

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

By Thomas I. Palley | January 18, 2006

## Abstract

Mainstream policy economics has been gradually lowering its claims about the positive impact of trade on development and poverty reduction. The new approach is a compassionate agenda that says if trade liberalization is to reduce poverty, it must be flanked by public investment in infrastructure and human capital. However, this new agenda raises numerous questions about how to finance public investments, whether these investments should be sequenced in advance of liberalization, and whether trade liberalization is desirable if the investments are not made. Most importantly, the new agenda still does not address the systemic critique that trade liberalization hinders development by eliminating important policy tools.

This policy paper proposes an alternative framework for thinking about trade, development, and poverty reduction. That framework emphasizes domestic commerce promotion and strategic value-chain analysis that focuses on how developing countries can capture more of the value they create. The paper also argues for incremental policy change rather than grand liberalizations. In a world of uncertainty, optimal decision theory advises “Go slow if you don’t know.” Finally, the paper proposes a tropical-products trade round that can produce a win-win outcome for both North and South.

## 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 fashion.

All countries trade, providing strong *prima facie* evidence that international trade is an economic positive. However, the query 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 on this issue. Instead, posing the question and doubting the optimality of current World Trade Organization (WTO) rules invites being labeled an anti-trade protectionist. Such labels in turn allow WTO boosters to avoid engagement with pivotal concerns.

This paper explores the current state of the trade and development debate. It suggests some alternative economic paths and is intended for an audience of nongovernmental organizations (NGOs).



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The focus is the trade-development nexus, and the paper does not present a complete alternative development framework. That is a broader and more ambitious exercise.<sup>1</sup>

### Trade, Growth, and Welfare: The Current Debate

A decade ago, mainstream policy economics argued vigorously that trade promotes development.<sup>2</sup> If this were true, given the massive increase in global trade over the last 25 years, the global economy ought to have experienced accelerated growth. Instead, global economic growth has actually slowed relative to the prior quarter-century. This suggests that trade is at best only weakly associated with growth.

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This concern with character is especially important with regard to development and poverty reduction.

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Even granting 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 discover 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. Since developing countries lag behind in capital accumulation and technology, trade may raise both factors if it encourages investment and diffusion of technology from developed countries. Such an outcome should then precipitate a surge in growth, but this is belied by the increasing income ratio of North to South. Of course, it could be argued that things might have been worse absent trade liberalization, but the widening wealth gap is *prima facie* evidence that any beneficial 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.

Since development and poverty reduction are lagging despite extensive trade liberalization, the claims of mainstream policy economics regarding the benefits of trade liberalization are now being modified.<sup>3</sup> The new position is that trade remains good for growth, but to promote development and poverty reduction, trade must also be accompanied by flanking policies that ensure (1) investment in health and education (human capital) and (2) investment in transportation and communications infrastructure to enable distribution and marketing.<sup>4</sup>

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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 mainstream economics from its previous excessive claims about the development benefits of trade, the new economics position does not address the core theoretical debate about whether there are better trade policies than those embodied in the WTO. Is it possible that alternative trade policies plus flanking investments might be a case of  $2 + 2 = 6$ ?

At the operational level, the 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 in order for trade to generate development and poverty reduction, then WTO liberalizations need to be accompanied by binding commitments to fund flanking investments. Such commitments are currently absent, suggesting that the development dimension of the Doha trade round is missing, according to the logic of its proponents.<sup>5</sup>

### 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. One 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. Tariffs follow a hump-shaped Laffer curve.<sup>6</sup> A zero tariff will yield zero tariff revenue. Likewise, a massive tariff may yield low revenue by making imports too expensive and thus pricing them out of the market. The maximum revenue-raising tariff is somewhere above zero, yet the WTO regime is philosophically dedicated to the removal of all tariffs.

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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 an excessive focus on exports stands to generate degraded competition between Southern

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economies. Countries will find themselves crowding each other out and pushing down prices of the goods they sell. Fifty-six 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. Finally, 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.

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In sum, the new public-investment-enhanced version of trade as development remains afflicted by longstanding 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-styled trade liberalization.

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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 every trader finds a niche. Even though countries may have an absolute advantage in nothing, the international economy makes a place for everyone by prompting countries to specialize in what they are relatively best at. However, this conclusion assumes global full employment and globally scarce labor. It does not apply 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 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 an industry that might have provided 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 also large rural societal disruption costs. Farming communities are destroyed, and former farmers migrate to the cities. Urban workers are then hurt both when increased urban labor supplies lower wages and when 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. 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 each country's readiness to engage in international trade. A sports metaphor can help understand this critique.

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Putting a heavyweight boxer in the ring with a lightweight will result in an unfair fight since the boxers are unequally matched. This can hold for trade; countries need to prepare themselves for international engagement. Such preparations might include 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 19th century.

In sum, the new public-investment-enhanced version of trade as development remains afflicted by longstanding 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-styled trade liberalization.

### 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 (1) it often relies heavily on imported inputs, and (2) no domestic distribution, marketing, retailing, or servicing are developed, because the market is off-shore.

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Not only can a domestic commercial focus yield larger development multipliers, 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 that they cause inefficient trade diversion. The supposed inefficiency results from countries trading with their neighbors rather than with 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 and thus avoid the heavyweight-lightweight mismatch problem. Second, the value created in production and trade is captured within the region rather than being siphoned off to



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the North. Third, such trade can economize on the use of expensive foreign-exchange reserves.

A second alternative approach is value-chain analysis.<sup>7</sup> Traditional 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 fair 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 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 globalization and product branding, which have altered bargaining power along the stages of production.<sup>8</sup>

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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.

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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 of the production chain.

These changes harbor 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 that they created. This in turn enabled workers to organize unions and thereby capture some of that value for themselves. In today's global economy, apparel and textile manufacturers have lost the power to capture value, explaining why it is so difficult to organize unions in these sectors.

To some degree these changes generate price benefits for Northern consumers, but a lot of the shift in gains accrues to branding firms and powerful retailers situated at end of the value chain.<sup>9</sup> For developing countries, the problem is clear. They are at the beginning the value chain and are capturing less and less value as globalization takes hold. Conventional trade liberalization does not address this problem; in fact, it appears to 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

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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 Southern brands? Can global labor standards help capture value by prescribing a floor that ensures that a minimum level of value is retained within each country? Such labor standards would also then stimulate domestic commerce because workers would earn higher wages. Finally, do WTO rules eliminate some worthwhile policy instruments such as local content requirements and industrial policy?

### Trade Policy: The Baby and the Bath Water

Revolutions of thought tend to throw the baby out with the bath water. The same holds for counter-revolutions. In historical macroeconomics, Keynesians (but not Keynes) tended to disregard both incentives and market forces and instead narrowly emphasize the effects of aggregate demand. The 1970s monetarist counter-revolution in turn restored the importance of incentives and markets but disregarded the Keynesian factor 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 a doubt, that paradigm was in need of reform. In many countries, rent-seeking had led to permanently high tariffs, and local industries showed no tendency toward becoming internationally competitive. Countries also pursued capital-intensive showcase industrial projects that were costly, failed to meet

size requirements for efficiency, and contained no hint of global comparative advantage. As such, these projects lacked economic and commercial logic, and the countries would have been better served by investing their scarce resources elsewhere.

That said, the import-substitution paradigm had a strong domestic development component, encouraging national production capacity and commercial development since output was sold in the domestic market. Rather than completely abandoning import-substitution, developing nations should have enacted measures to diminish rent-seeking and promote competition.

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

The existence of tariffs attracts rent-seeking. One possible institutional response is the creation of independent, accountable tariff boards that operate in the public sunlight and at some distance from

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politicians. Such tariff boards could be modeled after independent central banks with the International Monetary Fund (IMF) and World Bank serving as external monitors.

Marketing boards should also be revived. In colonial times these boards served a constructive role, providing an incentive for small farmers to connect with the market economy. By administering a centralized distribution network, they generated economies of scale and scope that lowered marketing costs and earned higher prices, thereby garnering more value for small farmers. The boards were also paired with agricultural extension services, which provided technical assistance to small farmers and boosted agricultural productivity. However, marketing boards were subject to manipulation 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, autonomous boards modeled along the lines of independent central banks and externally monitored by the IMF and World Bank.

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The focus would be on those commodities that most benefit developing countries and where Northern subsidies are most damaging.

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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 purged. That means political honesty and integrity are critical, giving rise to the perennial query, “Who will guard the guardians?” Transparency and accountability laws are key, as are freedom of the press and democratic structures to maintain political and electoral checks. NGOs have a role to play, as does open and public consultation by the IMF and World Bank. Without the political will to check corruption and rent-seeking, the above policies could do more harm than good. If governments are thoroughly venal, it may be better to curb their powers, reduce their tax revenues, and just leave the money in the hands of private agents.

This leads to an important point. Trade liberalization is frequently justified as eliminating corruption and rent seeking. This is a mistake. If the problems are corruption and rent seeking, then the need is for political and institutional measures that directly address these concerns while retaining policies that foster growth and development. Trade liberalization may reduce corruption, but it also jettisons 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, public policy should directly promote these features.

### 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 or bad) outcomes. In general, extremes (feast or famine) are undesirable; it is better to have a smooth flow of income and employment. Consequently, policy should avoid radical shifts. This insight has relevance to trade



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liberalization, where there is much uncertainty and dispute about impacts.

Globalization poses the additional problem of lock-in; there is a danger of implanting policies that are hard to reverse. Comprehensive changes may entrench policies that turn out to be undesirable and that lock out desirable alternative options.

The implication of these two arguments is that small, incremental changes are best. This is a very different line from the “bicycle momentum” metaphor peddled 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; otherwise it will lose momentum and fall over. By contrast, a go-slow perspective recognizes that it is better to fall over than to cycle off a cliff.

### A Tropical-Products Round

The notion of incremental trade liberalization suggests the idea of a tropical-products trade round involving commodities such as rice, sugar, cotton, and orange juice. The focus would be 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. In the South there would be some losers among those countries that import but do not produce any tropical commodities, as prices would rise owing to the elimination of Northern subsidies. 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 Northern taxpayers from the elimination of specific agricultural subsidies. Third, consumers would enjoy lower prices as quotas were dismantled. Fourth, Northern labor would appreciate benefits both as consumers and taxpayers, while manufacturing would be unaffected. Northern industrialists might complain that they get no benefits from the agreement, but they would not be hurt, and all they could claim is that this would be a missed opportunity. Finally, Northern producers of tropical products are poorly positioned to oppose the move since they tend to be large agribusinesses whose political profile is unappealing. This contrasts with taking on the dairy and grain farming lobbies, who have a more amicable political profile.

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Even if a tropical-products round ends up being rejected, advocating it can serve a useful political purpose.

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## 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. An insider tack could encourage genuine pro-development trade policies at the WTO. A second strategy could highlight the fundamental flaws in the WTO economic analysis of trade. The perennial danger, of course, is that engagement inside the WTO might further entrench the legitimacy of the WTO's views on trade. To avoid this, all engagement must reject any *quid pro quos*, and insider proposals must be accompanied by a vocal outsider presence that challenges the economic thinking embedded in the WTO. However, we need to be clear that this outsider challenge is not a rejection of trade *per se*, but rather a criticism of the current WTO mindset regarding trade and development.

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## END NOTES

- <sup>1</sup> In 2002 I wrote about such an alternative development framework, which can be found at [www.thomaspalley.com](http://www.thomaspalley.com) and [www.fpif.org](http://www.fpif.org).
- <sup>2</sup> See Bhagwati and Srinivassan, 1999.
- <sup>3</sup> 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)
- <sup>4</sup> See World Bank Institute (2003).
- <sup>5</sup> 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 assistance may see aid for trade largely displacing existing grants, and therefore generating little net advantage. For these reasons, the aid-for-trade agenda is full of pitfalls.
- <sup>6</sup> The Laffer curve is named after Arthur Laffer, who originally described the hump-shaped relationship between tax rates and tax revenues.
  - <sup>7</sup> The seminal paper on value-chain analysis is Gereffi (1994).
  - <sup>8</sup> Economists talk about moving up the value-added chain, but their focus is on stages of production. The current focus involves a bargaining-power perspective, with globalization and product branding altering bargaining power along the stages of production.
  - <sup>9</sup> 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).

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