Thinking Outside the Box about Trade, Development, and Poverty Reduction

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I. What Are the Questions?

When Gertrude Stein lay sick and dying in Paris she is reported to have turned to her companion Alice Toklas and asked »What is the answer?« When Toklas replied »I don't know,« Stein is supposed to have retorted »Well then, what is the question?« In many regards the policy debate over the linkages between trade, development, and poverty reduction is beset by the same problem. The questions asked and the theoretical lens used to understand the world determine the answers we arrive at.

All countries trade, providing strong *prima facie* evidence that international trade is an economic positive. However, the question is not one of trade versus no trade. Rather, it is »what system and rules of trade are best for economic development and poverty reduction?« This is a straightforward question, even though the answer is not. Yet it is surprisingly difficult to secure engagement with this question. Instead, posing the question and doubting the optimality of current World Trade Organization (WTO) rules, invites being labeled an anti-trade protectionist. Such labels allow WTO boosters to avoid engagement with the core question.

This paper explores the current state of the trade and development debate. It is intended for an NGO audience, and suggests some alternative economic frames for the debate. The focus is the trade–development nexus, and the paper does not present a complete alternative development framework. That is a broader, bigger exercise.[1]

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1. Elsewhere (Palley, 2002) I have written about such an alternative development framework. Readers are invited to consult that policy brief, which can be found at www.thomaspalley.com and www.fpif.org.

II. Trade, Growth, and Welfare: the Current Debate

A decade ago, mainstream policy economics argued vigorously that trade promotes development.[2] If this were true, given the massive increase in global trade volumes over the last twenty-five years, the global economy ought to have seen accelerated economic growth. Yet this has not happened, and global growth has actually slowed relative to the prior twenty-five years. This suggests that trade is at best weakly associated with growth.

Even granting such a positive association, the question remains contentious because positive correlation is not the same as causation. In this regard, the careful empirical work of Rodrik and Rodriguez (2001) is important as it suggests that countries that experience economic success become successful traders. The implication is that trade is an artifact of development rather than a cause of development.

In addition to this empirical challenge, there are also theoretical challenges to the claim that trade increases growth. Standard growth theory decomposes the sources of growth into capital accumulation, labor force growth, and technological advance. For developed countries there seems little reason to believe that trade significantly impacts any of these factors, and trade is therefore growth-neutral. In developing countries, which lag regarding capital accumulation and technology, trade may raise both if it encourages investment and diffusion of technology from developed countries. These factors should show up as a surge in growth, but this argument is belied by the fact that the income ratio of North to South has been increasing rather than decreasing. Of course, things might have been worse absent trade liberalization, but it is *prima facie* evidence that the trade effect is at best weak.

Finally, the trade debate tends to focus on growth, but increased welfare rather than growth is the real goal of economic policy. Growth is necessary for rising welfare, but it is not sufficient. There is also need to attend to the »character« of growth and ensure that it is inclusive. This concern with »character« is especially important with regard to development and poverty reduction.

With development and poverty reduction lagging despite extensive trade liberalization, the claims of mainstream policy economics regarding

2. See, for example, Bhagwati and Srinivassan (1999).

the benefits of trade liberalization are now being modified.[3] The new position is that trade remains good for growth, but to promote development and poverty reduction it must be accompanied by »flanking« policies that ensure (i) investment in health and education (human capital) and (ii) investment in transportation and communications infrastructure to enable distribution and marketing.[4]

This is a broader, more attractive policy agenda. Analytically, it takes the traditional trade liberalization agenda and ties it to the traditional development agenda, and then makes the claim that »2 + 2 = 5«. However, while rescuing the mainstream from its previous excessive claims about the development benefits of trade, it does not address the core theoretical debate about whether there are better trade policies than those embodied in WTO. Thus, it is possible that »alternative« trade policies plus flanking investments might be a case of »2 + 2 = 6«.

At the operational level, the new flanking investment agenda raises new questions. First, what are the consequences of WTO trade liberalization if unaccompanied by these flanking policies? Second, how are these flanking policies to be financed? Third, is there a need for sequencing, with flanking investments coming before liberalization? If flanking public investments are so critical for trade to generate development and poverty reduction, then WTO liberalizations need to be accompanied by binding commitments to fund these investments. Such commitments are currently absent, suggesting that the »development« dimension of the Doha trade round is missing according to the logic of its very proponents.[5]

3. Winters et al. (2004) write: »There is no simple general conclusion about the relationship between trade liberalization and poverty. Theory presumes that trade liberalization will be poverty-alleviating in the long run and on average. Equally, however, it does not assert that trade policy is always among the most important determinants of poverty reduction or that the static and microeconomic effects of liberalization will always be beneficial for the poor« (quoted in Mealy, 2005).
4. See, for example, World Bank Institute (2003).
5. There has been some talk of »aid for trade,« whereby Northern governments would give aid in return for trade liberalization in the South. However, the sums remain to be established, as does their duration. Moreover, the politics of foreign aid may have aid for trade just displacing existing aid, and therefore generating little net additional aid. For these reasons, the »aid for trade« agenda is full of pitfalls.

III. Problems with New Compassionate Trade Liberalization

Most importantly, the new compassionate (public investment plus) model of trade liberalization remains afflicted by many of the criticisms leveled against the earlier simplistic »free trade equals development« model.

A first problem concerns tariffs as a source of government revenue. WTO trade liberalizations lower tariffs, in turn potentially lowering government revenues. Yet, the new compassionate trade liberalization model calls for greater public investment, which means that government revenues are even more necessary.

For many developing countries tariffs are the most economically efficient way of raising tax revenues. Thus, there is an optimal public finance justification for tariffs. Raising taxes through other means could impose large economic costs, and these costs could potentially exceed any notional gain from trade liberalization. There is a hump-shaped Laffer tariff curve.[6] A zero tariff will yield zero tariff revenue. Likewise, a massive tariff may yield low revenue by making imports too expensive and pricing them out. The maximum revenue raising tariff is somewhere above zero, yet the WTO regime is philosophically dedicated to the removal of all tariffs.

A second problem with the new trade and development framework is that it remains anchored in the export-led growth paradigm that has dominated development economics for the last two decades. This paradigm is problematic (Palley, 2003; Blecker and Razmi, 2005). At bottom, it is doubtful that all developing countries can grow via export-led manufacturing. The global market is limited, and excessive focus on exports stands to generate degraded competition between southern economies. Countries will find themselves crowding each other out and pushing down the prices of the goods they sell. Fifty-five years ago Raul Prebisch (1950) and Hans Singer (1950) identified the problem of secularly declining developing country terms of trade. At that time, the problem applied to primary products. Given today's export-led manufacturing growth paradigm, the problem now applies to low-end manufacturing goods. Lastly, owing to the export-led model's reliance on foreign markets rather than domestic markets, the global economy has a »beggar-thy-neighbor« economic quality. This generates a zero- or maybe even negative-sum setting, which could place the global economy on a deflationary slow growth path.

6. The Laffer curve is named after Arthur Laffer who originally described the hump-shaped relationship between tax rates and tax revenues.

A third concern with the new compassionate trade model is its continued assumption that everyone has a place in the »free trade sun.« The model is rooted in comparative advantage, which maintains that everyone finds a niche. Even though countries may have absolute advantage in nothing, the international economy makes place for everyone by having countries specialize in what they are relatively best at. However, this conclusion requires the assumption of global full employment and globally scarce labor. It does not hold in a world of mass unemployment and surplus labor.

This has critical implications. Countries such as Kenya and Zambia have seen their local textile industries decimated by imports of second-hand clothing. The justification for such imports is that the clothes are cheaper, and that the displaced textile workers will find more valuable employment elsewhere. But this will not happen if there is surplus labor. Instead, workers can become permanently unemployed, and a country can lose its textile industry, thereby possibly depriving it of the first stepping-stone to the development of a manufacturing sector.

The same problem can apply to agricultural imports that lower prices and displace subsistence farmers. While it is true that there are gains to urban workers who pay less for food, there are large rural societal disruption costs. Farming communities are destroyed and farmers forced to migrate to the cities. Urban workers are then hurt since increased urban labor supplies lower wages; they are also hurt to the extent that they lose rural networks that are part of an extended family insurance system. These non-market economic losses may outweigh the market gains from lower prices. In the language of economists, the gains from capturing Harberger triangles can be small compared to the social costs of remaking society. The lesson for trade policy is that there can be high costs to low prices.

A final problem with the trade as development model is its lack of attention to countries' readiness to engage in international trade. A sports metaphor can help us understand this critique. Putting a heavyweight boxer in the ring with a lightweight will result in an unfair fight as the boxers are unequally matched. This can hold for trade, and countries need to prepare themselves for international engagement. Such arguments support the strategic use of tariffs and industrial development policies. Chang (2003) has documented that policies of this type were used by industrialized countries when they set out on the path of development. Additionally, empirical work by O'Rourke (2000) has confirmed the existence of a positive correlation between tariffs and growth in the late nineteenth century.

In sum, the new public investment–enhanced version of trade as development remains afflicted by long-standing critiques of free trade. It is important to recognize that these critiques are not an argument against trade. Instead, they are an argument against a particular set of trade rules that shrink the set of development policy tools. In particular, they challenge the claim that the best way to accelerate development and poverty reduction is to simply drop tariffs in accordance with WTO-style trade liberalization.

IV. Thinking Outside the Box about Trade and Development

International trade is a particular type of »commerce,« one that crosses borders. The WTO trade liberalization debate focuses on multilateral international commerce. However, there are other forms of commerce, including national commerce, bilateral international trade, and regional international trade. An »outside the box« perspective suggests that it may be better to promote domestic commerce and domestic market engagement. Such commerce yields deeper development linkages than does export-led growth, which tends to promote forms of enclave development analogous to a modern plantation economy. Two major reasons for the shallowness of export-led development are that (i) it often relies heavily on imported inputs, and (ii) no domestic distribution, marketing, retail, and servicing are developed because the market is offshore.

Not only can a domestic commerce focus yield larger development multipliers, but it can also be viewed as a form of needed development sequencing. In terms of the earlier heavyweight–lightweight metaphor, it prepares the domestic economy for engagement with the international economy.

The same logic holds for regional trade arrangements such as Mercosur in South America. Traditionally, mainstream trade economists have frowned upon and discouraged such arrangements, arguing they cause inefficient trade diversion. The supposed inefficiency results from countries trading with their neighbors rather than the globally most efficient producer as determined by the principle of comparative advantage. However, regional trade agreements have several advantages. First, regional neighbors often tend to be at similar stages of development, therefore avoiding the heavyweight–lightweight mismatch problem. Second, the value created in production and trade is captured within the region rather than being siphoned off to the North. Third, such trade can economize on the use of expensive foreign exchange reserves.

A second »outside the box« approach is value chain analysis.[7] Trade theory assumes that countries and economic agents are paid their worth. The claim is that the competitive market process prevents exploitation and ensures that producers and workers are paid their contribution (marginal product). Value chain analysis follows a product from the ground to the final consumer, and identifies who captures how much value along the entire chain. Many trade economists do talk about moving up the value chain, but they have a stages of production »value-added« focus. An alternative focus involves a bargaining power perspective and emphasizes »value-capture.« This pattern of capture has changed significantly owing to (i) globalization and (ii) product branding, which have changed bargaining power along the stages of production.

A key feature of globalization is that it enables Northern companies to engage in global production and sourcing. This enables buyers to put countries in competition with each other. Thus, Mexican firms and workers compete for business against Indonesian and Chinese firms and workers, and they all compete against supplier firms and workers in the North. This increases the bargaining power of the buying party. A second feature of the new era is the emergence of product branding, which shifts value to the storefront end of the chain. Both of these features are exemplified by such companies as Nike and Gap, who source globally at very low cost, add a brand logo, and then capture enormous value at the retail end.

These changes have enormous implications for both workers and development policy. Consider apparel and textile manufacturing. Thirty years ago, before the advent of global sourcing, manufacturers had more power and were therefore able to capture more of the value created. This in turn enabled workers to organize unions and capture some of the value for themselves. In today's global economy, apparel and textile manufacturers have lost the power to capture value, which explains why it is so difficult to organize unions in these sectors.

To some degree these changes generate price benefits to Northern consumers, but it is also the case that a lot of the change is simply a shift

7. The seminal paper on value chain analysis is Gereffi (1994).

of value to branding firms and powerful retailers situated at the end of the value chain.[8] For developing countries, the problem is clear. They are at the beginning of the value chain and are capturing less and less value. Conventional trade liberalization does not address this problem, and may even amplify it.

The twin lenses of domestic commerce promotion and value capture suggest a new set of policy questions. First, how can government policy promote domestic commerce? Are regional South–South trade agreements a superior way of stimulating commerce and retaining value? Can the global South work directly with Northern NGOs and consumers to capture value by insisting on corporate codes of conduct and by developing own brands? Can global labor standards help capture value by putting in place a floor that ensures a minimum level of value is retained within the country? Such labor standards will also then stimulate domestic commerce because workers will receive higher wages. Finally, do WTO rules eliminate some worthwhile policy instruments such as local content requirements and industrial policy?

V. Trade Policy: the Baby and the Bathwater

Revolutions in thought tend to throw the baby out with the bathwater. The same holds for counter-revolutions. In macroeconomics, Keynesians (but not Keynes) tended to disregard incentives and market forces, and narrowly emphasized the effects of aggregate demand. The 1970s monetarist counter-revolution in turn restored the importance of incentives and markets, but it disregarded the Keynesian problem of aggregate demand.

Development economics has experienced a similar pattern. Thus, the baby was thrown out with the shift from import-substitution to export-led growth in the 1980s. The new focus on exports contributed to a disregard for domestic market development, which had figured significantly in the import-substitution paradigm. Without doubt, that paradigm was in need of reform. In many countries, rent seeking had led to permanent high tariffs and industry showed no tendency to become internationally

8. The shift in value capture is reflected in the generalized decline in the wage share in most OECD countries that has occurred since the early 1980s (OECD, Annex Table 23, 2003).

competitive. Countries also pursued capital-intensive »show« industrial projects that were costly, failed to meet minimum efficient size requirements, and in which there was no hint of global competitive advantage. As such, these projects lacked economic and commercial logic, and countries would have been better served investing scarce resources elsewhere.

That said, the import-substitution paradigm had a strong domestic development component, encouraging domestic production capacity and domestic commercial development since output was sold on the domestic market. Rather than complete abolition, measures to diminish rent seeking and promote competition should have been enacted.

This suggests that some of the policies from the import-substitution era have a role to play today. One policy involves distinguishing between tariffs on consumption goods and tariffs on capital goods. The former can provide a progressive source of revenue that also helps manage the balance of payments. The latter are to be avoided (zero-rated) since they raise the cost of production, and make for reduced international competitiveness.

The existence of tariffs attracts rent seeking. One possible institutional response is the creation of independent public tariff boards that operate in the public sunlight and at some distance from politicians. Here, a possible organizational model could be that of independent central banks, and the IMF and the World Bank could also serve a useful role as external monitors.

Marketing boards are another institution that should be brought back. In colonial times, these boards served a constructive role, providing an incentive for small farmers to connect with the market economy. By providing a centralized distribution network, they generated economies of scale and scope that lowered marketing costs and earned higher prices, thereby capturing more value for small farmers. They were also paired with agricultural extension services that provided technical assistance to small farmers, thereby raising agricultural productivity. However, marketing boards were subject to capture by corrupt political elites who used them to tax the rural sector and confiscate foreign exchange export earnings. Again, this suggests the need for open public independent boards modeled along the lines of independent central banks, and monitored with the assistance of the IMF and World Bank.

These types of policy interventions can spur growth and development, and have done so in the past. However, they can only work if corruption and rent seeking are kept out. That means politics and the quality of policy are critical, giving rise to the perennial problem of »who will guard the guardians?« Transparency and accountability laws are key, as is freedom of the press. So too is democracy to maintain political and electoral checks. NGOs have a role to play, as does open public consultation by the IMF and the World Bank.

However, absent the political will to check corruption and rent seeking, the above policies can do more harm than good. If governments are thoroughly corrupted it may be better to reduce their powers, and to reduce tax revenue and just leave the money in the hands of private agents.

This leads to an important point. Trade liberalization is frequently justified in terms of eliminating corruption and rent seeking. This is a mistake. If the problem is corruption and rent seeking, then the need is for political and institutional measures that directly address these problems while retaining policies that foster growth and development. Trade liberalization may reduce corruption, but it throws away useful development policies. This is a deep flaw in the liberalization agenda. Trade should not be used as a surrogate for good governance, democracy, and active civil society. Instead, policy should directly promote these features.

VI. Go Slow: Policy in an Uncertain World

In macroeconomics there is a famous theorem (Brainard, 1967) that states »if you don't know, go slow.« The logic of this theorem is that in a world characterized by uncertainty about the impact of economic policy, large policy moves can lead to extreme (good and bad) outcomes. In general, extremes (feast and famine) are undesirable and it is better to have a smooth flow of income and employment. Consequently, policy should avoid large moves. This insight has relevance to trade liberalization where there is much uncertainty and dispute about impacts.

Additionally, globalization poses a second problem of »lock-in.« Thus, there is a danger of putting in place policies that are hard to reverse. Consequently, big changes may cement policies that turn out to be undesirable, and lock-out desirable alternative policies.

The implication of these two arguments is that small incremental changes are best. This is a very different line of reasoning from the »bicycle momentum« metaphor pedaled by WTO boosters. Their claim is that another round of large-scale trade liberalization (the Doha round) is needed to keep the trade bicycle rolling, or else it will lose momentum and fall over. A go-slow perspective recognizes that it may be better to fall over than cycle over the cliff.

VII. A Tropical Products Round

The notion of incremental trade liberalization suggests the idea of a tropical products trade round, involving commodities such as sugar, cotton, coffee, cocoa, rice, and orange juice. Such a round could focus on those commodities that most benefit developing countries and where Northern subsidies are most damaging. All sides of the theoretical debate agree on the economic justification for such a move, and it would generate an aggregate win–win situation for both North and South. These are products where the theory of comparative advantage applies unambiguously.

In the South there would be some losers among those countries that import but do not produce any of these tropical commodities, as prices would rise owing to the elimination of Northern subsidized production. But there would be a net production gain in the South, suggesting Southern political support for such an approach.

The politics in the North also look good. First, a tropical products round would hold the high moral ground, since it would be good for development (and Doha is supposed to be a development round). Second, there would be large budget savings to taxpayers resulting from the elimination of certain specific agricultural subsidies. Third, consumers would gain as prices would come down because of the elimination of quotas. Fourth, Northern labor could support the round as workers would benefit as consumers and taxpayers, while manufacturing would be off the table. Nor would Northern industrialists be hurt, and the most they could claim is that this would be a missed opportunity for other (contested) forms of liberalization. Finally, Northern producers of tropical products are politically poorly positioned, as they tend to be large agro-businesses whose political profile is unappealing. This contrasts with taking on the dairy and grain farming lobbies who have a different political profile. Additionally, Northern production of tropical products is often environmentally damaging, as exemplified by the impact of sugar cane growing in Florida's Everglades. Finally, even if a tropical products agenda ends up being rejected, advocating it can serve a useful political purpose. First, it can show that WTO critics are for trade. Second, it can show that supposed free traders are against free trade when they do not get exactly what they want.

VIII. Conclusion: Strategies for Progressive Trade and Development Policy

The above proposal for a tropical products trade round illustrates how a »thinking outside the box« approach must use multiple strategies. One strategy involves an insider approach that pushes true pro-development trade policies in the WTO. A second strategy involves highlighting the fundamental flaws in the WTO economic analysis of trade. The perennial danger is that engagement inside the WTO can further entrench the legitimacy of the WTO's views on trade. That means all engagement must be on a no *quid pro quo* basis, and the insider strategy must be accompanied by a vocal outsider strategy that challenges the economic thinking embedded in the WTO. However, it should be made clear that this challenge is not a criticism of trade *per se*. It is a criticism of the current WTO view about trade and development.

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