development of a call centre sector as a national economic priority<sup>158</sup>. The Philippines too has been working hard to develop itself as an attractive offshore destination with tax breaks and infrastructure investment<sup>159</sup>, and has succeeded in drawing the likes of Proctor & Gamble and HSBC.

**3.35** Undoubtedly offshoring will pose challenges for regions and sectors of the UK economy, as it will in other parts of the world. Nevertheless, overall it can bring great benefits, both to the countries that export services, such as India, and those, like the UK, which import them.

## **Environmental Impacts of Trade and Investment Liberalisation**

**3.36** Recent years have seen a growing awareness of the environmental harm associated, at least in part, from economic growth and an ever-increasing global population. The preceding sections have dealt with the question of how economies may react and how governments need to respond to adjustment in labour markets. This section examines similar questions from an environmental perspective.

**3.37** There are some commonly held perceptions about the impact of trade liberalisation on the environment: some believe that it will impact negatively (for example, because of the extra resource demands of additional production and consumption) whilst others hold that trade liberalisation will have a positive impact (for example, because of enhanced diffusion of new technologies). However, the evidence available suggests that neither perception is entirely true.

**3.38** In reality a complex set of drivers exist which determine the likely impacts of trade liberalisation and it is likely that these will result in a mix of both positive and negative impacts on the environment. There will be winners and losers, both between and within countries, industries and socio-economic groups and the pattern of winners and losers will depend upon the specifics of the liberalisation package adopted.

### ***How does liberalisation affect the environment?***

**3.39** *Scale & Income effects.* The available empirical evidence suggests that economic growth, for example resulting from trade liberalisation, with increases in the scale of consumption and production, will generate adverse environmental impacts through an accompanying increase in the use of natural resources and higher levels of pollution. On the other hand, economic growth may have a positive effect on the supply of resources for environmental protection and on the demand for goods with less impact

<sup>158</sup> Guardian July 17 2003.

<sup>159</sup> Forbes.com 22 May 2003.

on the environment. The Environmental Kuznets Curve hypothesis proposes an inverted U-type relationship between environmental decay and income per capita – as incomes increase pollution initially increases, before peaking and then declining<sup>160</sup>. However, extensive empirical testing has failed to demonstrate the robustness of this hypothesis so that the relationship between growth in income levels and environmental outcomes is ambiguous and could vary according to a number of factors.

**3.40 *Technology and innovation effects.*** Technological developments create new or improved products and services and lead to innovations in the manufacture and distribution of existing products. When these products or services are traded, the associated environmental impacts may be different from those of the goods and services that they replace. In addition, diffusion of new technology from one country to another, for example through deliberate technology transfer, changes the impacts of products or services that are produced domestically.

**3.41 *Structural and location effects.*** Trade liberalisation may lead to structural changes in a country's economy, through specialisation in those goods or services where the country has a comparative advantage, leading to transfers of production between countries. Whether the structural changes have a net positive or negative environmental impact seems to depend on the pollution intensity characteristics of the industries that command a comparative advantage and hence gain from trade integration.

**3.42 *Regulatory effects.*** The impacts from all the cross-cutting effects discussed above depend on the nature and effectiveness of social and environmental policies or regulations in the affected country. Trade reforms may themselves have an impact on these policies and regulations. A country's policies and regulations may be constrained by the need to comply with multilateral agreements, whose aims may overlap with those of international trade rules. However, the evidence available thus far suggests that subscribing to environmental agreements does not damage competitiveness.

**3.43** From the developing country point of view, there has been a lively debate as to whether competition for FDI leads to a race to the bottom in environmental standards. The 'pollution haven' hypothesis proposes that countries may deliberately try to attract FDI by offering lower environmental regulations, resulting in a competitive 'race to the bottom'. This has been extensively tested but does not have strong supporting evidence as environmental protection costs are not considered to be a major factor in international companies' location decisions. Another concern, however, is that 'pollution chill' may result, whereby host countries do not impose higher standards of regulation that they might otherwise have adopted in order not to risk losing FDI. However, multinational corporations can have a beneficial effect through introducing environmentally efficient manufacturing techniques and management systems, although the potential environmental impacts are strongly dependent on national regulation.

<sup>160</sup> See, for example, Bhattarai et al 2002

### **Potential impacts on key policy areas**

**3.44 Climate Change and Energy.** The evidence suggests that growth in economic activity may be compatible with either a decrease or an increase in polluting emissions, depending on the other driving forces that are likely to emerge from and interact with increased levels of trade and production. This is because, even if increased economic activity would first tend to put more pressure on the environment, other dampening factors fostered by policy, lifestyle choices or technological development might come into play, possibly contributing to an overall net reduction in emissions.

**3.45 Forestry.** Trade liberalisation in the forestry sector could potentially result in a range of negative impacts, primarily due to an increase in deforestation. However, the evidence in terms of actual effects is mixed. Additionally, a number of studies recognise that international trade, in itself, is not directly a threat to forests and that it can even provide incentives for responsible management and more efficient practices. These potential benefits are thought to be dependent on the effectiveness of environmental safeguards.

**3.46 Fisheries.** International trade in fish and fish products can generate significant environmental and social costs, with over-fishing creating problems of stock depletion and threatening the livelihoods of fishing communities. On the environmental side, heavy fishing can affect genetic diversity of fish stocks and the future regenerative capacity of the fishery. Declining stocks of commercial fish for direct human consumption can threaten food security and nutrition levels in developing countries, particularly in coastal areas and among the poor where fish is a staple food. Trade liberalisation in fisheries must be combined with an effective fisheries policy, which could include measures such as effective monitoring of quantitative controls, removal of subsidies, and redistribution measures, for social reasons, during the adjustment period.

**3.47 Environmental Services.** Within the service sector, trade in environmental services is becoming increasingly important and some consider it offers the potential for a 'win-win' outcome from further trade liberalisation. However, there are also potential negative impacts, which may occur but have yet to be examined. Nonetheless, the key conclusion is that while a 'win-win' situation could be realised, it will be dependent on accompanying complementary measures.

**3.48 Sustainable Rural Communities and a Sustainable Farming and Food Sector.** The economic, environmental and social impacts of agricultural trade liberalisation vary greatly between countries, regions and locations. At the domestic level environmental gains may accrue from a fall in agricultural prices and production intensity, with reduced levels of fertiliser and pesticide application, but the impact on other environmental indicators (biodiversity, soil and food protection, landscape) is uncertain. In developing countries production is likely to increase by extension into marginal land, and increased use of fertiliser and pesticides, which will be exacerbated by weak regulatory frameworks. Modelling and empirical case studies are consistent in identifying the risk of potentially significant negative environmental and social impacts from agricultural trade liberalisation in developing countries.

## ***Policy conclusions***

**3.49 Sustainability Impact Assessments.** It is evident that trade liberalisation will result in a combination of positive and negative impacts, and it is likely that any liberalisation package will produce both winners and losers. If policies are to take account of the positive and negative consequences of liberalisation, then sustainability impact analyses should be undertaken for proposed liberalisation measures in order to examine the likely effects and aid the design of complementary measures to mitigate adverse effects. The EU's current model for Sustainability Impact Assessments provides a useful framework for this, although there are difficulties involved in completing such assessments; for example, lack of information to identify all the effects or to quantify and value the relevant costs and benefits. Similarly, it will be difficult to compare and weight impacts across different sections of society.

**3.50 Complementary Policies.** Flanking and other supporting measures are essential to minimise any negative repercussions that greater trade and investment liberalisation might have on environmental performance and help assure that any eventual positive impacts are maximised. The robustness of environmental and social policies and institutions, including the adequacy of supporting regulatory instruments, are important determinants of the environmental impact of trade and investment liberalisation. Where regulatory institutions and capacity are weak, as in many low-income countries, the optimal timing and sequencing of trade and investment liberalisation measures will need to be carefully considered.

**3.51 Policies on economic development and environmental (and social) protection** should be designed and implemented in conjunction with each other, thereby avoiding the separation of trade liberalisation policy from environmental policy.

## ***Practical examples of complementary policies***

**3.52 Market based economic instruments,** such as subsidies, environmental taxes and tradable permits, are considered to be both effective and efficient policy instruments to internalise environmental costs. For instance subsidies can be used to pay for previously unpaid environmental benefits, e.g. the provision of subsidies that support climate-friendly technologies. Environmental taxes can also be effective and efficient in promoting sustainable development. Empirical studies have shown that taxing air pollutants results in health benefits that are greater than the efficiency losses associated with the introduction of taxes, leading to both environmental and net efficiency gains. Other complementary policies may include trade measures based on process and production methods, for example eco-labelling, to enhance demand for goods produced with less impact on the environment, and subscription to multilateral environmental agreements which are considered to be an important means of protecting the global environment.

# Chapter 4: Liberalisation and Equity

## ***Chapter outline***

- Liberalisation and the distribution of income
- Liberalisation and poverty
- Trade and gender; the impact of liberalisation on women
- Liberalisation and labour standards in developing countries
- Tariff cuts and government revenues

## ***Introduction***

Liberalisation may produce both winners and losers. It is generally difficult to predict who these may be. Moreover, some groups in society will find it more difficult to adjust to adverse shocks than others. The very poor may be one such group, and the likely impact on them is relevant to policy formulation. One of the Millennium Development Goals, as set by world leaders in September 2000, was to reduce by half the proportion of people in 1990 living on less than a dollar a day by 2015. The impact on the poor in developing countries is important because a loss of income may make it impossible for them to continue in economic activity (e.g. as subsistence farmers) or may even be the difference between life and death for some. The poor, of course, include both men and women. But in many societies, women as a whole may also be more vulnerable to adverse shocks than men. This chapter examines the evidence on the impact of trade liberalisation on these (overlapping) groups. It also examines the question of whether globalisation has affected labour standards in developing countries – which may be a particularly important issue for the poorer workers, including women, and children. Finally, it examines the impact on government revenues of tariff cuts arising from trade liberalisation. Tariff cuts could have distributional impacts if alternative taxes affected groups in different way, or if the pattern of government expenditure was altered.

These potential impacts are considered in this chapter. This is not to imply that classifications used represent all potentially vulnerable groups. In some societies, other groups, such as ethnic or religious minorities, may face particular difficulties in adjusting to adverse shocks. And trade liberalisation may have differential impacts which are not necessarily correlated to vulnerability e.g. between rural and urban populations. For instance, agricultural reform in OECD countries could have a generally

favourable impact on rural agricultural producers in developing countries, but could have adverse effects for the urban population through higher food prices.

## Liberalisation and Income Distribution

*“Will the reforms in China lead to more income inequality? I hope so.”*

– remark attributed to Deng Xiaoping

**4.1** There is some concern, and debate, about the impact of globalisation on income inequality. Income inequality can mean inequality *between* countries, or *within* countries, or both. How far inequality should be a major consideration of government policy, or public concern, is open to debate. Reducing income inequality is not a specific aim of the Government’s development policy. However, policies in support of, for instance, wider access to education and reducing the insecurity of the poor will tend to reduce inequality as well as stimulating growth and poverty reduction.

**4.2** The case for reducing poverty is morally strong, but it is less evident that increased inequality should be a matter of concern if the poor get richer but the rich gain even more. The answer may depend, in part, on the country concerned. Wide income inequalities may lead to social discontent and hamper economic performance if conspicuous riches exist alongside widespread poverty. On the other hand, it has been argued<sup>161</sup> that wealth accumulation may allow the super-rich to engage in socially beneficial activities that individuals in a more equal society or governments would not undertake.

**4.3** For the last couple of centuries, there have been marked divergences in growth rates of average income *between* countries. Between 1820 and 1998, real GDP per head rose nineteen fold in Western Europe, North America and Australasia, thirty-one-fold in Japan, but only five-fold in the rest of the world. In 1820, the richest country in the world had real income per head about four and a half times as high as the poorest: in 2000, the ratio was 71 to 1<sup>162</sup>.

**4.4** In more recent years, the trends have been complex, and the answer to the question of whether inequality between countries has widened or not depends on the measure used. The gap between average incomes in the 20 richest countries and the 20 poorest has doubled over the last 40 years. This is because a group of countries – which are characterised by a marginalisation in the world trading system – have fallen behind not only developed countries but also other developing countries. Out of 108 developing countries, 16 had negative growth between 1960 and 1990, and another 68 had per capita growth of less than 1% a year<sup>163</sup>. This inability to maintain a reasonable level of growth is certainly not due to liberalisation by the poorest countries, but to other factors that have hindered their development, including wars and chronic macroeconomic instability. But there has also been a marked rise in growth in many developing

<sup>161</sup> Bhagwati 2004

<sup>162</sup> Wolf 2004

<sup>163</sup> Pritchett 1997

countries – including the populous ones like India and China – so that they have been catching up with developed countries. Overall, inter-country inequality weighted by population has declined because of this.

**4.5** Income distribution *within* countries depends on many factors. It has, for some years, been widening in countries such as the UK and the USA. One issue that dominated much of the debate in the 1990s was whether trade with developing countries has caused increased wage inequality and unskilled unemployment in developed countries.

**4.6** There has been an enormous amount of research on this issue<sup>164</sup>. Most evidence suggests that while increased trade with low wage economies has had an impact on developed country labour markets, technological change is a much more important influence on wage and employment patterns of the unskilled workers in developed countries.<sup>165</sup>

**4.7** There is no clear evidence that the period of globalisation has led to widening or decreasing inequality within countries. Kuznets put forward the thesis that, as economies grow, inequality first increases but then diminishes. Recent work by the World Bank, which looks at a large sample of countries over several decades, does not support this. Periods of growth are almost as often associated with increases in equality as they are with declines. Similarly, there is no simple relationship between openness to trade and changes in equality. There are about the same number of instances where inequality fell with more trade openness as instances where it increased. The only conclusion that can be drawn is that country-specific factors are highly important in explaining these different experiences.

## **Liberalisation and Poverty**<sup>166</sup>

**4.8** Measuring global poverty is not easy. Measures of poverty range from the simple, using individual income or expenditure, to the more complex where poverty is measured using an index including metrics of well being such as health, life-expectancy, and access to education. While acknowledging the limitations of its approach, the World Bank opts for a relatively simple method of gauging global poverty by using reference lines of daily consumption set at US\$1 and US\$2 a day, in 1993 purchasing power parity terms. While this approach cannot give a detailed picture of global deprivation, it does provide a useful and easily accessible means of observing general trends.

**4.9** Trends in poverty over the last two decades show a mixed picture. Global poverty has fallen by around 40%. Most of this improvement has come from China. Poverty in China, at \$1 a day, has fallen by two thirds since 1981. Over 400 million people have been lifted

<sup>164</sup> See for example, Slaughter and Swagel 1997, Cline 1997 and Ghose 2003 for reviews of this literature.

<sup>165</sup> For a contrary view, however, see Wood 1995

<sup>166</sup> See also, DTI White Paper on Trade and Investment 2004 p.60-68 for a discussion on poverty, liberalisation and the Millenium Development Goals

out of poverty and the rate of poverty has fallen from 64% of the population in 1981 to 17% in 2001. Elsewhere the situation is far less promising, with the number of people living in poverty either static, as in India (although a growing population has meant that the proportion of people in poverty has fallen significantly), or actually rising, as in Latin America and sub-Saharan Africa. Indeed, in sub-Saharan Africa, both the number of people living in poverty and the proportion of them in the total population have increased.

**Table 4.1 Number of people in poverty; million living on less than \$1 a day**

	1981	1984	1987	1990	1993	1996	1999	2001
East Asia and Pacific	795.6	562.2	425.6	472.2	415.4	286.7	281.7	284.3
China	633.7	425	308.4	374.8	334.2	211.6	222.8	211.6
East Europe and Central Asia	1.1	1.2	1.7	2.3	17.4	19.8	29.8	17.6
Latin America	35.6	46	45.1	49.3	52	52.2	56.3	49.8
Middle East and North Africa	9.1	7.6	6.9	5.5	4	5.5	7.7	7.1
South Asia	474.8	460.3	473.3	462.3	476.2	461.3	452.7	428.4
India	382.4	373.5	369.8	357.4	380	399.5	352.4	358.6
sub-Saharan Africa	163.6	198.3	218.6	226.8	242.3	271.4	294	315.8
<b>Total</b>	<b>1479.8</b>	<b>1275.6</b>	<b>1171.2</b>	<b>1218.5</b>	<b>1207.5</b>	<b>1096.9</b>	<b>1119.4</b>	<b>1103</b>

Source: World Bank Poverty Monitoring <http://www.worldbank.org/research/povmonitor/index.htm>

**Table 4.2. Percentage of Population in Poverty; Living Below \$1 Per Day**

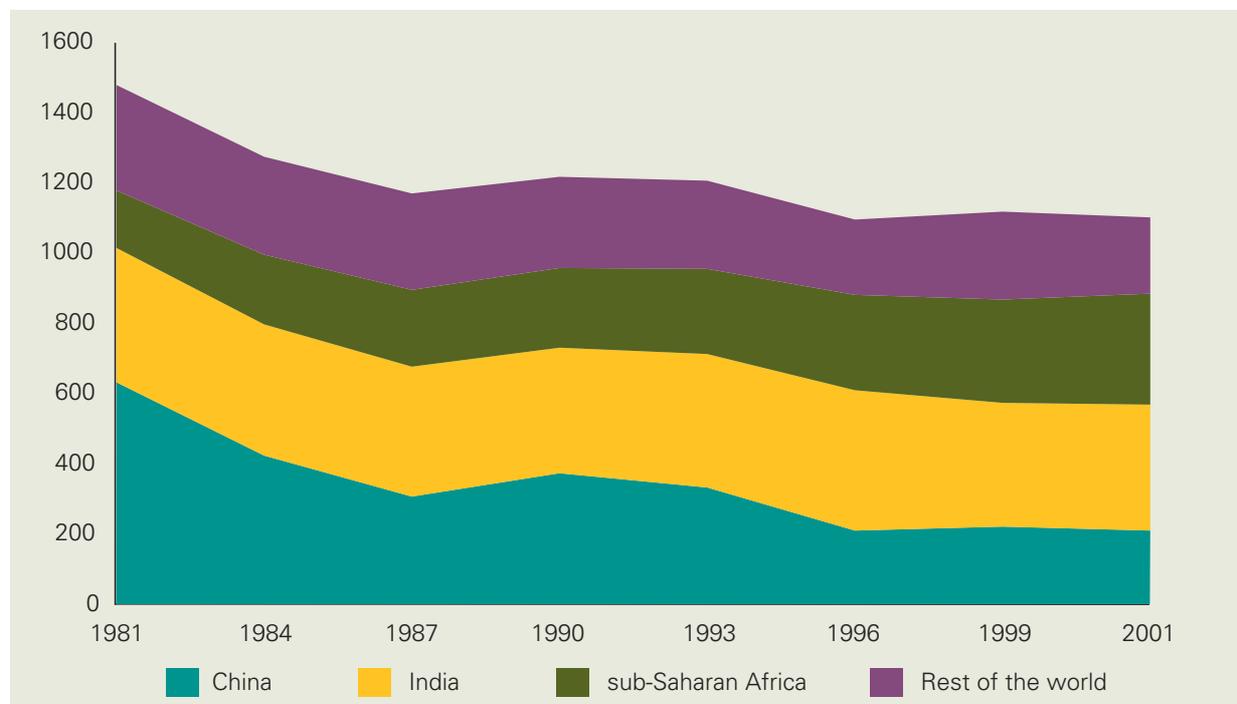
	1981	1984	1987	1990	1993	1996	1999	2001
East Asia and Pacific	57.7	38.9	28	29.6	24.9	16.6	15.7	15.6
China	63.8	41	28.5	33	28.4	17.4	17.8	16.6
East Europe and Central Asia	0.3	0.3	0.4	0.5	3.7	4.2	6.3	3.7
Latin America	9.7	11.8	10.9	11.3	11.3	10.7	10.5	9.5
Middle East and North Africa	5.1	3.8	3.2	2.3	1.6	2	2.6	2.4
South Asia	51.5	46.8	45	41.3	40.1	36.6	34	31.1
India	54.4	49.8	46.3	42.1	42.3	42.2	35.3	34.7
sub-Saharan Africa	41.6	46.3	46.8	44.6	44	45.6	45.7	46.9
<b>Total</b>	<b>40.3</b>	<b>32.8</b>	<b>28.4</b>	<b>27.9</b>	<b>26.3</b>	<b>22.8</b>	<b>22.2</b>	<b>21.3</b>

Source: World Bank Poverty Monitoring <http://www.worldbank.org/research/povmonitor/index.htm>

**4.10** Economic growth is a necessary condition for poverty reduction. The evidence on the relationship between trade and investment liberalisation and growth was reviewed in Chapter 2. Whatever the difficulties in establishing the linkage, it is clear that countries that experience take-offs in growth rates also experience marked reductions in poverty. In India, the proportion of the population living in poverty fell from 54% in 1981 to 35% in 2001. In China, the proportion has fallen from 64% in 1981 to 17% in 2001. In Indonesia, the fall has been from 60% in 1985 to 20% in 1998. In Vietnam, the fall has been from 75% in 1988 to 37% in 1998 – a dramatic halving in a decade. In that country, of the poorest 5% of households in 1992, no less than 98% had higher incomes by 1998 – the growth was feeding through to the poorest of the poor<sup>167</sup>. The role of liberalisation in stimulating the growth that has unquestionably reduced poverty is difficult to quantify. But in all these countries, there was a move towards more open economies over the period concerned.

**4.11** These are the success stories. The general relationship between liberalisation and poverty is less clear-cut. One seminal econometric estimate based on a wide selection of countries calculates that on average higher growth is associated with a one-for-one rise in the incomes of the poor<sup>168</sup>. But there are significant variations in this relationship between countries. Variations in poverty plainly depend on other factors than growth. For example, initial levels of income inequality and changes in inequality may also impact on poverty. It is generally agreed that more research is needed on these issues.

**Chart 4.1. Number of people in poverty; million living on less than \$1 a day**



Source: World Bank Poverty Monitoring <http://www.worldbank.org/research/povmonitor/index.htm>

167 Dollar and Kray 2004

168 Dollar and Kray 2002

**4.12** That, in the long run, higher growth will feed through into reduced poverty is an intuitively appealing conclusion. It corresponds to the past experience of developed countries, as well as that of the fast-growing developing countries. However, liberalisation may also impact on poverty in other ways. As noted in chapter two, the traditional theory of comparative advantage implies that one way in which the benefits of liberalisation are realised is through a re-allocation of factors of production between and within countries. In the short term, some lose from liberalisation and others gain. It is not evident a priori whether the poor as a whole gain or lose from this. Indeed, the poor in some sectors may gain, but others lose. This highlights the need for trade liberalisation to be part of a package of measures designed to reduce poverty.

### **Trade Liberalisation and Women**<sup>169</sup>

**4.13** Women may also be more vulnerable to adverse economic shocks. The World Bank notes in a recent report on the Millennium Development Goals<sup>170</sup> that “in no region of the developing world are women equal to men in legal, social and economic rights”. This underlying, pervasive and often institutionalised inequality should be borne in mind when considering the relationship between liberalisation and gender outcomes. It has been argued that because of socio-cultural structures and because of their frequent role as household carers, women disproportionately suffer the negative consequences of liberalisation and are less able than men to take advantage of the benefits.

**4.14** As noted above, trade liberalisation can generally be associated with positive economic growth, and economic growth with poverty reduction. Insofar as women suffer disproportionately from poverty, there may be an initial presumption that women therefore have the opportunity to gain from trade liberalisation. In sectors such as clothing manufacture, where female employment predominates, it seems clear that, as a whole, women in developing countries would benefit from further liberalisation. Furthermore economic growth has a positive effect in reducing inequality between men and women in other ways, for example in access to education. And increased gender equality is good for long-run economic growth<sup>171</sup>.

**4.15** Women and men are affected by trade liberalisation primarily through three mechanisms – as producers, consumers of goods, and consumers of public services<sup>172</sup>.

<sup>169</sup> See also, DTI White Paper on Trade and Investment 2004 p.90-91

<sup>170</sup> World bank Gender Development Group 2003

<sup>171</sup> Dollar and Gatti, 1999

<sup>172</sup> Fontana, M, Joeke, S and Masika, R 1998

## ***Women as workers***

**4.16** The bulk of the available research into the gender effect of liberalisation is concentrated on the labour market. The impact of trade liberalisation on women is likely to show up in the labour market through employment and through wages. Traditional trade theory, using the standard Hecksher-Ohlin framework, indicates that economies with a relatively large pool of unskilled labour (i.e. as found in much of Asia) would, on opening to trade, expect to experience growth in the demand for the goods produced by those sectors that use relatively more intensively unskilled labour (clothing, simple manufactured goods). The follow-on from this is that demand for unskilled labour will increase and hence too the wage of unskilled labour. Insofar as women in developing countries are more likely than men to be both outside of formal employment and unskilled, it is women who are likely to gain most from rising employment and rising wages. A different result may arise where the intensity of initial endowments follow a different pattern. In Africa, for example, most countries find themselves to be relatively abundant in land, rather than labour. In this situation the benefits of liberalisation are likely to be concentrated on landowners and agricultural workers, with the impact on women depending often on the cultural and societal norms in their country.

**4.17** In addition to trade literature, the economics of discrimination, as developed by Gary Becker<sup>173</sup> proposes that wage discrimination by employers is unsustainable in a competitive economy. As an economy opens to international competition, any wage differential between men and women that is based on discrimination (rather than, for example, productivity differences) will be eliminated. Profit maximising firms will be attracted to cheaper but qualitatively equivalent female labour, bidding up the women's wage and closing the gender pay gap, a result that was proven in the US<sup>174</sup>.

**4.18** Evidence on the above theories is, perhaps predictably, mixed, but does indicate that the growth of manufacturing exports by developing countries has been particularly beneficial to women in those countries<sup>175</sup>. The share of women employed in export processing zones (EPZs) is often extremely high; in Sri Lanka, 85% of those employed in EPZs are women, in the Philippines 74% and in Korea 70%. Work produced by the WTO on Mauritius, Mexico, Peru, Philippines and Sri Lanka shows that the expansion of exports was associated with substantial increases in female employment and in the female share of employment<sup>176</sup>. The same study goes on to show, however, that as the export sector moved into higher value work so the share of female employment declined. This may be a consequence of inequalities in education and training. Even as the employment shares in export manufacturing are rebalanced, women's wages increase relative to those of men, thus reducing the gender pay gap. Other evidence however, shows a negative relationship between openness and women's wages. In a comparative study, Taiwan, which has followed a path of increased liberalisation, saw an

<sup>173</sup> Cited in Black and Brainerd 2002 and in Berik et al 2002

<sup>174</sup> Black and Brainerd 2002

<sup>175</sup> Joekes 1999

<sup>176</sup> Nordas 2003

increase in the gender pay gap in the exporting sector while Korea, which has become relatively less open, experienced a slowly reducing differential<sup>177</sup>. A suggested explanation for this is that the intensity of international competition allows employers to exert greater downward pressure on women's wages because the patterns of domestic social and business structures provide women with weaker bargaining positions than men. Alternatively, women's reduced access to education may prevent them from taking advantage of liberalisation, or simply the increasing supply of women into the workforce may hold down wages in spite of increasing demand.

**4.19** In Africa, where agriculture predominates, the evidence on the impact of liberalisation on women in the labour market appears less positive. Trade expansion and liberalisation has been associated with a worsening of gender inequalities where, for example, the burden of work on women has increased significantly without mitigating consequences in terms of empowerment or income<sup>178</sup>. Furthermore, women farming in their own right are commonly unable to access credit or are subject to other constraints which prevent them from taking advantage of new export opportunities resulting in a relative worsening of their position. And they may also suffer, as producers, from cheaper imported alternatives such as food products and clothing, a problem which is all the more noxious when it involves the dumping of subsidised goods from the developed world.

**4.20** Although services make up the largest part of most economies, there is unfortunately little information on women, employment and the effects of trade liberalisation. Emerging evidence on service export sectors connected with business process outsourcing or offshoring does suggest, however, that, as in manufacturing, there is a strong demand for women's labour and that women form a high proportion of the workforce, including at higher grades<sup>179</sup>.

**4.21** Overall, employment empowers women, enhancing their bargaining position within the household and providing less quantifiable benefits such as increased self-esteem. This in turn is associated with increased household expenditure on health and education<sup>180</sup>. At the same time there is evidence that paid employment can, in some circumstances, result in increased vulnerability, exploitation and gender inequalities. This can be the case, in particular, in agriculture in Africa where gender systems relating to land and labour are often complex<sup>181</sup>.

177 Berik et al 2002

178 Joekes 1999

179 Joekes 1999

180 World Bank cited in Joekes 1999

181 UNCTAD cited in Joekes 1999

### ***Women as consumers***

**4.22** Trade liberalisation is good for consumers. It should lower prices of goods and services as cheaper alternatives are imported and local providers therefore need to become more competitive. Women will benefit from the lower prices both as individuals and as members of households. Where women have different consumption patterns to men the pattern of benefits will be different. The introduction of new and cheaper products such as food and household goods as a result of trade liberalisation will provide greater choice and may reduce some of the burdens on women in terms of domestic and other unpaid work<sup>182</sup>.

### ***Women as consumers of public services***

**4.23** It is frequently noted<sup>183</sup> that women typically act as the carer in the household and rely heavily on certain goods such as schooling and healthcare, and access to education is also important for their own development. There have however been concerns about the impact of trade liberalisation on tariff revenues and the ability to fund public services (see below). Another area of concern about government provision relates to the General Agreement on Trade in Services (GATS) and its possible effect in the liberalisation of sectors such as water supply, education and healthcare (see Chapter 5). It is argued that shifts in the prices of these goods that may come about as a result of a trade policy will tend to disproportionately affect women. For example, women may forgo healthcare for themselves or adequate nutrition in order to afford healthcare or schooling for their children. Moreover, when these services are not available or become too expensive women tend to supply them themselves, thereby increasing the burden of unpaid work.

**4.24** Fears about the impact of GATS negotiations are illusory. The decision to open a sector to competition, and to what extent, is a domestic policy decision. The GATS does not compel any country to privatise its public services. Moreover, the GATS do not prevent a country from legislating or regulating any liberalised service in pursuit of national policy objectives. While there have undoubtedly been examples of privatisations that have adversely affected the more vulnerable members of society, women would stand to benefit significantly as privatisation should, in many cases, lead to improved efficiency and, backed by effective regulation, this should translate into lower prices and higher quality.

**4.25** Thus, while trade will, in many cases, have different effects on women than on men, as well as between different groups of women, these are strictly second order effects and are determined by the social and political structures in the countries, communities and households in which women and men live. Trade may increase the number and quality of jobs available to women and the wages that they get paid for

<sup>182</sup> Williams 2003

<sup>183</sup> For example, Williams 2003

doing them, as appears to be the case for many women in Asia. On the other hand, liberalisation may increase foreign competition for goods that women produce and thereby reduce the amount of work available to them, as is sometimes the case, for example, in Africa. There are many other areas, as discussed above, where women are affected one way or the other as a result of liberalisation. Equivalent issues will arise for men. Women will win and lose, men will win and lose, and households will win and lose. The gains will amount to more than the losses.

## **Liberalisation and Labour Standards in Developing Countries<sup>184</sup>**

**4.26** The past decade has seen growing interest in the relationship between globalisation and labour standards. Debate has centred on a number of questions, including whether globalisation is leading to a “race to the bottom” in labour standards as countries compete for internationally mobile investment; does adopting labour standards hinder trade competitiveness; and whether trade measures should be linked to attempts to promote standards globally, particularly so-called core standards. Some argue that attempts to gain competitive advantage and attract investment tempt companies and governments to lower standards. Intervention is therefore needed to prevent this, including the possibility of imposing trade sanctions. Others argue the process of globalisation itself promotes economic growth thereby providing the resources to pay for higher labour standards.

### ***Labour standards***

**4.27** Four core labour standards are binding on all ILO members<sup>185</sup>. In addition, other ‘substantive’ standards, covering issues such as minimum wages or health and safety, are of concern to workers, activists and consumers, but their content and implementation varies according to national circumstances.

### ***The effect of core standards on competitiveness***

**4.28** Although it is widely accepted that the implementation of labour standards can raise productivity, there is more debate about their effects on labour costs – i.e. whether standards raise wages and other costs to employers by more than they raise productivity. The evidence (summarised in Box 4.1) is mixed, but some suggests that free collective bargaining tends to raise labour costs in manufacturing. Higher core standards do not appear to discourage FDI, but the available evidence neither conclusively confirms nor conclusively refutes the concern of some governments in poor countries that adopting higher labour standards might make them less competitive in world markets for low-skilled, labour-intensive manufactured exports such as footwear and clothing.

<sup>184</sup> See also, DTI White Paper on Trade and Investment 2004 p.99-100

<sup>185</sup> Freedom of association and the right to collective bargaining; elimination of all forms of forced or compulsory labour; effective abolition of child labour; and elimination of discrimination in respect of employment and occupation.

### ***A Race to the bottom?***

**4.29** Most evidence does not support fears that countries will gain from increased export competitiveness or attractiveness to foreign investment by suppressing core standards<sup>186</sup>. Labour standards are rarely the most important of the many influences on the location decisions of firms. And implementation of some core labour standards can have positive effects on stability and productivity.

**4.30** Indeed, studies have shown that there is a positive relationship between FDI and workers rights – for example it has been found that MNEs in OECD countries generally have company rules in place to prevent child labour in their affiliates. Many aspects of MNEs' working conditions are often above the national average, and not worse than those of comparable national employers<sup>187</sup>. A number of studies suggest MNEs in developing countries generally pay higher wages than local companies, and have engaged in initiatives to impose similar standards on their suppliers. Low labour standards may even act as a deterrent to FDI due to investors concerns about their reputation in the rest of the world, and social unrest in the host country.

**4.31** In China, some foreign owned firms have instituted higher standards of Corporate Social Responsibility than were previously in place, particularly with regard to labour conditions, health and safety, and environmental regulation. Not only do the firms themselves set higher standards, but companies such as B&Q have enforced these requirements of their Chinese suppliers, helping better conditions to trickle through the production chain. As well as improving the well-being of workers and the environment, the introduction of foreign practices in many cases has also helped to encourage entrepreneurialism, and a greater readiness to adopt good business practices.

**4.32** There is however concern about the suspension of labour standards in some export processing zones (EPZs). UNCTAD<sup>188</sup> identifies subcontractors who ultimately work for MNEs, and EPZs, where labour regulations are often relaxed in order to attract FDI, as areas of concern due to the quality of employment conditions. However, other evidence suggests that wages and some employment conditions tend to be, if anything, higher in some EPZs than in the rest of the economy<sup>189</sup>.

186 See for example OECD 1996 and OECD 2000

187 UNCTAD 1994

188 UNCTAD 1994

189 ILO 1998

### **Box 4.1: Core labour standards and competitiveness – the evidence**

Cross-country research on the economic effects of higher labour standards is hampered by the lack of good measures of labour standards<sup>190</sup>. There is also the problem of disentangling the impact of labour standards from that of other forces. As a consequence, the results of studies have varied and most of them have been disputed.

Studies (mainly of developed countries) suggest freedom of association and collective bargaining allow workers, especially unskilled ones, to negotiate higher wages and better working conditions. In OECD countries, the wages of unionised workers are up to 20% higher than those of non-unionised workers<sup>191</sup>. Moreover, all thirty studies reviewed by Filer et al<sup>192</sup> show that in the U.S. the wage difference between unionised and non-unionised workers is higher for unskilled than for skilled workers, by an average of about 15%. The few available studies of developing countries suggest wage differences between unionised and other workers tend to be smaller than in OECD countries<sup>193</sup> and cause only small economy-wide efficiency losses<sup>194</sup>.

The OECD<sup>195</sup> finds no correlation between the implementation of union rights and real wage growth. But most other studies suggest a connection<sup>196</sup>. The OECD studies also found no evidence that higher labour standards reduce foreign direct investment. This conclusion is supported by other studies – the explanation being apparently that any adverse effect via higher labour costs is offset by positive effects via greater social stability<sup>197</sup>. However, many jobs in labour-intensive manufacturing for export, particularly of clothing and shoes, are not in foreign-owned firms (i.e. in firms financed by foreign investment), but in locally-owned firms producing under contract for foreign buyers, so it is important also to look directly at the effects of labour standards on trade flows.

The OECD finds no relationship between core standards and sectoral trade patterns or export performance. By contrast, studies by Rodrik and by Mah<sup>198</sup> suggest that high labour standards can diminish the comparative advantage of developing countries in labour-intensive goods such as textiles and clothing. The results of Rodrik and Mah are disputed by others<sup>199</sup>, but are consistent with work by Belser<sup>200</sup> who finds that higher labour standards tend to reduce labour-intensive manufactured exports. The effect of labour standards on trade is thus an area where there is clearly a need for further research, which among other things should distinguish more systematically among different sorts of standards – the impact of reducing discrimination against women, for example, is unlikely to be the same as that of outlawing forced labour or allowing free collective bargaining.

190 Elliott and Freeman 2003

191 Blanchflower and Freeman 1992

192 Filer et al 1996

193 Rama 2001

194 Aidt and Tzannatos 2002

195 OECD 1996, 2000

196 Rama 1995, Rodrik 1996, Kucera 2001 and Belser 2001

197 Kucera 2001

198 Rodrik 1996; Mah 1997

199 Morci and Shulz 2001; Flanagan 2002

200 Belser 2001

### ***Can trade sanctions be used to promote standards in developing countries?***

**4.33** Whether trade policy could or should be linked to labour standards is a matter of particular controversy. The evidence here is thin. Punitive trade policy measures have rarely been used to promote labour standards. Evidence from the US suggests (the threat of) withdrawal of GSP preferences has had some success. In the EU GSP scheme however, the take-up of so-called “positive incentives” to promote labour standards has been very low. The success of trade sanctions for other foreign policy goals has been mixed.

**4.34** More generally, there are a number of arguments against the use of punitive trade sanctions to achieve higher core labour standards.

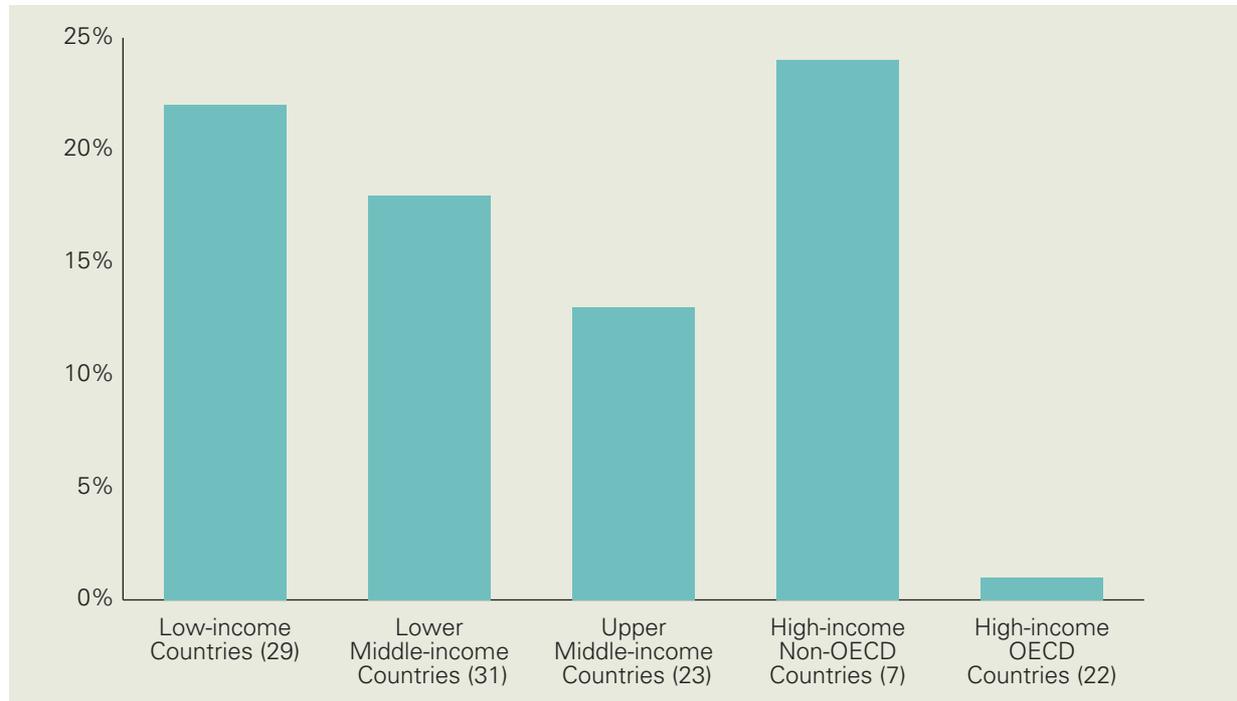
- It could jeopardise the DDA, and with it, one route to increased prosperity in developing countries.
- It is difficult for sanctions to influence behaviour outside the export sector.
- It could burden the WTO dispute settlement system, which is already under strain.
- Sanctions are more likely to influence behaviour when imposed by large, strong economies against weak, smaller economies. Might be more difficult to use them to change behaviour in large economies (e.g. China).
- Fear of sanctions could encourage firms to extend informalisation of employment, outsourcing and subcontracting in order to circumvent labour regulations<sup>201</sup>.
- There is also a risk of trade sanctions discriminating against poor countries, which lack the regulatory and institutional infrastructure for implementation, and within countries bearing particularly heavily on poor people.

## **Impact of Tariff Cuts on Government Revenues in Developing Countries**

**4.35** Cuts in developing countries’ import tariffs are often resisted for fear of government revenue loss. By implication, there is concern that tariff cuts reduce the level of resources available to implement growth and poverty reduction policies. Tariff revenues account for a significant proportion of tax revenues in developing countries. There is significant variation ranging from 13% of tax revenue in Myanmar to 75% in Guinea. On average, however, tariff revenues constitute around 22% of tax revenues in low-income countries and around 18% in lower middle-income countries<sup>202</sup>.

<sup>201</sup> Dessing 2001

<sup>202</sup> World Bank, World Development Indicators (2003), averaged over the most recent three years

**Chart 4.2 Tariff revenue as a proportion of tax revenue**

Source: World Bank, World Development Indicators 2003

**4.36** The experience of a number of African countries that went through structural adjustment programmes in the 1980s is often cited to illustrate how tariff cuts may hamper the ability to achieve development objectives. Loss of tariff revenues led to severe cutbacks in expenditure as part of macroeconomic stabilisation policies. In particular, capital expenditure was reduced drastically, which would have likely had adverse effects on the sustainability of long-term growth.

**4.37** As countries become richer, the growth in the tax base and strengthened capacity to collect and administer domestic taxes leads to reduced dependence on tariff revenues. In the short run, however, import tariffs are easier to collect than domestic taxes; the tax base is low because much economic activity falls outside the formal sector; and tax evasion is high because of lack of enforcement and administrative capacity.

**4.38** In view of these fiscal challenges, it is important to consider the relationship between tariff cuts and government revenue to mitigate potential negative effects of the former on the latter. Theory shows that this relationship is ambiguous. Government revenue will increase if the demand for imports is relatively price elastic i.e. if the percentage fall in the tariff is offset by a bigger percentage increase in quantity demanded for imports, both tariff revenue and revenue from domestic consumption taxes (e.g. VAT or sales tax) will increase. Government revenue may decrease if the demand for imports is relatively price inelastic i.e. if the percentage fall in the tariff is offset by a smaller percentage increase in quantity demanded for imports, tariff revenue

will fall but revenue from domestic consumption taxes will rise. The overall effect on government revenue will depend on the relative effect of each.

**4.39** It is difficult to empirically isolate the effect of tariff cuts on tariff revenue. As discussed above this relationship depends on how tariff cuts interact with demand for imports and other trade reforms (e.g. tariffication). As a general trend, however, tariff revenues as a percentage of GDP have often remained high in developing countries despite cuts in tariff rates<sup>203</sup>.

**Table 4.3 Trade tax as a share of total tax revenue (un-weighted averages, %)**

Region	1980	1990	1998	% change 1980-1998
OECD all	4.7	2.7	1.1	-76.6
Non-OECD	24.2	20.5	17.7	-26.9
Africa	38.6	31.9	37.5	-2.8
Asia and Pacific	29.0	27.6	19.2	-33.8
Middle East	31.7	28.9	25.2	-20.5
Western Hemisphere	24.9	14.3	14.2	-43.0

Source: OECD

**4.40** Table 4.3 shows that the importance of trade taxes as a percentage of total tax revenue in all regions have declined in relative terms over a period when significant liberalisation took place. However, trade taxes still account for a significant share of total tax revenue in poor countries. In Africa for instance, the share of trade tax in total tax revenue fell between 1980 and 1990 but then rose from 1990 to 1998 resulting in an overall decline in trade tax receipts equivalent to only 2% of GDP.

**4.41** Econometric analysis of the determinants of government revenue shows that between 1975 and 2000 low income countries have been able to offset at most one third of trade revenue loss through other sources of government revenue<sup>204</sup>. There is also evidence, albeit quite weak, of a higher tariff replacement factor in countries that have introduced VAT. Middle-income countries' replacement factor is higher at almost half while for high-income countries the replacement factor is higher than one. These results reflect the difficulties faced by poor countries in mobilising non-tariff revenues in the short term.

203 Keen (Ed) IMF, 2003

204 Keen and Baunsgaard 2003

**4.42** There are a number of examples of countries successfully reducing their reliance on tariff revenues. Senegal for instance was able to compensate the loss in tariff revenues as a result of regional liberalisation and to increase government revenues, going from 13.2% of GDP in 1994 to 17.8% in 2002, by accompanying regional tariff reduction with a fiscal reform in favour of domestic taxes<sup>205</sup>. In Ghana<sup>206</sup> the economy responded positively to Structural Adjustment Programmes and government revenues were maintained, mainly because of the fiscal policy change and the introduction of VAT but also because of complementary fiscal measures to broaden the tax base and increase efficiency in tax collection.

**4.43** Tariff liberalisation has effects beyond the fiscal sphere in other sectors of the economy that can in turn affect the fiscal position in the long run. For instance:

- Lower tax rates reduce the pay-off to corrupt practice and political influence and should help reduce the discrepancy between what duties should yield by the way of revenue and what they actually yield. This can translate into a shift from informal towards formal transactions and to the extent these are taxable into government revenues.
- Lowering import duties is expected to discourage investment in previously protected sectors and, by reducing anti-export bias in the structure of taxation, could favour investment in export-oriented activities.

<sup>205</sup> VAT is now the most important source of government revenues in Senegal, while direct taxation accounts for only 23% of revenues, due to weakness of the fiscal administration and the narrow direct fiscal base.

<sup>206</sup> Jebuni, Oduro and Tuku 1994

# Part 2: Policy

In Part 2 we look at some of the practical issues confronting UK government policy. Chapter 5 looks at the economic rationale for UK trade policy in more detail, including the justification for the primacy given to the multilateral route to liberalisation and some of the main issues subject to negotiation as part of the Doha Development Round. Chapter 6 explores policies aimed at maximising the potential for UK companies to engage in trade and for the UK economy to maximise the benefits from Foreign Direct Investment. Chapter 6 also examines economic policy more generally and how it can best promote smooth adjustment to the pressures exerted by globalisation. Finally, Chapter 7 looks at some of the challenges facing trade policy in the future.

# Chapter 5: The Government's Trade and Investment Policy

## ***Chapter outline***

- Why do we need a multilateral trade system?
- What are the likely gains from a successful trade round?
- Trade protection and developing countries
- Liberalisation of trade in services; gains and criticisms
- Liberalisation of agriculture trade
- Liberalisation of non-agriculture trade; barriers and progress
- Liberalisation of investment; benefits, evidence and criticism
- The case for and against the inclusion of a competition agreement
- Trade facilitation and government procurement

This Chapter examines the economic basis for Government trade policy. It starts by asking why we need a multilateral trade system at all, rather than rely on unilateral or bilateral liberalisation. It then examines in more detail the importance of the Doha Development Round and some of the obstacles to progress. It looks at the way in which existing protection by developed countries falls disproportionately on exports from developing countries, which partly explains the emphasis on a "development Round". It focuses on the main negotiating issues: agriculture, industrial products and services, but also looks at the case for an agreement on the four so-called "Singapore Issues" namely, investment, competition, trade facilitation and government procurement.

## Why do we have a Multilateral Trade System?

**5.1** The analysis in Part 1 suggests that, in most circumstances, a country can gain from liberalising its trade regime regardless of whether others do the same. Why then do we need a multilateral trade system to regulate the conduct of international trade and not instead rely on self-interest to ensure that each country liberalises its trade regime?

**5.2** Most countries increasingly recognise the benefits of a liberal trade regime and have increasingly switched from inward to outward-oriented policies. But as discussed in Chapter 2 trade liberalisation can bring non-trivial adjustment costs and there remain strong pressures to protect markets. The benefits of liberalisation are widely dispersed so the voice of consumers, industrial purchasers and even exporters are not heard as loudly as they should. The adjustment costs of liberalising, by contrast, are often concentrated on particular industries and companies. The existence of pressure groups representing these largely explains why countries – including the UK itself – have been reluctant to remove barriers unilaterally. This has helped promote a self-reinforcing cycle, each country pointing to others protection as a reason for maintaining its own barriers.

**5.3** The advantage of the multilateral system is that it provides a framework within which advocates of freer trade can persuade others of its merits. Exporter and consumer interests provide a counterweight to those who positively benefit from protection and those reluctant to embrace it because of adjustment costs. Moreover, individual countries can point to others' liberalisation as a "compensation" for their own liberalisation. And within the context of a multilateral round, cross-issue trade-offs are possible, widening the scope for an agreement.

**5.4** The multilateral system also provides a range of other advantages. It acts as a forum for trade negotiations. It provides for national treatment: once imported, goods and services are treated no less favourably than those that are domestically produced or provided. Another important principle enshrined in the WTO is non-discrimination: with some exceptions a government must not discriminate between goods and services of other members. It helps promote transparency and certainty: trade restrictions should as far as possible be transparent and bound in WTO schedules. And it also provides a dispute settlement system, which helps weaker nations protect their rights and ensure stronger nations fulfil their commitments.

### ***Multilateralism versus bilateralism***<sup>207</sup>

**5.5** In reality, some of the benefits of multilateral liberalisation could also be achieved through the negotiation of a series of bi-lateral or regional trade agreements (RTAs), of which the European Community is a prime example. Governments therefore face

207 Bilateral agreements are further covered in DTI White Paper on Trade and Investment 2004 p.84-85

important choices between pursuing their trade objectives through the multilateral system alone, through bi-lateral agreements, or both. This section examines the relative economic merits of multilateral and bilateral agreements, and in particular, the available evidence on the contribution of bilateral agreements to global welfare.

**5.6** RTAs have become an important feature in the world trading system. In 2003, the WTO<sup>208</sup> estimated that 176 RTAs notified to it were operative, another 70 agreements were operative but not yet notified and a further 70 were under negotiation. An explosion in the number of RTAs began in the late 1980s and accelerated in the 1990s. Some 113 RTAs were notified between 1990 and 2002.

**5.7** Around 43% of goods trade is between RTA partners, and it could exceed 50% by 2005 (Table 5.1). Only 4 WTO members are not parties to at least one RTA, and only 1 (Mongolia) is not known to have plans to enter one. The EU itself has over 30 RTAs.

**5.8** To some extent, these numbers overestimate the influence of RTAs. Not all trade between RTA partners is on preferential terms (because MFN rates may be zero or sectors excluded from the RTA), and 40 of the agreements concluded since 1990 have been between transition economies, representing an attempt to preserve something of the situation that existed prior to the collapse of COMECON. Moreover, a large number of the 18 RTAs existing in Africa appear to represent little more than intentions to do something at a later date. Nevertheless, a trend towards bilateralism seems clear.

### ***The respective merits***

**5.9** Economic theory holds that a multilateral agreement on trade liberalisation will increase world welfare more than a series of bilateral agreements. Both multilateral and bilateral approaches can increase the efficient allocation of resources by promoting so-called "trade creation". However, unlike multilateral agreements, bilateral agreements can also lead to "trade diversion" – and that will reduce welfare. Trade diversion occurs when exporters who receive preferences under the RTA displace other exporters, even those who are lower-cost ones, in the RTA market. Competitive exporters outside the RTA lose out to RTA members in the RTA markets. Any trade increase is thus in part at the expense of these third parties. The partners to the RTA may also lose. The liberalising countries lose tariff revenue. Prices to consumers should fall, but less so than they would under multilateral liberalisation.

**5.10** Apart from the possibility of trade diversion, there are other disadvantages to the bilateral approach. First, the growth of RTAs has made trading more complex and costly. Traders can face a multiplicity of rules of origin and standards depending on where the trade comes from and where it goes. This is costly and makes the trading system as a

whole less transparent. The problem is compounded where RTAs overlap, thus creating a “spaghetti” of rules. Although difficult to put a cost to this, it is likely to be non-trivial, as evidenced by analysis of the EU’s trade relations with East Europe after the fall of communism.

**5.11** A second problem is that RTAs can reduce the political support for wider liberalisation. They can produce a lobby of producers with an interest in preserving their preferences – certainly not having them eroded by multilateral liberalisation. It is also notable that bilateral agreements tend to exclude agriculture. Thus an influential segment of society has a strong reason to prefer them to multilateral liberalisation in which agriculture would be on the table.

### ***Can RTAs be justified?***

**5.12** The evidence on RTAs is complex, and alternative views are possible – for example that they actually stimulate multilateral negotiations. For instance, some argue that the formation of the European Common Market was an important factor in leading the USA to press for new multilateral negotiations, as it sought to minimise the trade diversion effects on its own industries. It is also argued that RTAs have emerged at times when progress in the multilateral arena was widely seen as unlikely. In this view, the RTAs are inferior to the multilateral approach, but better than nothing.

**5.13** An allied argument is that, the most significant aspects of RTAs relate to areas in which there are few multilateral rules, and the RTA is thus going beyond what might reasonably be achieved multilaterally. Equally, however, RTAs can include provisions, such as the recent US emphasis on labour clauses, which may make trade more complex, and, perhaps inadvertently, may produce adverse effects.

**5.14** A similar argument has been used to support the EU’s proposals to negotiate RTAs (the “economic partnership agreements”) with ACP countries to replace the existing arrangements. Although these may have only limited impact on trade creation and diversion, it has been argued that they will lock the ACPs into a more liberal policy stance than might be achievable under multilateral negotiations. It would also serve to create a larger internal market for the ACP blocs. As many have very small domestic markets, this could bring important benefits for domestic industries (an “economies of scale” argument that was also used in the context of the EU). Both factors could create a more favourable climate for attracting FDI to the ACP countries.

### ***The Evidence***

**5.15** Most research has looked at whether the trade creation effects of RTAs outweigh the diversion effects. For whatever their effect on the multilateral system, RTAs are not beneficial if they produce welfare losses.

**5.16** Individual analyses tend to produce mixed results<sup>209</sup>. It is difficult to draw robust conclusions that could be generalised to RTAs as a whole. This is not surprising – they vary in the depth of their provisions and the effects may vary according to the relative development of the partner countries.

**5.17** One important conclusion that could be drawn however is that there is little to support the view that RTAs produce deeper integration than the WTO could. Recent work by the OECD<sup>210</sup> concluded that in many respects RTAs have not progressed too much beyond WTO agreements and that it was very difficult to determine whether they represented an improvement in the liberalisation of trade. A WTO study of ASEAN also noted that differences between preference and MFN rates were usually small and that the costs of meeting origin requirements could be high, suggesting that ASEAN had had a limited effect on regional trade.

**5.18** In more general terms, it has been observed that RTAs tend to omit “sensitive” products – of which agriculture is a prime but not the only example – and to leave tariff peaks unchanged. For example, the WTO have calculated that, under the EU-South Africa agreement, the EU gives preferential treatment on only 55% of tariff lines, and South Africa on only 47%. The WTO study also confirmed that countries with high MFN tariffs also have high preferential tariffs in RTAs. They cite a number of cases where the peak tariffs just remain unchanged<sup>211</sup>. This, of course, does not mean that RTAs do not offer real concessions. But the evidence supports the not surprising point that, in general, countries that are reluctant to liberalise certain sectors multilaterally are likely to be reluctant to liberalise those sectors bilaterally.

**5.19** Secondly, the evidence suggests that generally RTAs have a fairly limited effect on trade flows. The WTO examination of individual analyses concludes that many find evidence of slight trade creation effects and insignificant trade diversion<sup>212</sup>. This conclusion appears to be born out by a simple examination of export concentration ratios. These measure the ratio of the inter-regional trade share to that region’s share of world trade. If RTA members trade more with each other than the rest of the world, this ratio will be more than 1. In fact, for a variety of reasons, neighbours tend to trade more with each other even without RTAs. The interesting question is whether, after an RTA is formed, the regional bias increases further.

**5.20** The EU has seen little rise in its concentration ratio since 1970, and an actual decline since 1995. The NAFTA ratio has risen since it was formed, but was rising rapidly before that. Individual analyses tend to suggest that that NAFTA itself has played a very

209 For a summary of results, see Lloyd and Maclaren 2003

210 OECD 2002 (2)

211 WTO 2003

212 WTO 2002

small part in the rise in intra-regional trade between its members<sup>213</sup>. The concentration ratio for ASEAN, which was founded in 1992, is no greater now than it was in 1970. But the picture is mixed. These simple measures show that, for instance, MERCOSUR and SADC have experienced considerable rises in intra-regional trade since their formation (Table 5.2).

**5.21** The converse of limited trade creation of course, is that there is limited scope for trade diversion. Most individual analyses have tended to find very little trade diversion<sup>214</sup>. Analysis through the use of computer models ("GTAP" models) tends to suggest that the relatively small positive effects from trade creation outweigh the negative effects from trade diversion.

**5.22** In conclusion, the evidence does not suggest that RTAs have so far had a very detrimental effect on the world trading system, in the sense of leading to significant trade diversion. However, the virtues claimed for RTAs in terms of trade creation and a broader form of liberalisation than would be possible under multilateral negotiation seem to be much less than their proponents suggest. Moreover, there is a negative aspect to RTAs in that any segmentation of markets through the need for more rules of origin etc must impose additional, if not easily quantifiable, costs on trade, and these would be expected to rise if more RTAs were created, and particularly overlapping RTAs. And there remains always the possibility that their existence strengthens lobbies opposed to multilateral liberalisation. The traditional economic conclusion – that they are inferior to multilateral liberalisation – remains intact.

**Table 5.1 Preferential trade share of intra RTAs trade in merchandise imports by region, 2000 and 2005**

Region	2000	2005 (forecast)
Western Europe	64.7	67.0
Transition Economies	61.6	61.6
North America (inc Mexico)	41.4	51.6
Africa	37.2	43.6
Middle East	19.2	38.1
Latin America	18.3	63.6
Asia	5.6	16.2
World	43.2	51.2

Source: WTO

213 Lloyd and Maclaren 2003

214 Lloyd and Maclaren 2003

**Table 5.2 Intra-Regional Export Concentration Ratios, 1970-2001**

Region	1970	1980	1985	1990	1995	2000	2001	Year in Force
EEU	1.5	1.6	1.6	1.5	1.6	1.7	1.6	1957
NAFTA	1.2	2.2	2.7	2.6	2.8	2.9	2.9	1994
ASEAN	11.4	4.9	5.1	4.6	3.9	3.4	3.5	1992
SAARC	3.3	7.5	6.6	4.1	4.9	4.2	4.6	1985
MERCOSUR	6.2	8.0	3.1	6.6	14.9	15.2	13.6	1991
ANDEAN	1.1	2.5	2.6	4.5	15.4	8.7	9.6	1988
COMESA	5.5	12.1	8.9	15.6	17.8	11.6	12.9	1994
SADC	2.2	0.2	1.3	3.1	14.0	20.1	16.1	1992

Source: WTO

### ***What might be gained from a new Round?***<sup>215</sup>

**5.23** Despite the spread of RTAs, the EU and most other trading nations have put the Doha Development Round at the top of their trade policy agenda. This reflects recognition of the gains achieved from previous rounds and the prospect of further gains.

**5.24** This section summarises the findings of five major studies which have attempted to quantify the impact of a new multilateral Round, particularly those which shed light on the relative contribution of liberalisation of agriculture, industrial products and services to global and developing country prosperity<sup>216</sup>.

**5.25** It is important to note some of the limitations of such studies, which are based on Computable General Equilibrium (CGE) models. CGE models are much better at assessing the impact of quantifiable trade barriers such as tariffs and subsidies than other forms of protection, for example, technical regulations or from agreements on some of the Singapore issues. None of the studies take account of transitional adjustment costs resulting from trade liberalisation, as resources move from contracting to expanding sectors of the economy. But nor do they take account the permanent benefits arising from other important elements of the Round, such as the increased certainty resulting from the binding of tariff barriers, the liberalisation of services or strengthened procedures for resolving trade disputes.

**5.26** Although all major studies conclude that the Round is likely to produce substantial benefits, there are significant differences in the size of the estimated gains. Among the studies examined here, the estimated global gains from a new round range from around

<sup>215</sup> See also, DTI White Paper on Trade and Investment 2004 p.69-70

<sup>216</sup> Five studies are covered by this note. These were Nagarajan (1999) Brown, Deardorff and Stern (2001), Australian Department of Foreign Affairs (1999), Anderson et al (2000) and the World Bank (2002). Details of other studies can be found in the HM Treasury / DTI paper : "Trade and the Global Economy: The role of international trade in productivity, economic reform and growth" May 2004.

\$250bn per year to \$600bn per year. Gains for developing countries range from \$100bn to \$180bn.

**5.27** These differences reflect variations in the assumptions of the economic model used in the analysis, of the liberalisation package likely to be agreed and its timing, and in the estimates of initial levels of protection.

**5.28** Even in terms of the *relative* size of the benefits from the three main areas of negotiation – agriculture, industrial goods and services – and how these gains vary between developed and developing countries, there is a lack of agreement among the studies reviewed (Table 5.3). However, some common themes emerge:

- Taken as a whole, both developed and developing countries stand to gain from liberalisation in each of the main areas of negotiation.
- Developed country gains tend to be larger in absolute (Dollar) terms, but relative to existing GDP, most studies suggest that developing countries stand to gain more.
- Gains from services liberalisation is perhaps the most difficult to estimate simply because trade barriers in this sector are non-quantitative. But some tentative estimates suggest the gains could be extremely high, and could ultimately bring the largest gains for developing countries.
- Most studies suggest that developing countries have at least as much, if not more, to gain from liberalisation of industrial tariffs as agriculture.
- Some of the most important gains come not from gaining increased access to export markets, but from liberalising one's own trade barriers.
- The Round should not be seen just in terms of North- South conflicts. In the case of industrial products, for example, high developing country trade barriers hurt other developing countries. Average MFN tariffs in manufactures are three times higher for trade among developing countries than for exports to high-income countries.
- By and large trade liberalisation is not a zero sum gain. Gains for one country are not generally at the expense of others. One exception arises where liberalisation has a major effect on world prices of particular products. (So-called terms of trade effects). In this case, it is possible that net exporters of products whose price rises benefit at the expense of net importers, and vice versa.
- The gains could be much larger in the longer term than the short to medium term. Adjustment is crucial in determining the extent to which countries take advantage of potential gains and avoid costs. The quicker they adapt, the larger will be the gains.

- To the extent that liberalisation increases the rate of investment in an economy or otherwise boosts productivity e.g. through technology spillovers, the long-term gains are much larger.

**Table 5.3: Estimated Income Gains from a New Round – \$bn**

Study	Scope		Agri- culture	Industrial Goods	Services	Other	Total
<b>European Commission (1)</b> (Nagarajan)	50% cut in protection in agriculture	EU	17	43	15	13	92
	Manufacturing tariffs & services	Developed	20	108	47	67	246
	plus liberalisation of trade facilitation	Developing	6	82	15	23	139
		<b>World</b>	<b>27</b>	<b>190</b>	<b>62</b>	<b>91</b>	<b>385</b>
<b>Michigan University</b> (Brown et al)	33% cut in protection	EU	0	63	11	na	13
		Developed	2	160	329	na	491
		Developing	8	51	61	na	120
		<b>World</b>	<b>11</b>	<b>211</b>	<b>390</b>	<b>na</b>	<b>611</b>
<b>Australian Government</b>	50% cut in protection in agriculture	EU	13	7	73	na	93
	manufacturing tariffs & services	Developed	72	25	201	na	298
		Developing	17	42	50	na	109
		<b>World</b>	<b>89</b>	<b>66</b>	<b>251</b>	<b>na</b>	<b>406</b>
<b>Anderson, Francois et al</b>	Elimination of protection in agriculture & food, & manufacturing	EU	na	na	na	na	na
		Developed	122	25	na	na	146
		Developing	43	65	na	na	108
		<b>World</b>	<b>165</b>	<b>90</b>	<b>na</b>	<b>na</b>	<b>254</b>
<b>World Bank GEP 2002 (2)</b>	Elimination of protection in agriculture & food, & manufacturing (Without Productivity Effects)	EU	na	na	na	na	na
		Developed	106	67	na	na	173
		Developing	142	44	na	na	186
		<b>World</b>	<b>248</b>	<b>111</b>	<b>na</b>	<b>na</b>	<b>355</b>

(1) Totals do not add to sum of the components due to “interaction” effects i.e. benefits that arise from the liberalisation of multiple sectors.

(2) The World Bank also provided tentative estimates of services liberalisation for developing countries. These suggest that the gains far outweigh those from liberalisation of manufactures and agriculture.

## Protection and Developing Countries

**5.29** The section above noted how the estimates suggest significant gains to developing countries from a successful Round. Much of the available evidence suggests that it is the actions of developing countries themselves, in terms of both trade and domestic policy reforms, which will have the biggest impact on their ability to benefit from globalisation. However, there is also much to support the view that developed countries

trade regimes impose disproportionate costs on developing countries. On the whole, the post- Uruguay Round tariff structure penalises developing countries because their exports tend to be concentrated in products where market access is highly restricted.

**5.30** Average tariffs in developed countries are significantly lower than in developing countries. The effective average tariff imposed by OECD countries – i.e. taking account of preferential treatment of imports including those to developing countries, is thought to be less than 2%. However, this masks a significant bias against products of export interest to developing countries and the fact that a disproportionate share of total revenues is collected from low income countries. For example, exporters from Mongolia and Norway both paid the US about \$23m in tariffs in 2003. However, Norway exported 40 times as much as Mongolia<sup>217</sup>.

**5.31** The tariff schedules of the EU, US, Japan and Canada all display a high degree of escalation. The World Bank<sup>218</sup> estimates that Quad tariffs on raw materials is just over 5%, nearly 10% for intermediate goods and around 15% for final goods. Escalation is thought to provide a significant disincentive for developing countries to move up the value-added chain.

### ***Agriculture***

**5.32** Trade-distorting agricultural support policies in OECD countries have a major detrimental effect on developing countries. For example OECD protection rates for sugar are frequently above 200% and producers receive more than double the world market price. OECD support to sugar producers of \$6.4bn per year roughly equates to the total value of developing country exports. US subsidies to cotton growers totalled \$3.6bn in 2001/2 – three times US foreign aid to Africa. Around 18% of LDC exports comprise goods that are subsidised in at least one WTO member, compared with 3-4% for non LDC countries.

### ***Industrial Goods***

**5.33** Most developed country industrial tariffs are very low. However, the exceptions tend to be in relation to labour-intensive products of export interest to developing countries, most notably clothing. In the US, Japan and Canada clothing tariffs average 16-17%, while clothing also accounts for a large number of EU tariffs in excess of 10%.

**5.34** However it is also important to recognise that tariff protection by developing countries against other developing countries is a major impediment to prosperity. Work by Hertel and Martin<sup>219</sup> illustrate these points in relation to manufactures. Based on 1995 and MFN tariffs, they estimate that the average trade-weighted tariff imposed by developed countries was around 1.5%. However, the average MFN tariff imposed on

217 IMF 2004

218 World Bank 2003 (2)

219 Hertel and Martin 1999

imports from developing countries was around four times higher than against other developed economies (3.4% as opposed to 0.8%). This is entirely due to the fact the highest developed country tariffs tend to be levied against products that are predominantly exported by developing countries. However the same authors show that the trade-weighted developing country MFN tariffs against other developing countries is around 12.8% i.e. two and a half times as those imposed by developed economies.

**5.35** It might reasonably be argued that these figures are misleading as they fail to take account of tariff preferences offered by developed to developing countries in the form of schemes such as the Generalised System of Preferences (GSP). However, the impact of these concessions is more limited than sometime imagined. For example, under the GSP, preferences on “sensitive” imports such as clothing are often very limited. Moreover, the take-up of preferences is often discouraged by restrictive rules of origin. The numbers also fail to take account of the fact that part of intra-Developing country trade is based on preferential terms because of South-South regional trade agreements. Again however, it is thought that only around 20% of South-South trade is covered by RTAs.

### ***Contingent protection***

**5.36** Although affecting only a limited subset of trade, the use of Anti-Dumping, Anti Subsidy and Safeguard measures can have a profoundly restrictive effect on trade in some markets. The pattern of use of Anti Dumping measures suggests such measures also disproportionately affect developing country exports, but part of the problem is the imposition of measures by developing countries themselves. In 2002, the main targets of AD measures were China, the EU, Korea, the US and Taiwan. However, relative to total exports the main targets are nearly all developing countries. For example the US had only one definitive measure imposed on it for every Euro 14.9 billion of exports. India and China have measure imposed for every Euro 1.1bn and Euro 1.5bn of exports respectively.

### ***Liberalisation and trade preferences***

**5.37** There is general agreement that any successful Round will incorporate some form of special and differential treatment (SDT) for developing countries. The WTO agreement already has SDT provisions. Broadly, these take three forms:

- Exemptions – permanent or time-limited – from certain rules.
- Non-reciprocity i.e. liberalisation between developed and developing countries can be asymmetric.
- Preferential access to developed country markets.

**5.38** There is general agreement that a multilateral rules-based system is to the benefit of developing countries. It can be particularly beneficial to small, poorer developing countries that cannot afford discretionary policies themselves and have most to lose from the discretionary policies of richer countries. The main case for allowing temporary exemptions and derogations from WTO rules is where the agreements are resource-intensive to implement. One prime example of an agreement that may require significant expenditure to put in place is that on intellectual property rights (TRIPs). Here, developing countries were given more time to find the resources to implement the agreement – in terms of money and people. The mooted agreements on investment and competition would be other examples where it seems that many developing countries would require more time for implementation.

**5.39** There may also be a case for allowing developing countries more time to implement market access opening. This analysis has shown that trade liberalisation is most efficacious when it is part of a wider reform package. A “big bang” approach to liberalisation is not necessarily desirable when other reforms also need to be implemented. But this does not mean that it is desirable for countries to avoid making commitments to open markets.

**5.40** Non-reciprocity is a more contentious issue. The analysis of previous chapters has shown that, on balance, liberalisation fosters growth. The over-use of the concept of non-reciprocity is more likely to be harmful than beneficial to developing countries, both because it provides a convenient escape clause to avoid domestic reform, and because it removes an instrument that developing countries could use to generate better market access for their exports. Non-reciprocity is one reason why developed country tariff peaks are largely on goods produced in developing countries.

**5.41** Preferential access has been a major pillar of SDT and is probably the most controversial element. All developed countries offer preferential access arrangements. These can be quite complex. For instance, imports from developing countries may enter the EU under the EBA preferences for the least developed, the special preferences for ACP countries, under the provisions of certain FTA agreements, or under the standard or enhanced GSP. With the exception of the EBA arrangements for the LDCs, the eligibility criteria are not related to the state of economic development. Thus, a relatively well off Caribbean country will receive greater preferences under the ACP arrangements than a poorer country that was not a former European colony. Higher exports from preferences for one country can easily be at the expense of exports from a poorer one. Barbados gains from the EU sugar preferences at the expense of Brazil although its income per head is three times Brazilian levels.

**5.42** There has been some concern that multilateral liberalisation will reduce the value of preferences to developing countries. This is true: as MFN rates are reduced, the gap between those and preferential rates – the “margin of preference” – is likely to narrow. Some believe that this will have adverse effects on exports from developing countries in general.

**5.43** There are examples where preferences are quite important to the recipients. The EU sugar regime – which guarantees a favoured few access to the EU market at prices significantly above world prices – is a classic example.

**5.44** However, in general, the evidence suggests that preferences are of limited value to developing countries, and may even be harmful to their longer-term development. They are an inefficient mechanism to transfer income to developing countries. Uptake of preferences is generally quite low (reflecting in part the conditions normally attached to the schemes) and concentrated market structures may mean that a significant part of the benefit accrues not to the developing country producer but to the importer/trader. For instance, it has been estimated that transferring \$1 to Caribbean banana producers cost EU consumers over \$13<sup>220</sup>.

**5.45** Preferences can also fossilise production patterns, preventing diversification into products where the developing country is more competitive. One example is the Jamaican sugar industry, which, despite the substantial value of EU preferences, remained heavily dependent on government subsidies.

**5.46** Economic studies suggest that the overall effect of preference erosion is likely to be small. It has been estimated that a 25% cut in average tariffs would result in only a 0.2% decline in exports from LDCs, who receive the largest margins of preference<sup>221</sup>. Similar estimates of a very limited effect of preference erosion on the exports of LDCs are found in other studies<sup>222</sup>.

**5.47** In conclusion, preference erosion is in general likely to have a limited effect on overall exports from developing countries. It is not a meaningful argument against liberalisation. Some countries could however, lose from the elimination of certain preferences. But preferences are a very imperfect mechanism for transferring resources to them anyway. Better alternatives exist.

## **What might be gained from Service Liberalisation?**<sup>223</sup>

### ***Background***

**5.48** The share of services in GDP tends to rise with income, but even for the poorest countries it is now significant. In 1998 services accounted for 38% of GDP in low-income economies, 56% in middle-income and 65% in high income. The services/GDP ratio for low and middle-income economies has risen by 9 percentage points since 1980. Services are therefore the fastest growing sector in developing economies, as they are in developed ones.

220 Borrell 1996

221 Ianchovichina et al 2001

222 See Hoekman et al 2002 and Subramanian 2003

223 See also, DTI White Paper on Trade and Investment 2004 p.82-83

**5.49** Trade in services has grown faster than merchandise trade and by 1999 accounted for 20% of cross-border trade. (This figure understates the true size of trade in services, much of which takes place through establishing local presence in the “export” market, and is not recorded in balance-of-payments statistics). Services also account for over 50% of recent FDI flows. Developing countries have participated in this trade growth – some with considerable success. Nine out of the 25 leading importers and exporters of commercial services are developing countries. Developing country exports of commercial services grew by 12% a year from 1991 to 1995, twice the rate of growth in developed countries. Asia has recorded the highest growth rates.

**5.50** Although barriers to trade in services are indirect and difficult to measure, it seems clear that developing countries as a whole have more protected markets than developed nations. Developing countries generally have tended to make liberalisation commitments in fewer sectors than the developed. Developed countries have made commitments of some kind for 53% of all services, compared with 15% for developing countries. But there is considerable variation within the developing countries group. For example, of the Sub-Saharan African WTO members, 26 committed on 20 sectors or less, 9 on between 21 and 80 sectors, and 3 on more than 80 sectors.

### ***The gains from liberalisation***

**5.51** The basic arguments for the liberalisation of trade in services are the same as those for the liberalisation of trade in goods e.g. more competition, lower prices and wider choice, faster innovation, higher employment, and greater FDI and technology transfer.

**5.52** In some services the scope for benefits appears much greater than in traditional goods sectors. Telecommunications is a good example. Liberalisation has been followed by marked price falls, wider internet use, and thus increased access to world markets. In many services the need for local proximity means that market access can be met only by FDI, bringing with it the possibility of spillovers of new skills and technologies into the wider economy.

**5.53** Certain services, such as financial, telecommunications and transport services, are part of the basic infrastructure of any economy. Other producers will be hampered if they do not have access to an efficient and low cost supply of such services. Education and health services are essential to develop human capital.

**5.54** The UK is one of the world’s foremost exporters of services, second only to the US. Services account for over 30% of total exports. But the potential of developing countries as service exporters should not be ignored. China, Korea, Malaysia, Thailand and Taiwan are among the top 25 exporters of such services. China, Egypt, India, Korea and Morocco are major exporters of construction services. India, Korea and the Philippines are prominent exporters in computer software and data processing. Indian software exports have been growing at a compound annual growth rate of about 50%. Many

developing countries would benefit from liberalisation under mode 4 relating to the movement of persons, which is already an important and growing source of income for many developing countries. Net labour-related inflows to developing countries (labour income, workers' remittances and migrant transfers) increased by 70% between 1989 and 1996.

**5.55** The empirical evidence for the benefits of liberalisation takes two forms. Firstly, there are the results from general equilibrium models. Secondly, there are case studies of the impacts of instances of liberalisation in a service sector, for both developed and developing countries.

**5.56** Although beset by a lack of data on the precise size of trade barriers, many estimates suggest that liberalisation in services could provide greater gains than liberalisation in goods or agriculture. This partly reflects the belief that, in general, barriers to trade in services are very high. Studies by the Australian Ministry of Foreign Affairs<sup>224</sup> and Michigan University<sup>225</sup> for example suggest the gains from services liberalisation could be 100% and 50% larger respectively than the gains from goods liberalisation. The World Bank has estimated that services liberalisation could produce much larger gains than goods and agriculture<sup>226</sup>. One estimate is that significant liberalisation of global service markets could boost world GDP by 6%<sup>227</sup>.

**5.57** A WTO study<sup>228</sup> has identified over 160 relevant studies of services liberalisation, covering mainly developed but also some developing countries. These are largely concerned with autonomous deregulation by a particular country. The majority relate financial deregulation, but also covered are telecommunications, air and road transport. These studies suggest economic gains from liberalisation, but also point to significant adjustment costs. As with liberalisation of goods, the benefits are likely to be greater the better is the macroeconomic environment and associated policies such as prudential regulation and competition policy.

### ***Criticisms of services liberalisation***

**5.58** While there is no concrete evidence that liberalisation is detrimental to an economy in the long run, some fallacious arguments have been made against it.

**5.59** *Services Liberalisation caused the Asian Financial Crisis.* This mistakenly confuses market access in financial services with issues of capital account liberalisation and prudential regulation. The core of the Asian crisis was imprudent behaviour by certain banks. But that is not a market access issue. Making GATS commitments in financial services need not be at the expense of prudential regulation (indeed they may wish to

<sup>224</sup> Australian Department of Trade and Foreign Affairs 1999

<sup>225</sup> Brown, Deardorff, Stern 2001

<sup>226</sup> World Bank 2002

<sup>227</sup> Hufbauer and Warren 1999

<sup>228</sup> WTO 1997

simultaneously strengthen it) and does not require relinquishing controls on short-term capital movements. It should also be noted that foreign financial service firms can play an important role in assisting the recovery of developing economies from financial crises. In Mexico, Argentina, South Korea and Thailand, foreign banks have recapitalised and restructured crisis-stricken domestic banks.

**5.60** *It causes the demise of the public sector.* Services supplied in the exercise of governmental authority are not subject to the GATS. Article 1 of the Agreement provides a complete exemption from coverage for all such services. Any disciplines that may be developed on the subsidisation of services would not apply to government services. This applies also when those services are provided in parallel with equivalent private services. The WTO have pointed out that this is a principle to which all Member Governments attach great importance and none have sought to challenge this interpretation. There is, of course, no obligation on any WTO member to allow foreign supply of any particular service, nor even to guarantee domestic competition if it wishes to maintain a public monopoly.

**5.61** *Lower service standards.* There is nothing in the GATS that would require governments in committed sectors to compromise existing quality standards and licensing conditions or to prevent them tightening them if they so wished. These are perfectly legitimate aims of domestic regulation and the right to regulate is specifically safeguarded in the GATS.

#### ***Examples of the benefits of services liberalisation***<sup>229</sup>

- In Latin America, countries that granted monopoly privileges of 6-10 years to privatised state enterprises in telecoms saw connections grow at 1.5 times the rate achieved under state monopolies. And in Chile, where the government retained the right to issue competing licenses at any time, connections grew 3 times faster.
- A study of 26 Asian and Latin American countries between 1990 and 1994 found that employment in the telecoms sector increased by 20% in markets with some degree of competition, compared with only 3% in markets dominated by monopolists.
- Economies with open competition in the telecoms sector have on average less than half the connection charges compared to those without competition. In China, competition from a second mobile phone company was followed by a 30% cut in the price of a call, and in Ghana new competition led to a 50% cut.
- Economies with open competition in telecoms have on average five times more internet hosts than those without.

- In India, the expansion of commercial banks into rural areas following banking liberalisation increased both investment and productive output. Investment in tractors rose by 13%, in pumpsets by 41% and in milking machines by 46%.
- Elimination of barriers to competition in port services in Chile led to reductions in operating costs by 50% over two years. This allowed SMEs to expand exports.
- In Mexico, labour productivity at the two major airlines increased by 50-100% following privatisation and the introduction of foreign equity.

## What might be gained from Agricultural Liberalisation?<sup>230</sup>

**5.62** There is a long history of agricultural protection in developed countries. Trade liberalisation in agriculture has been difficult to achieve and it was only in the last round of GATT negotiations that agricultural policy was finally incorporated into the WTO framework. Thus the degree of support for agriculture in many developed countries is far higher than for other sectors of their economies.

**5.63** A number of different justifications have been used for agricultural protection. The original objective of the EU's Common Agricultural Policy (CAP), set in an era when agriculture accounted for a higher share of employment and consumers' expenditure and amidst post-war concerns about food security were to increase agricultural productivity, ensure a fair standard of living, stabilise agricultural markets and to assure availability of supplies. As the economic and social background has changed, so have the objectives of agricultural policy. Today society's concerns relate to the environmental costs and benefits of agriculture, the competitiveness of agricultural producers and the sector's contribution to rural communities. In economic terms, it is argued that there are external benefits to the rest of society from having a vibrant and diversified rural economy.

**5.64** It is not only the EU that offers substantial support to the agricultural sector. The degree of support for agriculture in many developed countries is far higher than for other sectors of their economies. The OECD calculations of producer support estimates (PSE) show the ratio of the gross transfers from consumers and taxpayers in a country to gross farm receipts in that country. They thus allow comparisons of the degree of support to agriculture between countries. In Australia and New Zealand – major and efficient agricultural producers – the PSEs in 2003 were only around 4% and 2% respectively. In the USA, it was 18%, in the EU 37% and in Japan nearly 60%<sup>231</sup>.

**5.65** It is estimated that in 2002 EU taxpayers paid €42 billion and consumers €52 billion through higher prices, a combined total of €94 billion, under the CAP. Put another way, the CAP costs a family of 4 in the EU around euro 1,000 a year<sup>232</sup>. The total transfer is

<sup>230</sup> See also, DTI White Paper on Trade and Investment 2004 p.76-79

<sup>231</sup> OECD 2004

<sup>232</sup> DEFRA calculation

equivalent to around 1% of EU GDP. Because food takes up a larger share of the budget of poorer families, the burden imposed by higher prices falls disproportionately on them.

**5.66** However, the level of support offered to farmers is less significant for trade and development than the level of support that is linked to production. The main economic instrument originally used in pursuit of the EU's objectives was market price support underpinned by tariffs and export subsidies. Over time, the use of market price support generated a number of damaging consequences. Higher prices stimulated production, reduced consumption and so generated excess output. It reduced net imports and resulted in subsidised exports that reduced the welfare of other agricultural producers, including poorer producers in developing countries. In addition the incentive to increase the intensity of production has harmed the environment.

**5.67** The degree of support for agriculture means that trade is highly distorted. Efficient producers can be denied access to markets, and developed countries can produce surpluses in some products that then have to be given subsidies for disposal on world markets. There is no justification in the theory of comparative advantage for the EU to produce high-cost sugar beet – with production stretching as far North as Finland- and export it, while an efficient sugar producer such as Brazil has no access to EU markets. Nor is there any justification for cotton to be grown in the more arid regions of the USA, at the expense of production in West Africa. The principle of comparative advantage is indeed completely over-turned.

**5.68** The support given to agriculture in developed countries frequently acts to the disadvantage of developing country producers. Subsidised exports can de-stabilise their domestic production and many agricultural producers producing for home consumption are poor. But it can also drive them from potential export markets. For instance, India has developed one of the world's largest industries for milk processing, but has experienced great difficulties in exporting to the Middle East in competition with subsidised EU exports of milk products. The developing countries lose out in these circumstances. The World Bank estimates that developed country agricultural policies could cost them up to \$75bn a year i.e. around 1.5% of their GDP<sup>233</sup>.

**5.69** This support is not costless for other sectors of the EU economy. Higher prices divert resources into agriculture from sectors where they could be used more efficiently, thus reducing productivity and economic growth. The result is that EU GDP is lower than it would otherwise be. The distortions caused by the CAP are estimated to have reduced EU GDP by between 0.2 to 0.4%<sup>234</sup>. The cost to the UK is likely to be above the EU average as a net food importer and budget contributor.

233 World Bank, Global Economic Prospects, 2003

234 DEFRA calculation

**5.70** In addition to the trade distortion and internal costs of production-linked subsidies, they are a very inefficient means of transferring support to producers. The transfers are partly dissipated in higher costs and leak out of agriculture, in particular to upstream input supply industries. Subsidies tend to encourage higher rents and other input costs, such as feed and fertiliser – so a substantial proportion does not remain with the farmer. Moreover, production-related subsidies encourage extensive use of fertilisers and pesticides – often with environmentally damaging effects. It is a fundamental economic principle that any transfers deemed necessary should be properly targeted towards their objectives, using appropriate instruments that minimise distortions.

**5.71** Over the past decade the EU has made substantial reductions in the levels of domestic support through institutional prices by converting these into direct payments. The recent reforms of the CAP have made substantial progress towards reducing the production distortion effects by decoupling these direct payments. The intention is to make producers focus on the market and ensure that they do not produce merely to receive subsidy. In the Uruguay Round, agricultural tariffs were reduced by 36%, and since 1992, EU export refunds have been reduced by two thirds. The EU has recently offered to eliminate export subsidies altogether.

**5.72** Nevertheless, substantial price supports remain in the EU for sugar and dairy products and there remain substantial barriers to agricultural imports. Significant reductions in these would generate benefits for domestic consumers and developing country producers and would stimulate a more efficient allocation of domestic resources.

## **What might be gained from Liberalisation in the Non-Agricultural Sector?**

**5.73** Although the WTO, and before it the GATT, has had considerable success in reducing non-agricultural protection since the war, there remain a number of important tariff and non-tariff barriers to trade in this sector.

### ***Tariffs***

**5.74** The main features of non-agricultural tariffs of the main developed and developing countries is shown in Table 5.4. Important features include:

- Average tariffs of the major developed countries tariffs are low, but tariff peaks (tariffs in excess of 15%) remain in a number of important areas, notably fish, textiles and clothing. Developed countries also impose a large number of very low “nuisance” tariffs (tariffs which have little protective effect and raise little revenue).

- Developing country tariffs are generally much higher than those of developed economies, and there are a large number of tariff peaks.
- Developing country schedules also display so-called “binding overhang” whereby tariffs are bound at higher levels than the levels at which they are applied in practice.
- Most developed countries have bound all tariffs, whereas for some developing countries, a significant number of tariffs remain unbound.
- Both developed and developing country tariff schedules display a degree of “escalation” (tariffs increase with the degree of processing).

### ***Non tariff barriers***

**5.75** NTBs are also to be subject to negotiation, though as yet very little detail has emerged. NTBs are discussed further in Chapter 7.

### ***The effects of a NAMA agreement and barriers to progress***<sup>235</sup>

**5.76** Various assessments published in recent years suggest that an agreement to eliminate or substantially reduce industrial tariffs could have major economic benefits for developed and developing economies alike. Some of these studies are summarised above in Table 5.3. Such studies do not generally take account of the benefits of liberalising non-tariff barriers, so almost certainly understate the true gains from an agreement.

**5.77** Most studies suggest that the EU would make significant gains, and although the impact on the UK is not separately identified, there is every reason to believe that we would gain in line with the EU average.

**5.78** Some studies suggest the most important gains to developing countries will come from cutting their own tariffs, which generates gains to consumers, boosts productivity and opens-up unexploited opportunities for South-South trade previously stifled by high developing country tariffs. For example, a World Bank study suggests that, to the extent that trade liberalisation has a significant impact on productivity performance in liberalising economies, around 80% of the total income gains to developing countries could come from opening-up their own markets<sup>236</sup>.

**5.79** However, the impact on individual developing countries is the matter of some disagreement and uncertainty. An example of this, is a debate over the extent to which liberalisation depresses international prices of certain key manufactures and hence adversely affects the terms of trade of some of the major developing country suppliers

<sup>235</sup> See also, DTI White Paper on Trade and Investment 2004 p.82

<sup>236</sup> World Bank 2002

such as China and India, as well perhaps as other developing country producers. Other issues affecting developing countries are generally not taken into account in such studies, including preference erosion and adjustment costs.

### ***Barriers to progress***

**5.80** As in other areas, the prospect of economic gains does not guarantee that countries will willingly enter into negotiations. This is partly because defensive producer interests tend to carry more political weight than consumer interests. And, more generally, because trade negotiators tend to view cutting their own tariffs as a “concession” and only others’ cuts as a gain. Such an approach ignores the potential benefits of liberating one’s own market and poses a real threat to progress. Moreover, such an approach poses a number of particular difficulties for the negotiations given the current structure of tariffs across the world.

- The fact that average developing country tariffs are currently much higher than developed country tariffs (See Table 5.4 below) means developed countries have much less to “offer” in the negotiation, making a balanced, yet liberalising settlement difficult to achieve.
- A significant share of developing country exports to developed countries already pay less than the full MFN rate as part of preferential trade agreements such as the GSP. This further reduces what developed countries have to “offer” in the negotiations. And to make any real difference, they would have to all but eliminate industrial tariffs.
- Even if developed countries offered to reduce or eliminate industrial tariffs, not all developing countries would necessarily welcome this as the preferences they currently enjoy would be eroded or even eliminated.
- Many developing country schedules display “binding overhang”. For example, Brazil’s average bound tariff is around 30%, while its average applied rate is around 15%. Therefore, even if Brazil cut its bound tariff by 50%, it would make very little difference to the tariff Brazil actually charges. If, as seems likely, negotiations will be based on bound rates, very large cuts will have to be made to developing country tariffs in order to open their markets in real terms.
- Although developing countries have much more to offer, they are likely to be reluctant to offer much if anything because the Doha Declaration calls for less than full reciprocity. However the Doha round is also supposed to deliver real economic benefits for developing countries. To achieve these, most studies suggest that significant cuts will have to be made to developing country’s own tariffs.

**Table 5.4: Non-Agricultural Tariffs**

	Base Bound Tariffs <sup>(1)</sup>			Base Applied Tariffs	
	Average %	Number of Lines >15% (Peaks)	Highest Tariff %	Average %	Year
EU	4.0	135	26	4.3	2001
US	3.3	230	48	3.6	2001
Japan	2.9	87	30	2.7	2001
India (2)	33.4	2742	150	35	1997
China	8.9	787	50	16.3	1997
Brazil	29.9	9593	85	14.9	2001
Australia	11.3	799	55	4.6	2001
Korea	9.5	906	80	7.5	2001
Malaysia	16.9	3317	40	8.1	2001

Source: WTO Consolidated Tariff Schedules Database/Integrated Database

(1) Bound Ad valorem tariffs only

(2) Provisional data for 2002 from the IDB suggest that India's average applied rate had fallen to around 27.6%

### ***Negotiations so far***

**5.81** Although little progress has been made to date, negotiations so far suggest that it may be possible to base an agreement on some form of tariff reduction formula, an agreement to eliminate tariffs altogether in particular sectors of export interest to developing countries, increase the level of tariff bindings and some form of agreement to tackle non tariff barriers. Such an approach would be capable of delivering significant benefits, but the scale of benefits depends crucially on the details.

**5.82** However, it also seems likely that LDCs will be exempt from any obligation to cut tariffs. It is not clear that this will help integrate such economies into the world trading system. At the same time LDCs might also be feel they are losing as a result of preference erosion in the industrial sector.

## **Investment and Competition Issues**

### ***Investment agreement***

**5.83** The arguments for and against having an investment agreement are finely balanced. There are two basic arguments in favour of an investment agreement. First, investment is good for growth and poor countries tend to get little FDI. For instance, sub-Saharan Africa receives less than 2% of the world's FDI inflows. Second, Governments can help to attract investors with better (e.g. more transparent) legal

and institutional frameworks, and the WTO is the appropriate forum for establishing the broad rules for such frameworks.

**5.84** While generally not denying the benefits of FDI, critics of an investment agreement argue that it will not lead to a significant rise in FDI to developing countries; it will deprive them of “policy flexibility” with respect to FDI; and it will not be a balanced agreement, because it will impose disciplines and obligations on host governments, without parallel responsibilities on investors or their home governments.

**5.85** The available evidence suggests that creating a good investment climate stimulates investment. However, there is a lack of evidence that an agreement of the type likely to emerge from negotiations would lead to a significant increase in the overall level of FDI going to developing countries or boost the share going to poorer ones. But, at the same time, there is no evidence that an agreement could actually be detrimental to developing countries.

### ***What steps are being taken to liberalise FDI?***

**5.86** Most countries are now liberal towards FDI in manufacturing (and competing to attract it), but much less liberal towards services. It is estimated that about 80-85% of remaining restrictions apply to services, specifically telecommunications, energy, financial and transport services. Further steps are being taken to stimulate flows of FDI, which is illustrated by the increase in unilateral, bilateral, regional and multilateral initiatives relating to investment.

**5.87** Between 1991 and 2001, nearly 1400 changes were made to national FDI regulation in various countries, nearly 95% of these changes made conditions more favourable for FDI<sup>237</sup>. And by the end of 2001, 2100 Bilateral Investment Treaties (BITS) had been agreed worldwide, more than five times the number that had been agreed at the start of the 1990s<sup>238</sup>. The proportion of agreements negotiated between developing countries also grew significantly from a little over 16% at the start of the 1990s to 42% in 2001. At the regional level, investment provisions are included in ASEAN, Mercosur, the EC and NAFTA. Finally, the GATS applies to FDI, when it is used to develop a direct commercial presence in a country with the intention of supplying a service. Furthermore, the Agreement on Trade and Investment Measures (TRIMs), prohibits a number of operational measures on investment that, to some extent, undermine the effects of trade liberalisation under the General Agreement on Tariffs and Trade (GATT).

### ***What are the aims of a multilateral agreement?***

**5.88** *Stimulating FDI.* An agreement may serve as a mechanism through which governments make irrevocable commitments and “lock-in” policy reversals, thereby

<sup>237</sup> World Bank 2003 (2)  
<sup>238</sup> UNCTAD 1998

changing the expectations of investors. The increased transparency and predictability, which an agreement would seek to promote, would be an incentive for investors.

**5.89 *Efficient Allocation of Resources.*** BITs by their nature discriminate between foreign investors in a way that is inefficient. They may also lead to a more powerful partner imposing less advantageous terms on a weaker partner, when compared to a multilateral agreement. There is, however, a lack of evidence on the significance of these points.

**5.90** In the 1970s governments encouraged FDI under “import substitution” policies, through discriminatory taxation, subsidies or the promise of barriers to imports, into industries producing goods that would otherwise be imported. This led to FDI flowing into inefficient industries: one study in the 1970s showed that out of 50 investment projects in large developing countries 40% were uncompetitive. One benefit of an investment agreement would be to dismantle these counterproductive policies.

**5.91 *Minimising costs of facilitation.*** A multilateral agreement could free countries from negotiating bilateral agreements, and subsequently reduce costs of negotiation.

### ***Is there any evidence of the presence or scale of these benefits in practice?***

**5.92** The benefits of an investment agreement are difficult to either prove or quantify, not least because an investment agreement is without precedent<sup>239</sup>. One approach is to look at the impact of agreements that approximate to investment agreements including BITs, regional investment agreements, and elements of the GATS and TRIMS.

**5.93** Around 50% of investment flows to developing countries in recent years have had the security offered by BITs. However, research by the World Bank fails to find any evidence that BITs have materially altered the level or distribution of investment flows<sup>240</sup>. This confirms the results of previous UNCTAD work. This suggests that any benefits from such agreements are small and masked by the effects of other determinants of investment, both positive and negative. For instance, in countries plagued by political instability (as in the case of many LDCs), potential investors may be sceptical of any supposed security offered by investment regulations. In others (like China) the attraction of a huge and growing market may make them indifferent as to the degree of security offered.

**5.94** Some detailed country studies find a positive link between an improved investment climate in the broader sense, including better regulations, and investor interest in that country<sup>241</sup>. However, equally, others suggest the prime reason for the marginalisation of LDCs in FDI flows is primarily due to deep-rooted problems like political instability and lack of infrastructure.

239 Graham 2000

240 World Bank 2003:129

241 Morisset 2000

**5.95** There is no empirical evidence to link any significant increase in FDI flows to developing countries with the conclusion of GATS agreement<sup>242</sup>.

### ***Criticisms of an investment agreement***

**5.96** Some criticisms made of an investment agreement are actually based on fears about the effects of FDI itself e.g. in terms of whether it leads to a race to the bottom in terms of labour or environmental standards. The general effects of FDI are discussed elsewhere in this paper.

**5.97** The central criticism of an agreement per se is that it would restrict the “policy flexibility” available to developing countries. In economic terms, it is very hard to argue that the freedom to discriminate between domestic and foreign investment has generally been in the interest of developing countries. “Policy flexibility” is not a well-defined term but there are two broad sorts of potential measures.

**5.98** First, those that seek to limit the degree of foreign investment in order to allow the growth of the domestic industry. The rationale here is similar to the “infant industry” argument used to justify trade protection. This is discussed in Chapter 3. A CAFOD paper<sup>243</sup> attempts to demonstrate that developed countries discriminated against FDI in the past and that this fostered their development. However, counter-examples to those provided in the CAFOD paper can be found in the Freedom to Trade paper<sup>244</sup>.

**5.99** Second, there are those that attempt to impose restrictions on the behaviour of inward investors that are not imposed on domestic firms e.g. local content restrictions, technology transfer requirements, restrictions on equity ownership and repatriation of income. These arise from the belief that the host country can extract further benefits from FDI through these policies. Although the evidence is sparse and somewhat dated, surveys of firms suggest that such measures have little effect on actual behaviour, and that restricting their use is unlikely to hinder development. The EU has argued for a flexible agreement on GATS lines that in principle would allow some degree of policy flexibility. Critics argue, however, that the flexibility allegedly offered by the GATS agreement has not happened in practice.

### ***Competition***

**5.100** As part of the Doha Development Round proposals for a WTO Competition Agreement included a framework to facilitate co-operation, a framework of core principles including transparency, non-discrimination and fairness, and a ban on “hard-core” cartels. The proposals reflect a belief that:

<sup>242</sup> UNCTAD 2000

<sup>243</sup> Chang and Green 2003

<sup>244</sup> Bartlett 2003

- a multilateral framework for competition is needed in view of the globalisation of business;
- the full benefits of trade liberalisation and development policies can be frustrated though private actions such as vertical restraints, which hinder market access, or cartels which raise the price of traded goods and services;
- such distortions can only be effectively tackled when WTO members are working to a framework of common rules and cooperation
- some anti-competitive practices have cross-border effects, e.g. international cartels. An agreement could improve cooperation between competition authorities in different countries.
- a common framework across countries would reduce unnecessary costs for business from the application of different competition laws to the same international transactions.

**5.101** An agreement that hastened the adoption of effective competition policies could undoubtedly foster economic efficiency, particularly in developing countries. However, it is virtually impossible to quantify any such gains. While some research is available on the impact of cartels, evidence of competition infringements hindering market access is much more difficult to find.

**5.102** A number of studies provide examples of developing country interests being harmed by cartel behaviour. Levenstein and Suslow<sup>245</sup> estimated that developing country imports from industries that had suffered from price-fixing were as much as \$81bn, or 6.7% of total imports and 1.2% of GDP. For the poorest countries the proportion was even higher. Another study<sup>246</sup> suggests that international cartels are more likely to target sales at countries that do not themselves have anti-cartel laws. Moreover the costs to developing countries from higher prices as a result of one cartel alone exceeded a quarter of the estimated costs of competition policy enforcement, had such a policy been in place. However, most studies cover the domestic as well as the international dimension to cartels.

### ***Challenges***

**5.103** Despite the prospects of gains from a successful and substantive competition agreement there are a number of difficulties to negotiating even a relatively basic framework agreement. And looking further ahead to the future, negotiating a more ambitious competition agreement would face a number of additional hurdles.

<sup>245</sup> Levenstein and Suslow 2001

<sup>246</sup> Clark and Evernett 2002

- Although they do not speak with one voice, developing countries have tended to view this issue with varying degrees of scepticism, if not opposition. Many either do not have an enforceable competition policy, or are fearful of the resource costs of implementing one. Others have a rather different view of the role of competition policy from most developed countries.
- Although there is some evidence on the adverse effects of international cartels, conflicts of national interest are likely to prove to be a barrier to tackling these. And the lack of hard evidence on private practices, such as vertical restraints, acting as a barrier to trade suggests that this could prove a controversial issue.
- There is huge scope for legitimate differences in interpretation of the principles of competition policy. For example, on how to treat vertical restraints and issues such as price versus non-price competition.
- Even if there were agreement on principles, fundamental, and again legitimate, disagreements on the practical application of those principles are inevitable. A number of competition decisions are very finely balanced, handicapped by information gaps, and open to legitimately different interpretations. In many cases much depends on factors such as the definition of the “relevant market” and of entry barriers. Similarly, views on issues such as predatory pricing differ markedly among those who are otherwise in agreement about the aims and conduct of competition policy. Often, the wisdom of a particular competition policy decision can only be judged with hindsight, often many years after it is made, if ever.
- Introducing a substantive competition regime into the WTO might require an effective dispute settlement process, but this could well overload the system and provide a permanent source of uncertainty for all WTO members.
- In principle some competition issues can already be addressed in the WTO e.g. the Kodak/Fuji case on nullification/impairment of legitimate expectations from Japanese tariff concessions. However, this case should perhaps provide a warning on the potential disagreements on interpretation of competition policy. Messerlin<sup>247</sup> for example, points out that the Japanese regulations at the heart of the dispute were put in place between 1964 and 1973, whereas the Japanese tariff concessions which the US claimed were being undermined were not made until 1979.
- As discussed later in Chapter 7 there is a strong economic case for replacing the use of Anti-Dumping with competition policy or at least incorporating competition principles into Anti-Dumping policy. However many WTO members are likely to strongly oppose any such move.

- Many WTO members are likely to insist on retaining a national interest over-ride in their competition policy. This could dilute some of the benefits of any agreement and will be a formidable barrier to overcome.

### ***Trade facilitation***

**5.104** As tariffs come down, assessing how other factors affect trade has increasing policy relevance. Many such factors are grouped under the heading of “trade facilitation”.

**5.105** There is no standard definition of this term in public policy debates. In the narrowest sense, it encompasses the logistics of moving goods through ports and more efficient ways of providing documentation. A broader definition includes the wider environment in which trade transactions take place, including the transparency and honesty of customs and other regulatory behaviour and the role of product standards.

**5.106** On theoretical grounds, moves to facilitate trade appear to offer win-win situations. There is, for instance, no good reason to think that there are benefits from cases where it takes twenty-four days to move goods through a port. Even if this is a form of covert protectionism, there will be considerable losses to the importing country, especially for its export industries that rely on imports. Such inefficiencies are simply a drag on competitiveness.

**5.107** The empirical literature on the benefits of trade facilitation measures is limited. But there has been recent work by the OECD<sup>248</sup> and the World Bank<sup>249</sup>. Both illustrate that the gains from trade facilitation could be considerable. The OECD calculates that a 1% reduction in trade transaction costs (itself a very conservative estimate of the potential savings) could boost world GDP by \$40 billion. Around two-thirds of the gains would accrue to developing countries. They estimate that this would raise GDP in developing countries by 0.5% – and by nearly 1% in Africa.

### ***Government procurement***

**5.108** The problem of competing demands in the face of limited resources is never more apparent than in the field of government procurement. Failure to obtain value for money means less spending on health, education and social services. Value for money must therefore be seen as a key element in the efficient provision of public services and should be in any development strategy. The case is further strengthened by developing country arguments that they cannot cut tariffs because of difficulties in raising revenues through other forms of taxation.

<sup>248</sup> OECD 2003

<sup>249</sup> Wilson, Mann and Otsuki 2004

**5.109** Procurement markets are also huge. One study<sup>250</sup> estimated that total procurement (consumption and investment expenditure) for all levels of government is around \$4733bn in OECD countries and \$816bn in non-OECD countries. This was equivalent to around 82% of world merchandise and commercial services exports in 1992. Of this, it is estimated that expenditure of \$1795bn (OECD countries) and \$287bn (non-OECD countries) is potentially contestable. For developing countries it has been estimated that that value of potentially contestable procurement is equivalent to around 5% of GDP.

**5.110** Despite their importance and scale, procurement markets are beset by a number of distortions ranging from opaque tendering, explicit preferences in favour of domestic suppliers, right through to outright corruption.

**5.111** As part of the Doha development round, WTO members are discussing whether to strengthen rules on transparency. While this stops short of tackling preferences in favour domestic suppliers<sup>251</sup>, opaque tendering and poor governance are important factors in discouraging bids from both domestic and foreign firms, leaving “insiders” in an artificially strong position to bid, and ultimately brings higher prices and lower quality. There is some evidence that improving transparency, in itself, can bring significant benefits<sup>252</sup>.

**5.112** The main barrier to progress appears to be the fear among some WTO members that an agreement on transparency will undermine their ability to offer preferential treatment to domestic suppliers. Such fears are without foundation. As has been pointed out in a recent report by the WTO<sup>253</sup> more transparency will increase the number of bids from both domestic and (where permitted or viable) foreign bidders. The impact on the number of successful foreign bidders is therefore ambiguous, but there should be gains for the domestic economy in terms of improved value for money.

250 OECD 2001

251 For a discussion of the economics of preferences in procurement, see Baldwin and Richardson 1972, Francois et al 1996; Evernett and Hoekman 1999 Choi 2003 and Srivastava 2000

252 See Evernett and Hoekman 2003 for some evidence on this question.

253 WTO 2003

# Chapter 6: Role of Government in Facilitating Trade and Investment

## ***Chapter outline***

- Markets and their limits: the case for intervention
- The promotion of exports and inward investment; the roles of ECGD and UKTI

Chapter 2 outlined the benefits of trade and investment. Government intervention in promoting trade and investment is widely practised throughout the globe. This chapter outlines the economic case behind government intervention in trade and investment policy and the ways in which the government plays a key role in this area. These range from maintaining a strong and stable macroeconomic environment to specific interventions that counter market failure such as information brokerage services for domestic firms seeking external markets to supply side reforms to improve economic efficiency. This chapter starts with the general case for intervention, then considers how this applies to trade and investment before assessing the evidence.

## **Markets and their Limits: The Case for Intervention<sup>254</sup>**

**6.1** Markets are generally the most efficient way to allocate resources. So liberalisation, to enable markets to function as efficiently as possible (see Chapter 2 for details), is often the key to improving economic performance. Markets can have their limits. When these are reached and market failures occur, there can then be a case for government intervention.

**6.2** Market failure refers to where the market has not and cannot of itself be expected to deliver an efficient outcome, and where the government may be able to intervene and redress this failure. In some cases, government intervention can help to strengthen this mechanism so that markets are able to operate efficiently. There are other cases where

<sup>254</sup> Note market failure is not the only justification for government intervention. Another rationale for government intervention can be to achieve distributional objectives. However, this paper only examines market failures.

markets have inherent imperfections and failures, which if not addressed, can have a negative impact.

**6.3** The existence of market failures is not sufficient to justify government intervention. There also needs to be clear evidence that government intervention will have a net benefit.

### ***Addressing market failures***

**6.4** Government action to address market failures can take a variety of forms. These include:

- a. Providing a stable macroeconomic environment within which all agents can gain and are able to make decisions with greater certainty and at a lower cost. As noted in 2.99, a key flanking policy to achieve strong growth is a stable macro economic framework;
- b. To make markets work through a series of carefully directed and designed microeconomic reforms. These are discussed in more detail in section 2.100. Supply side reforms are important to ensure economies have the flexibility to take full advantage of the opportunities generated by liberalisation and to minimise the adjustment costs<sup>255</sup>;
- c. To make markets work more effectively by enabling firms to improve their competitiveness when market failures present obstacles.

### ***Cost-effectiveness of government intervention***

**6.5** If a market failure has been identified it is necessary to assess whether government intervention, taking into account the costs, including opportunity costs and the economic distortions that such an intervention would have, is cost-effective, i.e. whether the benefits of the intervention exceed the costs<sup>256</sup>. Such calculations can be complex as they need to take account of factors that cannot be directly observed or measured such as the long-term costs if UK firms were forced out of a market and due to sufficiently high barriers to entry were unable to return.

<sup>255</sup> Further information can be found in Flexibility in the UK economy, March 2004 [http://www.hm-treasury.gov.uk/media/22EE0/flexibility\\_report\\_264.pdf](http://www.hm-treasury.gov.uk/media/22EE0/flexibility_report_264.pdf)

<sup>256</sup> The UK Government has successfully implemented appraisal techniques throughout the public sector, whereby new policies, programmes and projects are be subject to comprehensive but proportionate assessment, wherever it is practicable, so as best to promote the public interest, HM Treasury, *The Green Book – Appraisal and Evaluation in Central Government*, 2003

## Market Failures in Trade and Investment

### *Externalities*

**6.6** One type of market failure, which can apply to trade and particularly investment, occurs when actions by a firm or individual create benefits or costs that cannot be contained within the firm or individual. Such actions are said to produce spillovers or externalities. Spillovers can impact on the whole economy, either negatively or positively depending on whether a spillover is a benefit or cost. In the case of a benefit, it is not in the interest of the individual firm to encourage the spillover. At the aggregate level, this translates to the market not providing enough spillover generating actions.

### *Imperfect information*

**6.7** Closely related to the issue of externalities is that of imperfect information. Information has an economic value and is central to the effective operation of competitive markets. Information may have public good characteristics if others cannot be prevented from having access to it, and so is likely to be provided in sub-optimal amounts by the private sector. When information is imperfect or available asymmetrically, firms may make sub optimal decisions at the expense of the nation's productivity and growth.

### *Other Reasons for government intervention*

**6.8** The government is unique in having the incentive and the means to address these market failures. In addition it has some unique characteristics that may justify intervention in areas which are not strictly market failures, but which have similar characteristics.

**6.9** For example in some international markets a degree of home government endorsement may be necessary for firms' tenders to be considered fairly. In such instances, home government involvement may be required to facilitate access or to provide credibility to firms. This is particularly the case with large investment decisions, especially in sensitive sectors such as utilities where home government support may be expected by overseas governments or firms.

**6.10** The current world trade and investment system is imperfect, as outlined in previous chapters. If externalities did not exist, the preferred approach would be to liberalise the system through the measures covered in Chapter 5. Given that some externalities do exist and that liberalisation may not be achievable, we need to consider what the second best alternative might be to determine the optimal UK response.

**6.11** Several different long-term outcomes may be possible, depending upon what policies are adopted. For example if there are significant barriers to entry to a market such as a steep learning curve and some countries support their firms while the UK

does not, then competitive UK firms could find themselves permanently excluded from the market. If these other countries cannot be persuaded to change their policies then offsetting UK government intervention could lead to an alternative outcome in which UK companies were able to establish themselves, leading to higher UK growth. This approach needs to be treated with care. If applied too laxly it can encourage excessive intervention, so it is crucial when considering such interventions to be clear that:

- a. The first best approach of negotiating multilaterally to remove the distortions is not possible; and
- b. The intervention will yield a net benefit, taking into account all relevant costs (including the opportunity cost) and benefits.

### ***Global Trade and Investment promotion***

**6.12** Most countries have established export/trade and inward investment promotion organisations. The policy justifications, the levels of state funding and the precise services offered all vary from country to country, so overall evidence about the current situation is unclear. It is clearly desirable to eliminate any distortions that exist. The UK is currently investigating the provision of export support by other countries to inform its strategy to reduce trade-distorting support subsidies that may be inherent in some official Export Credit Agencies' pricing decisions (see Box 6.1).

## **Trade Development and Productivity**

### ***Types of market failures and potential exporters***<sup>257</sup>

**6.13** Exporting firms, through their exposure to foreign markets, may experience benefits arising from new and innovative work practices. All studies concur that exporters are generally more productive and tend to have higher wages than non-exporters, but research into the nature of causality has mixed results and the evidence base is still growing. Some studies conclude that the association is due to self-selection as more efficient firms can afford the costs and balance the risks of expanding into overseas markets. Although most studies fail to find evidence of exporting leading to a further increase in productivity, there are exceptions.

**6.14** Studies of the UK<sup>258</sup> that match exporting firms to comparable non-exporting firms with similar internal characteristics suggest that growth after export market entry was higher than for firms with comparable levels of productivity and other characteristics. Recent research<sup>259</sup> into the causal nature of this link showed that firms receive a boost to

<sup>257</sup> This paper doesn't consider firms' decision making processes ie what makes firms want to export or not and whether this decision-making is optimal.

<sup>258</sup> See for example Girma, Greenaway and Kneller 2002

<sup>259</sup> Greenaway & Kneller 2004

their productivity in the year after they start exporting. Growth is between 2% and 4% faster than in the period before entry. There is scope for further research into causality, for example to ascertain whether only productive firms enter export markets (self-selection) or whether firms experience a boost to productivity as a result of exporting and to further explore the significance of regional or agglomeration effects.

**6.15** Given the evidence, firms may not be well informed about the benefits, costs and risks of expanding into new markets overseas, and even those that are may still be unaware of the best ways to achieve this and of what information is available. Although firms may pay for information in order to reduce risks and uncertainties, governments can reduce search costs through economies of scale and are able to pool information on foreign markets to allow firms to be more productive than otherwise. Such intervention may be particularly relevant for SMEs who frequently lack the capacity to identify profitable foreign markets and the consequences of entry.

#### ***Box 6.1: Export Credits Guarantee Department***

The UK's Export Credits Guarantee Department (ECGD) provides export insurance and export credit guarantees covering medium to long-term capital goods exports to developing countries.

Analysis of the economic role of export credit agencies (ECAs) does not suggest a clear-cut role for government. Private sector firms provide short-term insurance. There is more uncertainty in providing longer-term cover. Large private sector firms should have the capacity to spread and absorb the risks involved, but may find it unattractive to enter the market whilst public backed ECAs have a break-even remit.

Analysis by NERA<sup>260</sup> suggested that whilst government backed ECAs may have some advantages, for example they may be in a stronger position to pursue claims in the event of a loss, these did not provide a clear-cut rationale for government intervention. Subsequent analysis by NERA<sup>261</sup> suggested that the costs of running ECGD might outweigh the benefits generated once account is taken of the need to remunerate the risk capital involved.

ECA pricing is a complex issue. Benchmark OECD rates exist. However, it is questionable whether these are sufficient to enable ECAs to make a risk related return on their capital. The UK will work closely with other Governments during its Presidencies of the G8 and EU in 2005 to mutually eliminate any subsidies that may be inherent in other ECAs' pricing policies.

<sup>260</sup> NERA 2000 <http://www.ecgd.gov.uk/nera.pdf>

<sup>261</sup> NERA 2003, <http://www.ecgd.gov.uk/neraiifinalreportjan2003.pdf>

## ***Addressing exporting market failures in the UK***

**6.16** Recognising the potential for action to resolve market failures and improve business productivity, the Government helps companies in the UK to develop their potential to trade internationally and overseas enterprises seeking to locate in this country through UK Trade & Investment (UKTI)<sup>262</sup>. This role was set out in the Wilson report<sup>263</sup> which led to the establishment of UKTI's predecessor British Trade International and its customer facing brands Trade Partners UK and Invest UK. In addressing export market failures, UKTI provides services to businesses of all sizes, with the nature of the support reflecting individual firm needs. SMEs and those firms less experienced in exporting are intended to be the principal beneficiaries of trade development activities and financial support. Larger and more experienced exporters will have greater internal capacity for trading internationally, and where this is so, there is no case for the government to assist financially. UKTI does however help larger, more experienced firms through its unique capacities to facilitate access to senior decision-makers and to endorse firms' initiatives.

## ***Assessing the effectiveness of UKTI services***

**6.17** UKTI differs from its foreign counterparts by focusing on UK (potential) exporters in order to raise productivity as opposed to targeting higher export volumes. Assessing the benefits associated with such interventions is notoriously difficult, even if there is a theoretical case for action. Monitoring conducted by the University of Reading is developing a substantial dataset of customer firms' responses for further evaluation and research. Many firms reported that as a result of UKTI they learned new information that fed into behaviour, improved decision-making and increased productivity and profits, although major changes to working practice were rare. Private benefits to firms generally significantly exceeded costs, even after the potential for deadweight loss, displacement and substitution were taken into account.

## **Promoting Investment**

**6.18** Two types of market imperfection are relevant for overseas firms wanting to locate in the UK.

**6.19** First, overseas firms that locate in the UK can impart positive externalities or spillovers to domestic firms. These can be horizontal spillovers driven by the inward investor's proximity to firms in other sectors, or vertical spillovers to UK firms in the inward investor's production chain. The wide range of possible spillovers are explored in Chapter 2, and a key characteristic is that they apply to developed countries as well as to developing countries. Given that overseas firms do not directly benefit from these spillovers, it is likely that without UK government intervention there will be sub-optimal levels of inward investment.

<sup>262</sup> For a further discussion on UKTI and its role, see DTI White Paper on Trade and Investment 2004 p.47-58

<sup>263</sup> DTI/FCO, The review of export promotion: A report by the secretary of the Cabinet (1999)

### ***Importance of information***

**6.20** Secondly, there may be information deficits that prevent or deter overseas firms from locating in the UK. Investment decisions require specific and detailed information about the best sites, local contacts and regulations, which overseas firms may lack or find costly to acquire. This may also foster misconceptions about the structure, performance and success of businesses in the UK.

**6.21** Information has public good characteristics, and the level of foreign investment may be lower if there is insufficient, publicly available information. With the rapid advancement of information technology over the last century, there is unlikely to be under-provision of general information about the UK. But the detailed and objective information that potential inward investors require can be costly to acquire, even if it is available from private sector providers. The search costs incurred may mean that overseas firms will constrain their efforts to a small selection of possible investment locations. Many countries compete to attract inward investors by providing overseas firms with a range of information, assistance and support services. If the UK Government did not provide similar services, the UK could find itself disadvantaged.

**6.22** The spillover effects and information deficits provide a rationale for intervention by the government to improve the functioning of the economy, subject, as always, to weighing the benefits against the costs. There may also be a co-ordination role for central government to present a common image and to prevent duplication of effort by regions.

**6.23** The optimal government response will depend on the nature of the externalities, the significance of the information deficits and the ability of government to address these in a cost effective manner. The extent of externalities is examined in detail in the next section. As the prospect of positive spillovers appears to vary depending on the characteristics of the inward investors and the host sector, there is a strong case for seeking investors in areas where externalities are most probable. As for the information deficit, much depends on the relative importance of the costs and inconvenience of gathering information in investors' decisions, which is difficult to establish objectively. Search costs may be important, but they are only one influence alongside others such as the availability of skilled staff, language, regulation, transport links, proximity to markets and tax.

**6.24** When significant externalities exist there is a case for government intervention provided the benefits outweigh the costs. In the absence of externalities the case would be less clear-cut. When other countries proactively encourage inward investors, it may be optimal for the UK to do likewise. An alternative would be to negotiate a general reduction in promotional activities.

### ***Evidence: The benefits of inward investment***<sup>264</sup>

**6.25** There have been many studies of the impact of inward investment, but the empirical evidence is mixed, because inward investment is carried out for a variety of reasons and in varying ways.

**6.26** Studies show that foreign owned firms are typically more productive and pay higher wages than their UK counterparts. The presence of foreign direct investment can therefore raise average UK economic performance, although estimation of its net impact needs to consider the displacement and substitution that it can cause in addition to the cost of attracting it.

**6.27** The varied results of the empirical studies are shown by a relatively recent review of the literature<sup>265</sup>. Taking the whole world, studies are roughly split between those that find a positive impact on productivity and wages from inward investors and those that find no significant impact. In those studies that find a positive impact this generally falls once the studies control for other sources of differences eg firm size, sector, capital intensity, etc. Over half the studies of developing and developed countries report significantly positive productivity spillovers, but the studies of transitional economies found few signs of positive benefits.

**6.28** This spread of results arises because inward investment is carried out for a variety of motives and in varying ways. Relevant factors include the motives for investment (which can range from market access, exploiting a firm specific advantage, maximising supply chain efficiency to acquiring technology skills from a local cluster<sup>266</sup>), the extent of the technology gap between local firms and inward investors, local firms' absorptive capacity, sector characteristics and the origin of investment. Domestic firms and sectors may be exposed to greater competition, even when the net impact of the spillovers is likely to be positive.

### ***Factors determining the impact of FDI***

**6.29** Inward investment can have both intra and inter industry effects. The evidence for the UK is mixed; Pain and Hubert<sup>267</sup> suggest there are both intra and inter industry technical spillovers whilst Harris and Robinson<sup>268</sup> suggest possible production change spillovers (which can be either positive or negative) but no regional impact. This range of results is not surprising. Whilst some inward investors will intentionally be seeking to improve the efficiency of their production chain, others will not want to or may even be coming to the UK to learn themselves. Even when an inward investor brings superior technology/knowledge, UK firms may have not have the capacity to absorb its lessons if

<sup>264</sup> See also, DTI White Paper on Trade and Investment 2004 p.43-46

<sup>265</sup> Görg and Greenaway 2002 and 2001

<sup>266</sup> Driffield and Love 2001

<sup>267</sup> Hubert and Pain in N Pain (ed) 2001

<sup>268</sup> Harris and Robinson 2002

the gap between their and its capabilities is too great or if the UK domestic capability is already high<sup>269</sup>. Furthermore the impact on domestic firms of greater competition from the inward investors can have both positive and negative effects.

**6.30** Whilst externalities can potentially exist in all sectors, the evidence is stronger for manufacturing. Although there is less research on services, Oulton<sup>270</sup> finds a large productivity gap between foreign owned and domestic non-manufacturers. Although much of this gap can be largely be accounted for by differences in capital:labour ratios and employee skill levels. Hubert and Pain suggest there is technical diffusion for commercial services, but at a lower level than for manufacturing.

**6.31** An inward investor's country of origin may make a difference. Several studies<sup>271</sup> have found that US Multi-National Enterprises (MNE) typically emerge with significantly higher productivity than other MNEs (although the advantage may have declined over time). These differences persist even after factors such as firm size and sector are controlled for. There could be a variety of reasons for this including: US MNEs having greater firm specific advantages – superior technology, management, brands, etc; US firms may have acquired higher productivity than UK businesses; they may structure their overseas subsidiaries in a different fashion, for example if they sub-contract more work they are likely to have higher labour productivity; or there may even be some sort of global scale effects if they benefit from being part of larger MNEs.

**6.32** Indeed it is debatable whether foreign ownership is the key to the performance gap that is observed between inward investors and UK firms. Some recent work<sup>272</sup> suggests the main difference may be between multinationals and non-multinational domestic firms, rather than inward investors and domestic firms. This would be consistent with the theory that firms only become MNEs when they have a significant, protectable advantage that compensates for the costs of overseas investment. The implications are that observed performance differences owe more to firm or plant specific factors than to country of ownership.

**6.33** Fair performance comparisons between inward investors and domestic firms needs to consider the structure of the inward investors and distinguish between scale effects and technology driven productivity differences<sup>273</sup>. If inward investors operate on a greater scale in sectors where economies of scale exist, then they would be expected to perform better than domestic firms. They would also be more productive the more subcontracting they engage in compared with domestic firms. Further research is needed into these detailed but significant factors.

269 Girma 2002 also Girma, Greenaway and Wakelin 2000

270 Oulton 2001

271 For example, Oulton 2001, Griffith 1999, Martin and Crisculo 2003

272 Martin and Crisculo 2003

273 Girma 2002

### ***Addressing inward investment market failures in the UK***

**6.34** The UK was amongst the first countries to establish an organisation to encourage inward investment<sup>274</sup> and has since been imitated by many countries. UKTI currently provides information and services to help overseas companies set up in the UK and then to develop their businesses. It increasingly targets its efforts on knowledge driven sectors, seeking to maximise the potential spillovers for the UK economy.

### ***Addressing outward investment market failures by the UK***

**6.35** Whilst the above has concentrated on inward investment into the UK, similar market failures may limit outward investment by UK firms. As analysed in chapter 2, outward investment is likely to be beneficial for the investing companies. Hosting stronger companies will benefit the UK in the long run as the key to prosperity is hosting competitive, innovative companies, regardless of their nationality. There can also be spillover benefits for the countries receiving UK outward investment, although as shown above for the UK the extent of these will depend on a variety of factors. There is however, only limited research in this area and it would benefit from further work.

**6.36** Government can therefore play an important role in facilitating outward FDI by, for example, helping international institutions such as the World Bank and EBRD foster a suitable regulatory framework. This and other institution building issues suggest that investment and competition need to be considered in a wider context in the future – see Chapter 7. Governments have a unique role in being able to negotiate with each other to minimise barriers to overseas investment, notably institutional or regulatory obstacles. Similarly they are well placed to encourage the development of adequate property rights and stronger corporate governance, the lack of which can be one of the biggest deterrents to overseas investment.

**6.37** UKTI works with UK companies in their efforts to grow and remain competitive by investing overseas. It provides advice and assistance to companies seeking to invest overseas, although these are ultimately commercial decisions for the firm to take.

274 IBB (Invest in Britain Bureau) was set up in 1977. It is now part of UK Trade & Investment

# Chapter 7 Future Challenges

## ***Chapter outline***

- Liberalisation and standards
- Liberalisation and national security
- Trade defence measures

This chapter examines some live issues that will determine the conditions under which goods will be traded in the future. Developed countries in particular are seeking higher standards for goods available for sale on their markets. Such desires arise from the legitimate aspirations of their citizens, but they can lead to new barriers to trade. Increased threats to national security are also leading to tighter border controls, which again can make trade more difficult. In some countries, national security considerations remain a justification for protecting supplies of food or other products deemed essential. And there has been a rise in the use of anti-dumping measures. The challenge for governments is to ensure that the considerations that underlie these developments do not unduly restrict world trade.

## **Implementation Challenges**

### ***Standards***

**7.1** Trade liberalisation cannot address all non-tariff barriers (NTBs). Progress on breaking down government imposed non-tariff barriers has been slower than progress on tariff barriers. There is an increasing focus on tackling NTBs, both through multilateral<sup>275</sup> and bilateral<sup>276</sup> processes. But it would be unrealistic to expect all NTBs to be removed. Those that arise explicitly from protectionist objectives should be challenged. But other NTBs are the by-product of other policy objectives, for example where environmental or labour standards have not been harmonised. It will not always be possible to remove these NTBs through appeal to trade liberalisation arguments.

<sup>275</sup> For example the agreement on TRIMs.

<sup>276</sup> For example the focus on NTBs in the EU's Internal Market for Services Directive.

**7.2** There are particular tensions between the desires of, largely, developed countries to have higher standards and the ability of developing country exports to meet those standards. Developed countries are increasingly stipulating technical regulations for imports. Notifications to the WTO of new technical standard barriers have increased from around 10-20 a year in the early 1980s to over 400 in 1999. Not all standards are imposed by governments; some may be required by major importers, such as supermarkets, who perceive that their customers want certain levels of presentation and quality. These requirements can be very expensive to comply with and are a major barrier for developing country producers wishing to export. The burden may be particularly onerous for the poorest countries. It is estimated that 42% of exports from the LDCs face barriers such as phytosanitary standards<sup>277</sup>. The technical regulations can take a number of forms, such as labelling or environmental regulations, but it is food safety standards that have the biggest impact on developing countries. The misuse of environmental regulations can reduce their effectiveness. They should be based on objective impact assessments and be used to create effective mitigation strategies.

**7.3** Numerous developing countries rely heavily on agricultural exports, so how food safety is addressed in the world trade system is particularly critical. For example, implementation of the European Union's new aflatoxin standards will reduce African exports to Europe of nuts, cereals, and dried fruits, products highly sensitive to the aflatoxin standards. The EU standards would reduce health risks by only about 1.4 deaths per billion a year but would cut African exports by 64%, or \$670 million, compared with their level under international standards<sup>278</sup>. Moreover, a World Bank analysis<sup>279</sup> has estimated that adopting a worldwide standard for aflatoxin B1 could increase trade in nuts and grains by \$38 billion compared with levels under today's widely divergent national standards.

**7.4** It is recognised among the members of the WTO that non-tariff barriers can be an important impediment to trade, and members are seeking, as a first step, to agree a set of NTBs that will be subject to negotiations. No set has as yet been agreed, although some members have submitted suggestions. Broadly speaking, these suggestions fell into the following categories:

- *Standards and certification.* National standards differing from international standards; product, environment and labelling requirements; special sanitary and health related requirements.
- *Administrative procedures.* Extensive documentation requirements; onerous application and review procedures.
- *Customs fees, extra taxes and surcharges.* Port tax, inspection tax, etc.

<sup>277</sup> UNCTAD, *The Least Developed Countries, 2004 Report*

<sup>278</sup> Otsuki, Sewadeh, and Wilson 2001.

<sup>279</sup> Otsuki and Wilson 2001.

- *Quantitative restrictions (quotas) and import licensing*
- *Pre-shipment inspection*
- *Currency restrictions.* Exchange controls; currency license requirements.

### ***National security and increased trade costs***

**7.5** Nations or groups of countries such as the European Union control movement of certain kinds of goods and services in and out of their territory for a variety of reasons, widely defined as national interest. In recent years, principally since the September 11 2001 attack on the USA, a sub-set of these reasons covering “national security” has received more attention than at any time since the depths of the cold war. While it is legitimate for nations to protect their national security, new policies can inadvertently impose additional costs and impediments on legitimate trade that are very damaging to the welfare of both producers and consumers.

**7.6** The World Bank<sup>280</sup> estimate that each 1% increase in costs to trade from additional border security costs reduces world welfare by about \$75billion. Their study notes that there is an opportunity to ensure that investment in new security procedures contributes to quicker and simpler trade/customs transactions. This is an area where co-operation between countries is likely to lead to a far more efficient outcome than unconnected individual actions. As is discussed in Chapter 5, trade facilitation is extremely important area of trade reform.

**7.7** Costs are likely to be increased by

- Time delays. The impact of these varies from product to product but may average something like 1% of the cost of the goods delayed<sup>281</sup>.
- Multiple physical inspections of goods. This is costly and may cause physical damage as well as being slow, and providing opportunity for corrupt practices.
- Additional administrative processes. These can be particularly problematic when they are new or change with little warning.

**7.8** There is some anecdotal evidence that the impact may be most severe on exporters from developing countries (African container traffic to the USA) that have not been able to upgrade the security of their ports leading to slow and expensive checking on arrival in developed countries.

<sup>280</sup> World Bank 2003 (2)

<sup>281</sup> World Bank 2003 (2)

### ***Security of supply fears as a trade barrier***

**7.9** Security of supply is sometimes cited as an argument for protectionism, subsidy of domestic production or export restraint for essential goods such as food and energy. Some developing countries protect their agricultural sectors in particular because they wish, as far as possible, to build up agricultural production for such reasons. However, if trade is possible, domestic production is not always the most efficient way to meet domestic demand. The Common Agricultural Policy was set up to boost European food security after experience of food shortage due to warfare. Although this is no longer its purpose, the CAP has succeeded in its original aim – but, as explained in Chapter 5, with the imposition of substantial costs on both the European budget and European consumers and the unanticipated side effects on developing country markets from selling off European surpluses.

**7.10** The premise on which the policy was founded, that the physical security of supply of food from outside Europe was vulnerable was erroneous, and once the policy was in place, it has been extremely difficult to reform. For the last half-century there have been no physical impediments to Europe buying its food from more efficient producers, but the distortions of the CAP mean this happens far less than would otherwise be the case.

**7.11** Military equipment is particularly sensitive and there is an argument that military powers should retain domestic capacity to manufacture all inputs into military equipment in case foreign suppliers are withheld or blocked. Taken to extreme this would require a country to retain domestic capacity for almost every industrial and electronic input. The cost differential may be a strong incentive not to engage in this particular form of protectionism. Exportation of components that may have a military use has also been constrained in some cases. Where products have a single role this is a straightforward decision but a very wide range of products and technology can be defined as dual use.

**7.12** In some cases where national security is cited, the probability of the risk event feared is very low. An example of this is a recent decision in a western European country to block a corporate takeover of a pharmaceuticals firm by a European competitor on the grounds that foreign ownership could compromise supplies in an emergency.

In certain instances fears of damage to the economic national interest and for physical security both occur and it is sometimes difficult to separate and weight the individual components. The national economic interest is a more complex set of issues. This paper and the recent HMT-DTI joint paper<sup>282</sup> seek to show that the national economic interest is best served by an open approach to trade and investment within a framework that protects the rights of producers, consumers and workers.

## Trade Defence

**7.13** As trade liberalisation proceeds there is a fear that tariff barriers may be replaced by trade defence measures motivated by maintaining protection for domestic producers. WTO Agreements allow members to impose restrictions on imports from certain countries to combat the effects of unfair trade using Anti-Dumping (AD) and Anti-Subsidy (AS) measures. Members are also allowed to restrict surges of fairly traded imports under the WTO Agreement on Safeguards. Collectively these three instruments are known as Trade Defence Measures (TDMs).

**7.14** TDMs play an important role in international trade. Their importance stems from the number of cases, the value of trade affected, the level of duty typically imposed and the range of economic interests affected. Even the threat of using such measures is likely to have an impact, one which is harder to quantify.

### *Number of cases*

**7.15** The number of AD measures is significant and there are signs that their use is intensifying and spreading. Although there is a cyclical element to their use, there was a 90% increase in the number of AD proceedings initiated by WTO members between 1995 and 2002. It is no coincidence that this followed further reductions in tariffs and the banning of voluntary export restraints in the Uruguay Round. Moreover, whilst AD proceedings were once used almost exclusively by developed countries, there has recently been a particularly sharp increase in the use of AD by developing countries. And relative to their imports and exports, developing countries are now much heavier users and targets of AD than developed countries. The end of the Multi Fibre Arrangement (MFA) in December 2004 could see a further increase in Trade Defence activity by the EC and other developed countries.

**7.16** AS actions are much less frequent and generally involve lower duty rates than AD, and there is also less evidence of an upward trend over time. Safeguard cases are also much less frequent than AD cases, though there has been a marked increase in activity over time. Most recently, safeguard measures have dominated trade policy in the steel sector<sup>283</sup>.

### *Value of trade affected*

**7.17** There is relatively little hard information on the share of trade affected by TDMs. Indications from the EC suggest that a relatively small proportion of trade is covered by AD measures (usually less than 1% of EC imports). Similarly, for the US it has been estimated that around 1.8% of imports were subject to AD and AS measures combined

<sup>283</sup> For recent trends see Filippi and Stevenson 2004

(1991). Data for developing country members suggests that the proportion of trade covered by AD measures is probably significantly higher.

**7.18** However, the share of trade subject to measures may significantly understate the true impact of TDMs. Even the threat of opening a case or of imposing measures can have a major deterrent effect on trade. Defending against claims of dumping can be expensive: exporters have to devote time and resources to providing information, expert legal advice is often required, and uncertainty is created among traders. A study of EC cases launched 1985-90 found that even where an investigation was terminated, imports from the countries investigated declined by around 17%<sup>284</sup>.

### ***Levels of duty imposed***

**7.19** Trade barriers imposed as a result of TDMs tend to be very restrictive and in general are much higher than MFN tariff rates. They are therefore likely to have a real impact in the markets that they affect. A recent World Bank report suggests that the same is true for other WTO members<sup>285</sup>.

**Table 7.1 Anti-dumping duties are typically much higher than MFN tariffs**

	Average AD Rates (%)	Definitive duties	Average Applied MFN Tariffs (%)
	Low	High	
Industrial Countries	31	48	4
Developing Countries	58	83	13
All countries	43	64	5

Average of highest and lowest rates applied in anti-dumping cases (percent)  
Source: World Bank GEP 2004

### ***Why are TDMs controversial?***

**7.20** Trade Defence cases are not only important but, individually and collectively, tend to be highly controversial. AD and AS target particular countries and essentially accuse them or their exporters in engaging of “unfair” practices. Inevitably, this proves extremely unpopular. TDMs can have a profound impact on particular sectors of the economy and a wide range of market participants. In individual cases, TD inevitably produces a conflict between the interests of domestic producers on the one hand and domestic consumers/users and exporters on the other. In some cases these conflicting interests are sufficiently large to make front-page headlines, as was the case with the recent US steel safeguards. Developing countries in particular have traditionally viewed the use of AD by developed countries as hypocrisy. Even taking the case for TDMs as

284 Vandenbusssche et al 1999

285 World Bank 2004

given in principle, the application of AD policy in practice, and to a lesser extent AS and Safeguards, has a number of weaknesses. The WTO agreements allow national authorities to exercise huge discretion in the way in which they interpret the relevant WTO agreements, and create scope for uncertainty and abuse

**7.21** Defenders of TDMs, however, argue that they are essential to combat unfair trade and to allow weaker industries some breathing space to adjust to competition. Others claim that, whatever the rights and wrongs of TDM, they are a necessary safety valve for the system. Without them it would be much more difficult to persuade domestic industries to liberalise as part of multilateral trade negotiations.

### ***The Economics of TDMs***

**7.22** Part of the controversy surrounding TDMs stems from the almost unanimous criticism of AD policy by economists. This criticism is based on both theoretical analysis and a limited body of empirical work. This analysis suggests that what is defined, as dumping by the WTO Code is not necessarily unfair or undesirable in economic terms. Dumping – charging lower prices in export markets than prices in domestic markets, or than the full costs of production plus profit – can represent a wide range of pricing practices. Some are anti-competitive, but many are pro-competitive. Dumping can be a symptom of attempts by a firm or group of firms to dominate a market through a strategy of predatory pricing. However, it can also reflect genuine attempts by companies to break into new markets, to minimise costs, or to maximise profits in the face of high fixed costs of production and unutilised capacity. More generally, dumping is likely to be commonplace where demand conditions differ between national markets, where there are natural or man-made costs to international trade and where fixed costs are an important element in production or distribution.

**7.23** It follows that in most cases it will not be in the national economic interest to impose anti-dumping measures. Furthermore, many economists have argued that AD actions are themselves fundamentally anti-competitive as they may encourage monopolisation of domestic markets and cartelisation of international markets.

**7.24** The empirical literature on AD is relatively limited, but most suggests that AD actions are likely welfare reducing. A number of authors, including Messerlin and Bourgois<sup>286</sup>, have suggested that the most important distinction is between monopolising and non-monopolising dumping. Non-monopolising dumping is unlikely to reduce global economic welfare. However in an analysis of anti-Dumping actions by the EC Messerlin and Bourgois concluded that in around 98% of cases monopolisation through predatory pricing actions would not have been a feasible strategy for exporting firms, and even in the 2% of cases where this conclusion could not be reached,

predatory pricing remains only a possibility rather than a probability. Similar results have been found for the US<sup>287</sup>.

**7.25** A study by the United States International Trade Commission (USITC)<sup>288</sup> of AD and AS measures in eight sectors in 1991 found that gains to industries protected by such measures and their suppliers was outweighed by the losses to US consumers and industrial users of the protected products. The net effect was a welfare loss of around \$1.59bn to the US economy.

**7.26** Another Study by economists from the University of Nottingham<sup>289</sup> looked in detail at three case studies of EU AD/AS actions and in two cases derived approximate estimates of the impact of measures on UK welfare. In both cases they concluded that AD/AS measures are likely to have imposed welfare losses on the UK, and the value of these losses was equivalent to 33% and 17% respectively of the UK import bill for these products.

**7.27** A study by DeVault<sup>290</sup> looked at 30 US Dumping measures and concluded that the import relief provided by Anti-Dumping duties is small in comparison with the losses imposed on US consumers. Gallaway, Blonigen and Flynn<sup>291</sup> estimated the collective net cost of AD and AS measures in 1993 to have been in the region of \$4bn.

**7.28** Another group of studies has examined whether AD actions actually have the effect of restricting imports from targeted countries. These have shown mixed results. Prusa<sup>292</sup> for example, found strong evidence of trade diversion, raising doubts about the efficacy of AD measures in protecting domestic industry. By contrast a study of EU AD actions shows little evidence of trade diversion, suggesting EU AD actions are more effective in protecting EU industries than are US actions<sup>293</sup>.

**7.29** There is little hard evidence on whether AD actions help deter others from protecting their markets. However, the growth in the use of TDM by developing countries in recent years, suggests little success in deterring overseas protection. Indeed, the opposite may be true.

## ***Subsidies***

**7.30** Partly because they are less frequently used, AS measures have received much less attention in the literature. Like dumping, there can be welfare enhancing and welfare reducing subsidies from a global welfare perspective. Subsidies that fall into the former

287 Shin 1997

288 USITC 1995

289 Lloyd, Morrissey and Reed 1998

290 Devault 1996

291 Gallaway, Blonigen and Flynn 1999

292 Prusa 1997

293 Vandensussche et al 1999

category include those that genuinely and successfully address market failures, such as environmental effects or those that promote R&D.

**7.31** Even if a subsidy reduces global welfare, it does not necessarily follow that it is rational for a country to countervail them. Countries that import low-priced subsidised goods benefit from those subsidies in the same way as they would if the low prices of the imports derived from some natural as opposed to artificial cost advantage. As with Anti-Dumping, the circumstances under which it is economically rational to countervail subsidies are likely to be fairly limited and even here, a partial rather than a full countervailing duty may have greater benefit<sup>294</sup>.

### ***Safeguards***

**7.32** Standard economic analysis suggests Safeguard action, like any import restriction, is likely to reduce economic welfare of the country imposing them. In principle, they could prevent economic losses if they succeed in facilitating adjustment. However, the actual success of Safeguards in promoting adjustment has not received a great deal of attention in the literature.

Two points are worth noting, however. First, experience of other trade restrictions designed to buy domestic industries more time to adjust (e.g. the MFA) suggest that it is very difficult for protection to succeed in achieving this goal. Second, domestic industries seeking protection under Safeguards have often benefited from protection under AD or AS in the past, and may well revert to use of AD or AS protection after the Safeguard measures have expired.

### **Conclusion**

**7.33** Progress on the trade liberalisation agenda during previous WTO rounds has been significant. A successful DDA would represent a further and substantial step along the path towards multilateral liberalisation. However, as traditional barriers to trade are reduced, newer, often more subtle, barriers are emerging. This Chapter has examined the threat from three of the most important: standards, national security and trade defence measures. But there are others and new threats will almost certainly emerge in the future.

**7.34** The difficulty in each case is that the restriction on trade is partly a result of satisfying some legitimate aspiration of citizens, such as a desire for safe food, fair trade or fear of terrorism. But in each case trade is often restricted more than it need be and there is huge scope for protectionist abuse. The challenge for trade analysts and policy makers in the future is to disentangle the legitimate from the illegitimate elements and ensure policy minimises the scope for abuse and maximises the opportunities for trade.

<sup>294</sup> See Collie 1991 and Francois 1992

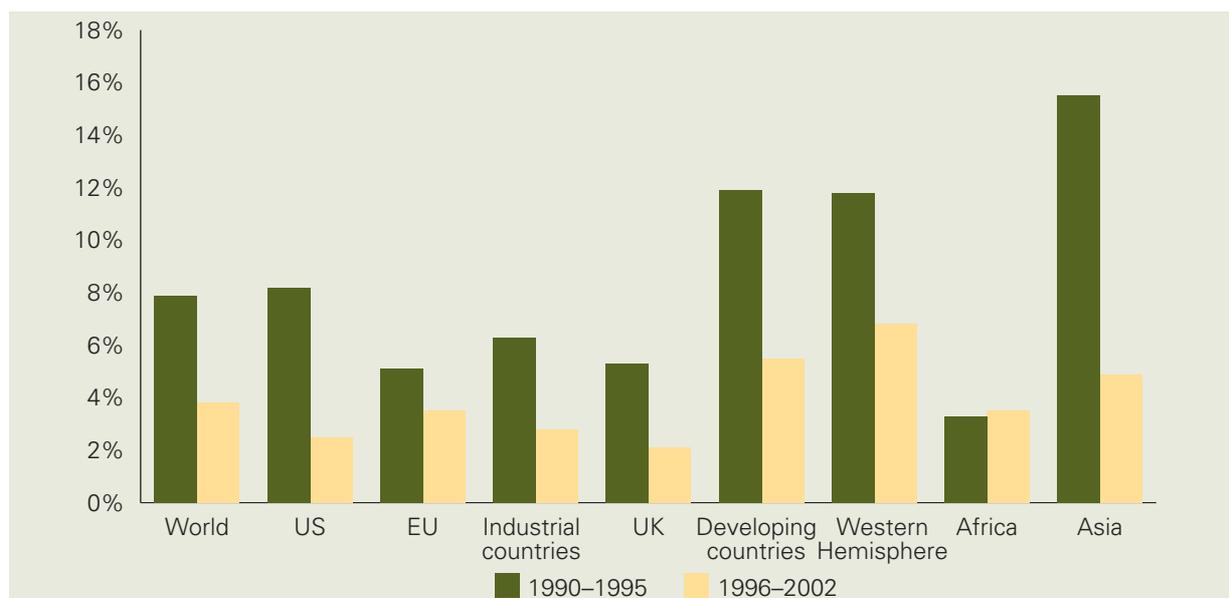
# Annex Recent Trends in World Trade and Investment

## Merchandise trade overview

The value of merchandise trade rebounded in 2002, growing by over 4 per cent on the year in spite of weak global recovery and the second consecutive year of declining US exports as its main overseas markets failed to pick up steam.

Taking a longer view, growth in world trade has slowed down in recent years, with export growth averaging around 3.8% a year since 1995 compared to around 8.0% from 1990 to 1995. These trends are detailed by region in chart 1. All regions have seen a slowing of average export growth, with the exception of Africa, which maintained a miserly growth rate of around 3.5%. The US and Asia experienced particularly dramatic slowdowns in average growth rates, largely the consequence of first the Asian crisis and then the more recent US turndown.

**Chart 1. Average annual growth rates of merchandise exports, 1990-1995 and 1996-2002**

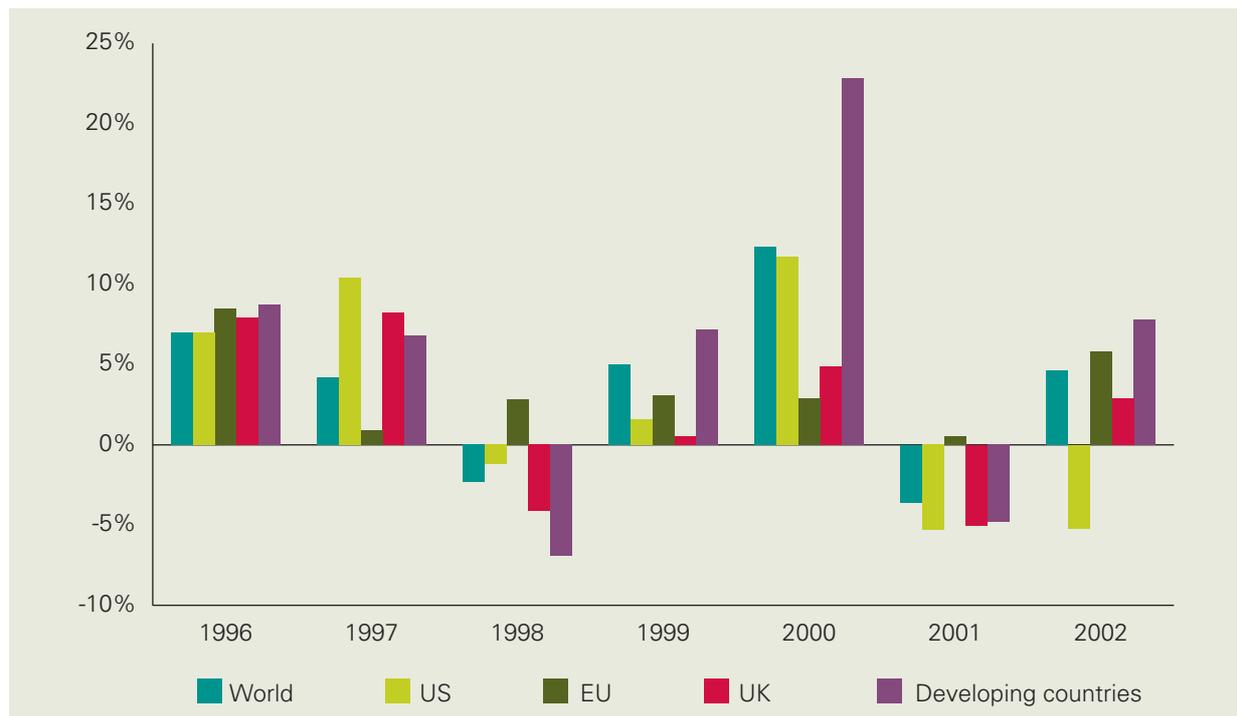


Source: IMF Direction of Trade 2003

Note: the regional groupings used in this analysis are based on those in IMF Direction of Trade. Roughly speaking, Industrial Countries (ICs) is a restricted group of OECD members; Developing Countries (DCs) are all non-ICs. Within the DC group, Western Hemisphere roughly equates to Central and Latin America.

The volatility of exports is illustrated in chart 2. The dramatic falls and even more dramatic rebounds of world trade along with the main drivers of the volatility, the US and the Developing Countries (DCs) (predominantly Asia) can clearly be seen. This is in contrast to the European Union (EU) whose exports appear far more orderly over the same period.

**Chart 2. Annual growth rates of merchandise exports 1996-2002, selected regions and countries**



Source: IMF Direction of Trade 2003

In terms of total world trade (Table 1, below), the share of the ICs has fallen from nearly three quarters in 1990 to less than two thirds on the most recent figures. The biggest component of this decline was the EU, whose share of world trade fell by 6 points. On the up were developing countries who increased their share of world trade by around a third over the same period, with most of this increase coming from Asia.

**Table 1. Shares of world trade, by selected region and country**

	1990	1995	2002
Industrial countries	72%	67%	63%
US	12%	12%	11%
EU	44%	39%	38%
UK	5%	5%	4%
Developing countries	28%	33%	37%
Western Hemisphere	4%	5%	6%
Africa	2%	2%	2%
Asia	13%	19%	20%

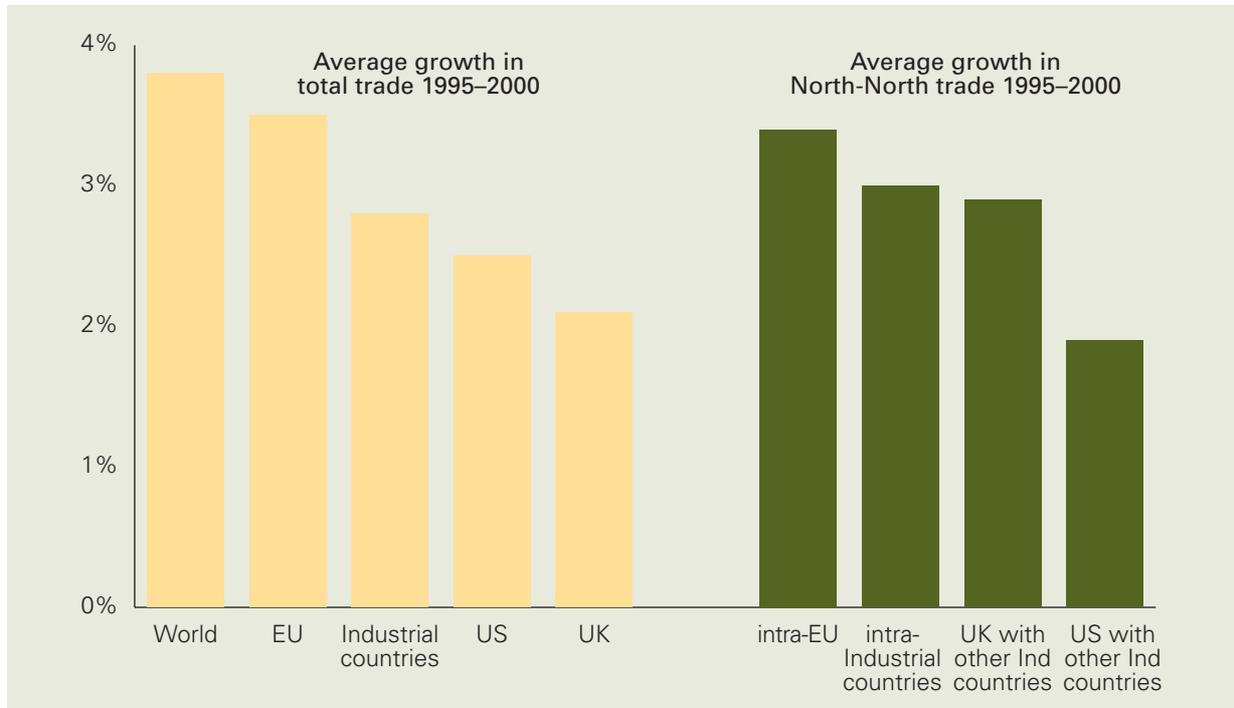
Source: IMF Direction of Trade 2003

### ***North-North trade***

North-North trade (trade between the ICs) accounts for around 45% of total world merchandise trade, down from around 55% in 1990 as average export growth both between the ICs themselves and between the ICs and the world as a whole has consistently lagged the world average.

For the ICs, trade with each other accounts for around 70% of their total trade. In general, North-North trade has continued to grow over recent years, expanding by over 50% since 1990. Its more recent performance has been dented by a dip in growth through 1997-1998 and then an actual fall in North-North trade in 2001. UK trade with other ICs fell nearly 8% in 2001 and US trade with other ICs by 5.5% in 2001 and a further 6% in 2002. Both the UK and the US registered weaker trade growth than the IC average since 1995 (Chart 3).

**Chart 3. Average growth in Industrial Country trade with the world and intra-Industrial Country trade 1995-2002**



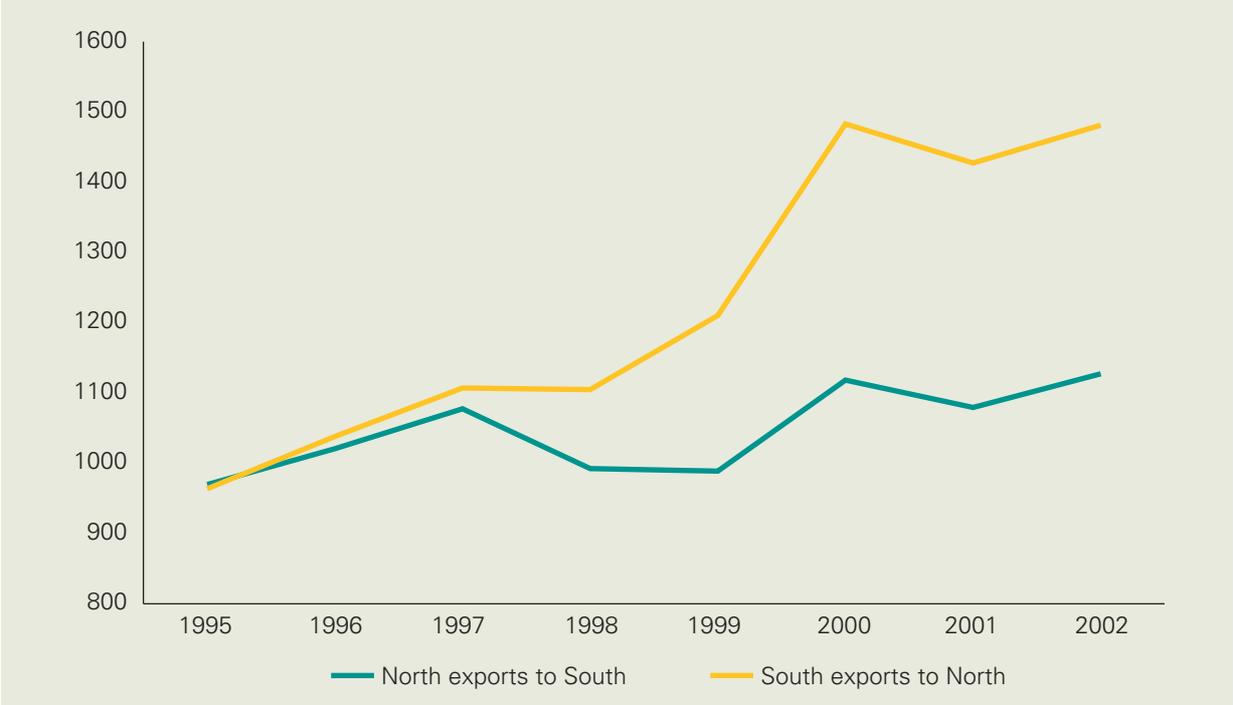
Source: IMF Direction of Trade 2003

### ***North-South trade***

In 2002 just over 40% of world trade was North-South – between Industrialised Countries and Developing Countries. This proportion is up from 36% in 1990 and 38% in 1995. The biggest share of this trade unsurprisingly was between Industrialised Countries and Asia; 43% of Industrial Country exports to Developing Countries are to Asia and half of all Developing Country exports to Industrial Countries originate in Asia.

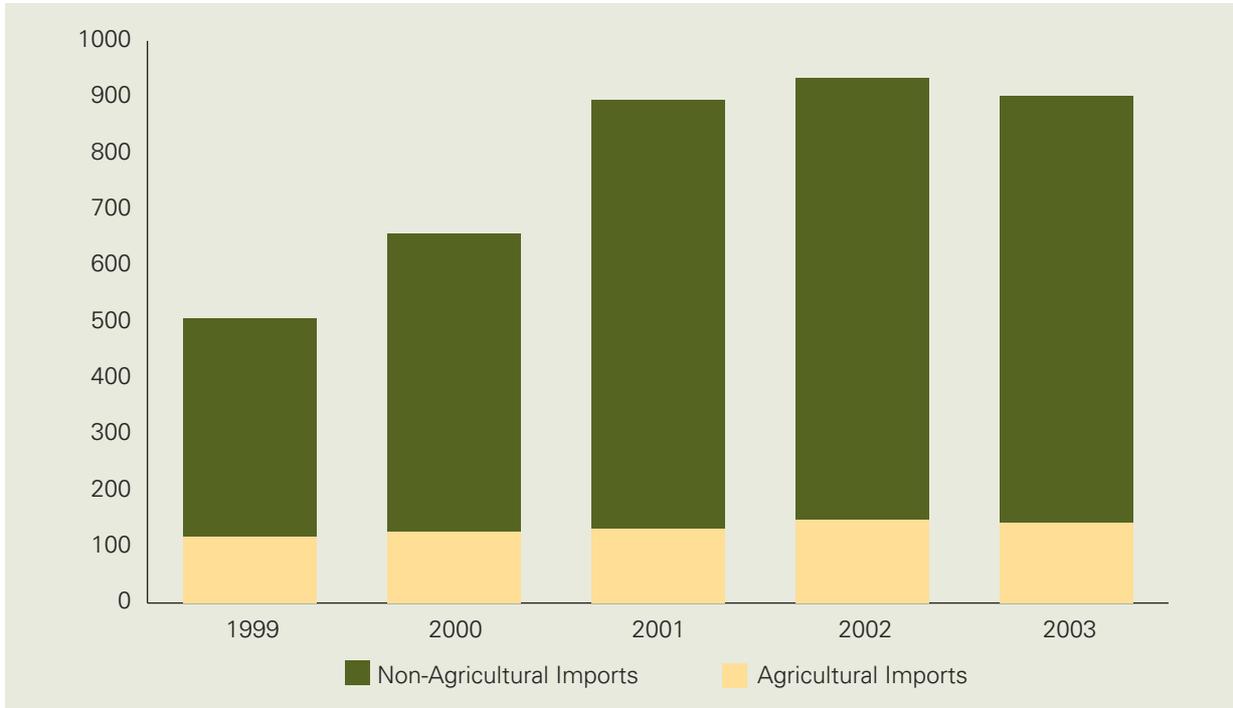
Overall, Developing Countries enjoy a trade surplus with the Industrialised Countries, with the value of exports moving from South to North around a third larger than exports going the other way. This trade gap has been widening since 1995 (Chart 4).

**Chart 4. A widening trade gap; North-South trade, \$ billions**

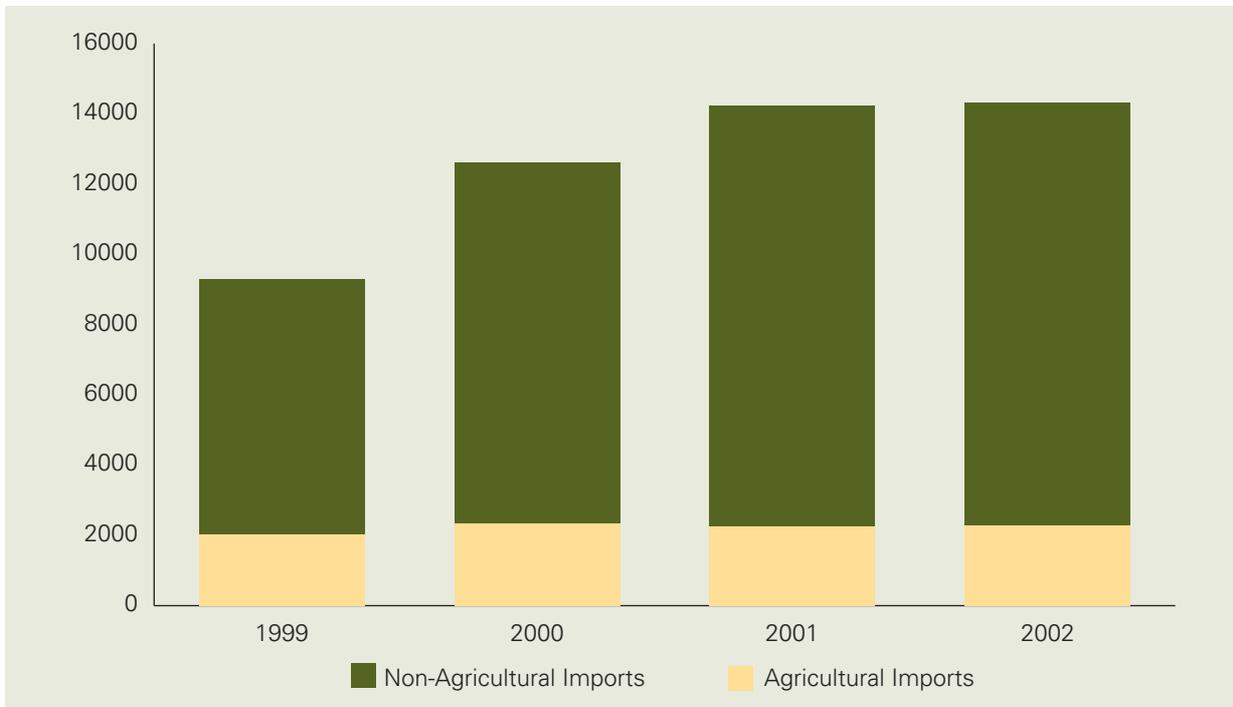


Source: IMF Direction of Trade 2003

A crucial constituent of the Developing Country category is the Least Developed Countries (LDCs). The LDCs are 49 of the world’s poorest countries, many of them in sub-Saharan Africa. These countries enjoy quota and duty-free access for all products, with the time-limited exception of sugar, rice and bananas, into the European Union under the Everything But Arms agreement that came into force in March 2001. Charts 5 and 6 illustrate the recent development of trade between the LDCs and the EU and the UK. They show in both cases a significant rise in exports from LDCs, in particular of non-agricultural products, although the EBA agreement only altered access for agricultural goods.

**Chart 5. Recent UK import totals from LDCs, £ millions**

Source: Customs &amp; Excise

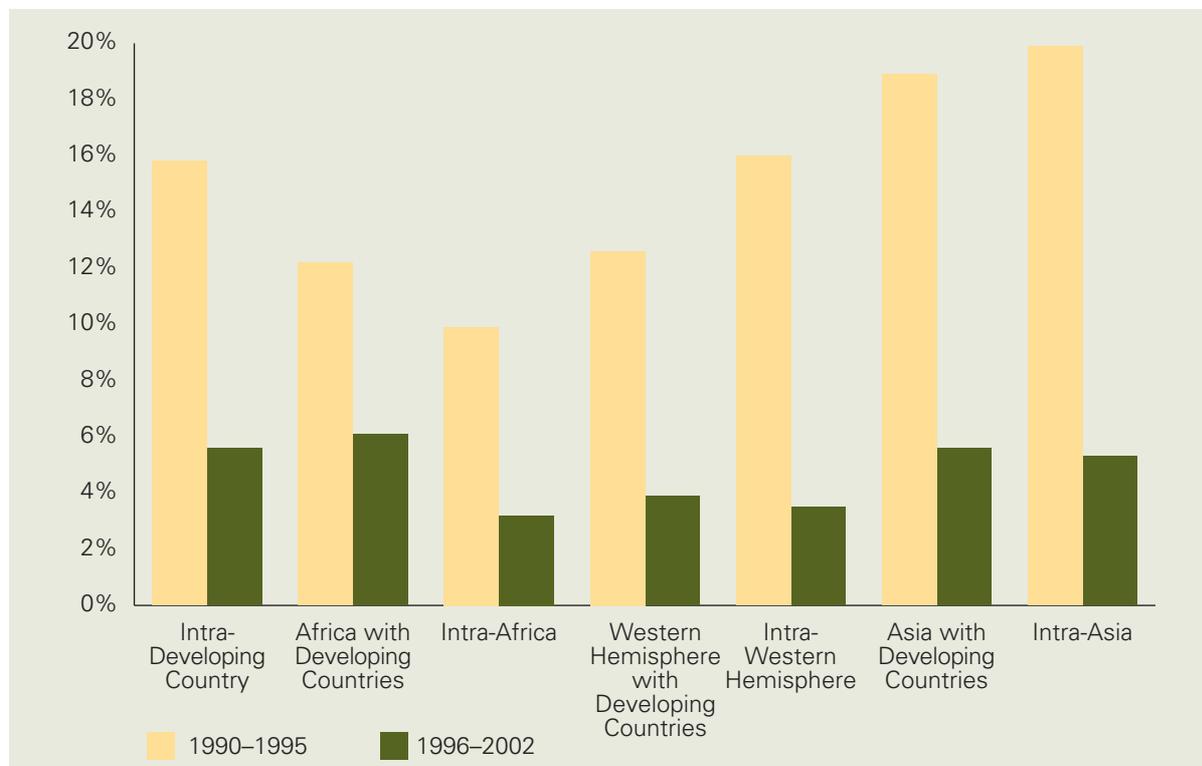
**Chart 6. European Union imports from LDC countries, \$ millions**

Source: Eurostat

## South-South trade

A common feature throughout this discussion has been the slowdown in the growth of exports after 1995 compared to the 5-year period beforehand. In this, South-South trade is no exception and in fact the slowdown has been especially pronounced. South-South trade as a whole grew far more strongly in the period 1990-1995, at an average annual rate of nearly 16%, than it did in the next period until 2002 when the growth rate fell to just over 5.5%. This pattern was experienced within all the sub-categories of South-South trade too, with intra-Asian exports, for example, dropping from an annual average growth rate of 20% to just over 5%.

**Chart 7. Average annual export growth rates for selected South-South groupings**



Source: IMF Direction of Trade 2003

The reasons for the weaker trade performance in the second period resulted from two significant slowdowns in economic growth in general, firstly as a consequence of the Asian crisis and secondly because of the US weakness in 2001.

Nevertheless, overall from 1990 to 2002, trade between developing countries grew faster, at 9% annually, than the world average, at 5% annually.

The share of intra-DC exports in total DC exports rose from 36% in 1990 to 43% in 2002. Again, the best part of this growth occurred in the early period and then got knocked

back by the Asian crisis, failing to pick up very much thereafter, as demand in the ICs was much stronger than in DC markets.

The relative size and economic strength of Asia is reflected by its dominance of South-South trade; nearly two thirds of DC exports are from Asia and over half of DC exports are intra-Asian.

### ***Trade in services***

By its nature, there is far less information about international trade in services, but an overview of recent trends is shown in the proceeding charts.

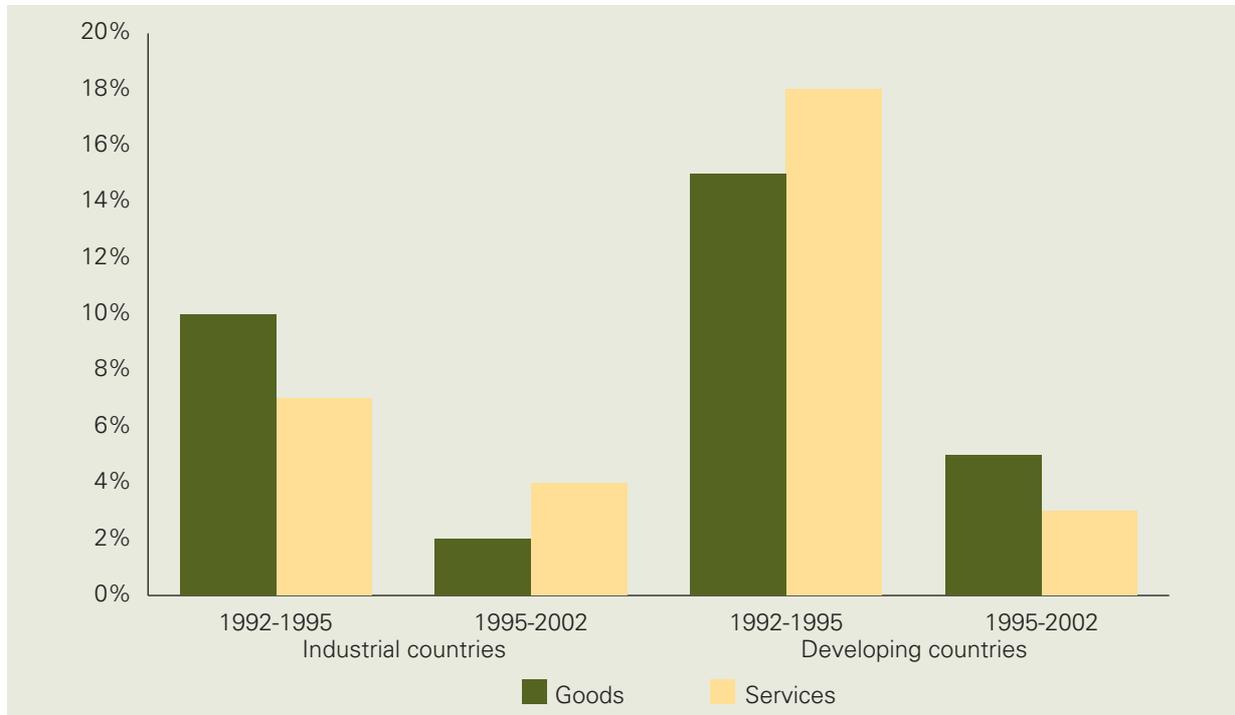
**Chart 8. Annual growth rates of services exports**



Source: IMF Direction of Trade 2003

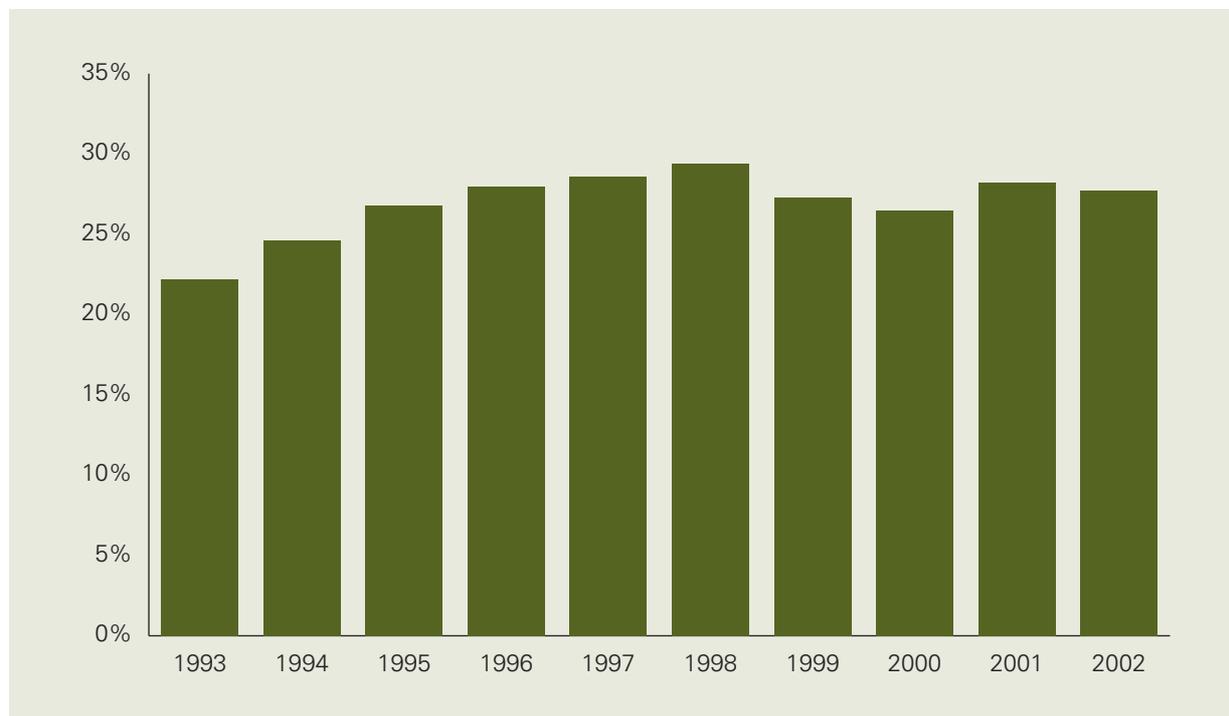
Trade in services has followed a very similar pattern to merchandise trade, growing strongly through the first half of the nineties and then slowed, first by the Asian crisis in 1997 and then the US slowdown in 2001. The progress of services trade has been somewhat less volatile than goods trade, however. It has avoided some of the giddy heights in annual growth rates, but services growth rates have stayed positive while goods trade slipped backwards in the worst years. The sum effect has been that, over the period 1992 to 2002, both goods and services trade each grew at an average annual rate of 8%. As a result, the share of services in total world trade has remained at just under 20%.

**Chart 9. Average annual growth rates of services exports**



Source: IMF Direction of Trade 2003

In Developing Countries, growth in services trade outstripped that in merchandise before falling back in the late nineties. The net result was that, over the whole period, the share of services in Developing Country exports actually fell and is currently around 14.5%. In the Industrialised Countries, while growth of services has dipped, it has held up better than growth in goods exports and hence has slightly increased its share of total exports. Over the whole period, Developing Countries have experienced higher services exports growth than the Industrialised Countries and have thereby increased their share of total world exports, up from 22.2% in 1992 to 26.4% in 2002 (although this is from a high of 29.4% in 1998).

**Chart 10. Developing country share of world services exports**

Source: IMF Direction of Trade 2003

### ***Trends in FDI***

Global FDI experienced its second consecutive year of significant decline in 2002. Inflows fell by 21% in 2002 following the even bigger slump of over 40% in 2001. Overall, both developed and developing countries experienced a 22% drop in FDI inflows.

More than half of the fall in FDI inflows was accounted for by just two countries, the United States and the United Kingdom. A large part of the drop in these two was due to greatly reduced mergers and acquisitions activity. In developed countries, 16 out of 26 experienced reduced FDI inflows.

Prior to the recent slump, FDI increased substantially, growing by leaps and bounds through the 1990s. However, these increases have been largely confined to developed countries and have been driven by the increases in cross-border mergers and acquisitions (M&A).

Mergers and acquisitions are the main types of FDI in developed countries, making up more than 80% of the total. In developing countries there is a higher proportion of so-called "greenfield" FDI, i.e. investment in new facilities, with M&A accounting for only around 30% of the total.

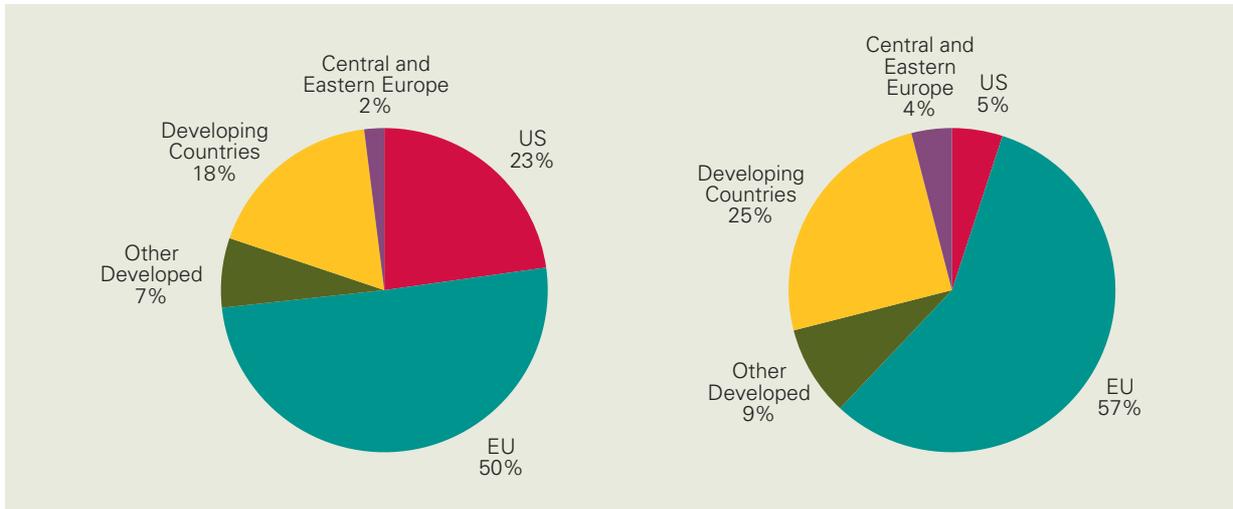
The effect of the global downturn in 2001 on FDI to developed countries illustrates the volatility of these flows. FDI flows fell by 40% in 2001 and then a further 21% in 2002. In 2002, FDI inflows amounted to \$651 billion, the lowest annual total since 1998. FDI inflows into the UK have been especially volatile, surging by over 120% in 1998 but then crashing by 50% in 2001 and a further 60% in 2002. FDI inflows into Developing Countries were comparatively far less volatile, although they fell in value between 1997 and 2002.

Africa, however, suffered dramatically reduced inflows, with inward FDI falling by over 40%. This, though, was rather a return to trend following the higher than usual inflows in 2001. Overall, FDI into Africa remains pitifully low making up less than 2% of world FDI.

**Chart 11. Annual growth in FDI inflows for selected regions**



Source: UNCTAD World Investment Report 2003

**Chart 12. Shares of world FDI inflows by region, 2000 and 2002**

Source: UNCTAD World Investment Report 2003

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