Benefits and costs of free trade for less developed countries

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Trade liberalization seems to have increased growth and income in developing countries over the past thirty years, through lower prices, firm-level efficiency gains and improved access to foreign inputs. However, aggregate gains from free trade are not necessarily equally distributed, so that trade liberalization has important costs for some people.

The current economic crisis has quickly spread to developing countries. Given bleak forecast for income growth, policy makers in poor countries might be under significant political pressure to raise barriers on international trade to weaken product market competition, save domestic jobs, and combat downturns in domestic output. So far, developing countries have in large part resisted temptation to increase barriers on trade. While protectionism has been on the rise, a recent report from the World Bank and the Center of Economic Policy Research suggests that higher trade barriers have so far appeared in relatively limited forms and through relatively more transparent trade measures allowed by the World Trade Organization (henceforth, the WTO).[1] However, the report also warns that protectionism could escalate. For example, developing countries can raise taxes on imports up to the maximum level determined during the WTO negotiations, without violating WTO rules. These maximum permissible import taxes tend to be high for developing countries, so the cost of imports could increase substantively. Consider the case of India. India's taxes imports are at an average of 15 percent in 2007, but India could increase tariffs to levels averaging about 50%.[2]

[1] Evenett, S. J., B. Hoekman, and O. Cattaneo, « The Fateful Allure of Protectionism: Taking stock for the G8 », CEPR-World Bank report, 2009, available at http://www.voxeu.org/reports/WorldBank.pdf.
[2] WTO, « Trade Policy Review: India », 2007, available at http://www.wto.org/english/tratop_e/tpr_e/tp283_e.htm

If policy makers succumb to calls for higher trade barriers, a wave of protectionism would escalate declines in world trade, which is already projected to decline by about 10% in 2009 due to sharp drops in global demand. In these recessionary times, it is thus important to examine why policy makers in developing countries should not succumb to protectionist pressures and continue support freer trade.

Obviously, protectionism would make consumers in poor countries worse off: higher import taxes make imported products more costly and enable domestic firms to charge higher prices as well. This means that consumers can afford fewer goods. What is perhaps less obvious is that protecting domestic workers and firms with higher trade barriers will likely not lead to higher domestic employment and profits of domestic firms. Higher taxes on imports will shield employment losses in industries that compete with imports. But other countries might retaliate by imposing their own trade barriers. This will lower exports and lead to lower revenues and job loss in the exporting industries. Saved jobs in import-competing industries would then come at the loss of jobs in exporting industries. Higher protection on products will also increase production costs for firms in developing countries that need to use protected products as production inputs, leading to lower earnings and job loss in those firms. For example, if India increases tariffs on steel imports, this helps Indian steel firms charge higher prices for steel sold in India. But it harms Indian firms and workers in automobile industry because automobile production requires steel.

The main argument against the return to protectionism comes from findings of research that has examined what happened in developing countries as they abandoned protectionism in favor of more free trade during the past 30 years. Until 1980s, most developing countries pursued protectionist policies, which shielded domestic firms from foreign competition through high taxes on imports and quantitative restrictions on imported goods. Some of these countries drastically reduced quantitative restrictions and taxes on imports during the 1980s and 1990s in large-scale trade reforms. For example, during the 1991 trade reform, India lowered its import tariffs from over 80% to about 30% in late 1990s and substantially reduced the use of quantitative restrictions on trade such as import licenses. Researchers used detailed nationally representative data of workers, households, and firms that span the period of these reforms to study the consequences of

trade liberalizations for growth, living standards, and poverty in developing world. So what have we learnt from the experiences of these countries?

Perhaps the main channel through which trade can improve living standards in poor countries is through economic growth. A recent study provides convincing evidence that countries that have abandoned protectionism in favor of freer trade experienced higher income and higher income growth.[3] The study compared income growth across over 70 countries during the past 30 year. During this period, some of these countries joined the WTO and lowered tariffs, while others continued to pursue protectionist policies. The study shows that countries that participated in multilateral trade reform during the past 30 years had higher income growth than countries that did not. Interestingly, a significant share of these differences in growth across countries occurs through lower import taxes on intermediate and capital goods in countries that implemented trade reform.

Looking at how firms respond to trade liberalization sheds further light on the channels through which trade contributes to aggregate growth. Public perception on globalization often focuses on the costs domestic industries endure as they lose protection from foreign competition through lost revenue and market share. Firms, in fact, incurred these costs in the trade liberalization episodes studied by the researchers. Some firms, usually the less efficient ones, downsized and went bankrupt. Firms that survived foreign competition sold their products at lower prices and experienced a loss in revenue.

But stronger competition also forced domestic firms to shape up and improve efficiency, generating aggregate productivity improvements. There is now a large body of evidence from developing countries including India, Indonesia, Chile, Mexico, Brazil and others that firms improved their productivity when they were no longer protected by high import tariffs. Some firms, especially the more efficient ones, also expanded their output through increased access to export markets. As a result, freer trade improved aggregate productivity by reallocating market share away from less efficient toward more efficient producers. Studies have shown that such

[3] Estevadeordal, A. and A. Taylor, « Is the Washington Consensus Dead? Growth, Openness, and the Great Liberalization, 1970s-2000s », National Bureau of Economic Research Working Paper 14264, 2008.

trade-induced reallocation accounted for up to two thirds of aggregate productivity improvements associated with trade in countries such as Chile, Mexico, and Colombia.

Another factor that is often not emphasized in public debate on trade liberalization is that domestic firms can, and do, benefit from lower tariffs through access to cheaper, more sophisticated, and new types of intermediate inputs from abroad. Let's take example of India's large-scale trade reform in 1991. The decline in tariffs contributed to more than doubling of imports of goods that can be used as inputs into production.[4] Interestingly two-thirds of this growth in imported inputs occurred in products that India did not import before, including products within machinery and computers. As a result, lower trade barriers not only made prices of existing imports cheaper, but also enabled Indian firms to access new types of inputs. Research has shown that access to cheaper and previously unavailable products improved productivity of Indian firms. It also enabled Indian manufacturing firms to start producing more products and these new products can account for about one quarter of India's manufacturing output growth during the 1990s. These findings point to an additional gain from trade through improved access to foreign inputs that would be cut off through increased protectionism.

Having discussed the link between trade and growth, one might next wonder how does this higher growth and firm productivity trickle down to households and affect poverty in poor countries? The usual argument that the economists make is that trade promotes growth and growth leads to lower poverty. While many economists believe that growth provides the channel toward poverty reduction, the link between trade and poverty via growth has been empirically elusive. Trade-induced growth could lower poverty by expanding employment and earnings opportunities of the poor, but growth could also bypass the poor.

Much of the academic debate on trade and poverty has focused on how trade affects poverty by affecting earnings of less educated individuals, who tend to be at the bottom of income distribution. Less developed countries are relatively well endowed with less educated

[4] Goldberg, P. Khandelwahl, A., N. Pavcnik, and P. Topalova, « Imported Intermediate Inputs and Domestic Product Growth: Evidence from India », NBER Working paper 14416, 2008.

labor and thus well positioned to produce and export goods that rely intensively on less educated labor in their production such as apparel and toys. Increased trade was thus expected to increase demand and earnings of less educated workers and lift the poor out of poverty.

This has in part occurred. Consider the case of Vietnam and Mexico, two countries which have recently benefited from the increased access to export markets in the United States and other rich economies. Within these countries, geographic regions vary widely in their composition of industries. Some regions have higher concentration of employment in industries that benefit from new export opportunities, while others do not. This implies that when these countries opened up to international trade, different regions were affected differently. What the research has shown is that increased export opportunities have benefited individuals living in areas with high concentration of exporting industries. Higher export opportunities increased wages of less educated workers, and lifted their families out of poverty.

But not everybody necessarily benefits from trade, especially if people cannot easily change the sector of employment or move geographically. How trade affects poverty depends on the circumstances in particular country, the nature of trade reform, and the ease with which individuals move across firms, industries, and regions.

Consider again the case of India. During the 1990s India observed large declines in poverty and liberalized trade likely contributed to these declines in poverty via growth, declines in consumer prices, and access to more varieties of products. However, the benefits of trade reform were not equally distributed across India. A study showed that poverty rates declined by less in rural India in areas where employment was concentrated in industries that lost protection than in areas less exposed to the loss of protection.[5] Workers in previously protected industries observed declines in their wages relative to individuals in areas better positioned to take advantage of trade liberalization. These workers fared relatively worse because immobility, in part stemming from inflexible labor regulations, precluded them from reallocating toward firms, sectors or regions that benefited from trade reform.

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[5] Topalova, P., « Trade Liberalization, Poverty and Inequality: Evidence from Indian Districts », in *Globalization and Poverty*, National Bureau of Economic Research, 2007 p. 291-336.

There are several factors that could account for difficulty of some individuals in poor countries to reallocate toward firms, industries, and regions with more economic opportunities. Understanding the reasons for immobility remains an area of ongoing academic debate. Some research suggest that labor market regulations play a role by increasing the cost of firing a worker. One unintended side effect of such regulation is that firms are more reluctant to hire a new worker, because a firm needs to pay a high firing cost if it needs to lay off this worker during a period of low demand. Another explanation might be that some individuals are less well positioned to share in the gains of globalization. The educational background, work experience, skill set, and age of workers laid off in firms affected by import competition might not match well with the job descriptions in the firms that are hiring in response to freer trade. Obtaining a job in a firm or industry that is growing as a result of international trade might also require that an individual moves to another geographic area. However, moving is costly. The costs of moving to a new location are not confined to the monetary expenses associated with the move. The cost of moving also includes the cost of separation from family and friends and might be particularly high in societies where individuals rely on family and networks also for insurance and safety net. The above mentioned adjustment costs are real and painful for the individuals involved and need to be addressed, hopefully through a government provided safety net.

The experiences of developing countries that have over the past 30 years abandoned protectionism in favor of freer trade point to the benefits from practicing freer trade. While not everybody gains from trade reforms and there are adjustment costs, countries with freer trade tend to have higher standard of living and grow faster. These experiences teach us that the return to protectionism is not the best way to compensate those hurt by the current crisis. More likely, protectionism would make the crisis worse.

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