Previous chapters have described the benefits of free trade and the costs of import protection, but many observers are skeptical that open trade policies can improve conditions in poor countries where a majority of the world’s population live. This chapter examines whether the case for free trade is qualified by the special circumstances of developing countries. Recent experience suggests that developing countries can reap substantial benefits from adopting more open trade policies, but that such policies alone do not guarantee development, particularly when corruption, civil conflict, excessive regulation, and other institutional failings prevent local entrepreneurs from taking advantage of world markets. This chapter also discusses developed country policies that are harmful to developing countries, such as agricultural protectionism, import barriers on labor-intensive manufactured goods, and requirements that labor standards be a condition for trade.

Trade Policy and Developing Countries

In past decades, developing countries were reluctant to participate in the world economy. Many people in poorer countries feared that rich countries would dominate and exploit them. Powerful foreign multinationals, it was believed, would gain control of small economies unless governments restricted their activities. Furthermore, the prevailing view among

1“It is sometimes difficult for sophisticated economists and politicians to understand the deep historic and cultural problems some [developing] countries have with the idea of free trade. Some still equate it with oppression from colonial days.” This comment comes from Mike Moore, the former director-general of the WTO. Moore 2003, 133.
economic experts in the 1950s and 1960s was that developing countries had limited opportunities to achieve growth through exports. International trade was expected to reinforce their comparative advantage in the production of simple primary commodities, thereby locking them into a pattern of specialization that would forever prevent their economic development.

Over the past two decades, these conclusions have been proven false. Countries that restricted foreign trade and investment may have avoided foreign exploitation, but remained desperately poor nonetheless. Meanwhile, international trade created opportunities that in fact promoted development and reduced poverty. Many countries that encouraged trade did not remain stuck producing just raw materials, but began exporting an increasing array of labor-intensive manufactured goods.\(^2\)

However, as a legacy of the past, developing countries have had to overcome severe trade-related policy distortions, including quantitative restrictions on imports and exports, high tariffs, overvalued exchange rates, and administrative controls on foreign exchange allocation. Politically powerful interest groups, including state-owned enterprises that fear competition and government bureaucrats whose power is derived from their decision-making authority, have fiercely resisted trade liberalization and often have been able to block trade reforms. As a result, even after many developing countries have reduced tariffs and liberalized trade policies, they still have much higher tariffs than developed countries. As table 3.1 showed, import tariffs in developed countries are less than 5 percent, on average, while those in developing countries are substantially higher, in the range of 10 to 30 percent, on average. Although developing country tariffs are significantly lower than a decade ago, these tariffs are often just the tip of the iceberg, as many of these countries have in place significant nontariff barriers to trade. Thus, there is ample room for further reforms of trade policy in the developing world.

Of course, free trade is not the single most important factor behind economic development. For many countries, reforms in other areas may be of greater importance and hence a more urgent priority. These include ensuring the security of property rights, providing legal institutions

\(^2\)Krueger (1997) provides an excellent analysis of how the old view of trade and development, based on erroneous assumptions and expectations, eventually gave way in the face of contrary evidence.
that support market transactions (enforcing contracts, etc.), and encouraging the development of financial markets. In many instances, these goals can be achieved not by proactive government policies, but by eliminating poor policies and counterproductive practices: the government should not arbitrarily confiscate or expropriate goods or property, should not protect monopolies and create obstacles to new business formation, should not suppress financial markets with heavy-handed regulations, and so forth. Other nontrade reforms may require proactive government policies, such as improving public health and access to schools.

Still, trade policy reforms can play an important contributing role in promoting development. Recent experience has demonstrated that a shift toward more liberal trade policies can bring about striking improvements in economic performance. This in turn leads to improved socio-economic outcomes, including the reduction of poverty, malnutrition, and infant mortality.

Consider the following statement:

History makes a mockery of the claim that trade cannot work for the poor. Participation in world trade has figured prominently in many of the most successful cases of poverty reduction—and, compared with aid, it has far more potential to benefit the poor. . . . Apart from financial benefits, export growth can be a more efficient engine of poverty reduction than aid. Export production can concentrate income directly in the hands of the poor, creating new opportunities for employment and investment in the process. . . . Experience from East Asia illustrates what is possible when export growth is broad-based. Since the mid-1970s, rapid growth in exports has contributed to a wider process of economic growth which has lifted more than 400 million people out of poverty. In countries such as Vietnam and Uganda, production for export markets has helped to generate unprecedented declines in the levels of rural poverty. Where export growth is based on labour-intensive manufactured goods, as in Bangladesh, it can generate large income gains for women. . . . The benefits of trade are not automatic—and rapid export growth is no guarantee of accelerated poverty reduction. Yet when the
potential of trade is harnessed to effective strategies for achieving equitable growth, it can provide a powerful impetus to the achievement of human development targets.

This statement did not come from a globalization cheerleader, but from Oxfam, the British charitable organization that is also very critical of the current system of world trade. Oxfam is among the growing number of nongovernmental development organizations recognizing that open trade policies enable countries to benefit from the growth of world trade.

The conclusions expressed in Oxfam’s statement are supported by empirical analyses of the relationship between trade and growth focusing specifically on developing countries. One recent study by David Dollar and Aart Kraay examined the top one-third of all developing countries in terms of the increase in their trade-to-GDP ratio since 1980. These countries—the “globalizers”—experienced a 5 percent annual increase in real per capita income, whereas the other developing countries—the “nonglobalizers”—saw only a 1.4 percent annual increase in real per capita income. The globalizers also cut import tariffs by twice the margin of nonglobalizers.

Individual country case studies reinforce the conclusions of the cross-country studies. As Dollar and Kraay note: “There are many interesting pair-wise comparisons between the globalising group and the non-globalising group: Vietnam versus Burma, Bangladesh versus Pakistan, Costa Rica versus Honduras. In each of these cases, the economy that has opened up more has had better economic performance.” Indeed, greater trade openness—marked by rising trade and low or declining trade barriers—has been a feature of virtually all rapid-growth developing country experiences in the last fifty years.

It is sometimes believed that globalization has been imposed on countries. Yet globalization is also a choice. Through their trade and foreign investment policies, countries can choose the degree to which they want to be a part of the world economy. Cambodia, Vietnam, and Uganda
have embraced the world market and have seen their trade-to-GDP ratios soar. Meanwhile, trade has shrunk as a part of the economies of Egypt, Nigeria, and the Dominican Republic. Some of these declines may be due to domestic disorder, macroeconomic mismanagement, or reduction in demand for country-specific goods (such as Zambia's copper), but some also represent government policies that deliberately hinder the ability of citizens to participate in the world economy. For example, Egypt, once one of the great trading nations of the world, currently has an export- (or import-) to-GDP ratio of only about 12 percent, a fraction of what it is for many export-oriented developing countries. Egypt's own policies have stifled trade and kept this ratio artificially low. Many parts of the world that chose not to participate in the world economy have succeeded in being marginalized.

The greatest example of a country turning its back on the world economy is China in the fourteenth century. The imperial court prohibited any foreign trade (without official permission) for about two centuries after 1371, even going so far as to forbid the construction of new seagoing ships in 1436. While these efforts did not completely eliminate trade, they severely curtailed it at a time when Chinese merchants were very active in the Indian Ocean and Africa. China's action did not stop globalization. But China lost its technological leadership and fell very far behind the rest of the world in military and commercial strength. Eventually it fell prey to political domination by the West in the nineteenth century.

That lesson still holds true today: countries that deliberately seek to isolate themselves from the world will only find their living standards falling behind those of other countries. The failed, autarkic state of Burma is a sad reminder of this fact. In the Middle East, too, many countries have resisted joining the world economy. At the time of the September 11, 2001, attack on the World Trade Center and Pentagon, Saudi Arabia, Iran, Iraq, Syria, Afghanistan, Algeria, and other countries in the region had one thing in common: they were not members of the World Trade Organization. With over 150 members, the WTO is not an exclusive club that has shunned them. Instead, these countries did not (until recently) feel compelled to become part of the club, a symptom of their disengagement with the rest of the world. According to the UN's Arab Human Develop-

7 Lindsey 2001.
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ment Report, many societies in the Middle East are closed, their economies stifled, their peoples repressed. They do not encourage business formation or welcome foreign investment, the exchange of goods across borders, or even international trade in ideas. According to the report, the Arab world translates about 330 foreign books annually, one-fifth of the number that Greece alone translates. Perhaps not surprisingly, the report found that one in two Arab youths is dissatisfied with the prospect of living in a closed society and has expressed a desire to emigrate.8

_______Two Billion People—China and India

Perhaps the most compelling examples of how more open trade policies can facilitate economic growth and development come from the two most populous countries in the world—China and India. Over the past quarter century, both countries have shifted from economic isolation to economic integration with the rest of the world. Both countries are now growing rapidly and have made remarkable strides in reducing poverty and raising the standards of living of their citizens.

Before 1979, China was virtually closed to world trade. China’s trade operated under a strict system of state trading in which about a dozen foreign trade corporations monopolized all international trade. China followed a Soviet-style system of central planning that suppressed foreign trade and made import-substitution industrialization its overriding objective. Imports were minimized and exports were authorized only to the extent required to pay for imports.9 The policy succeeded in building up domestic manufacturing, but investments in heavy industry failed to improve the welfare of China’s citizens.

In December 1978, China began to end its policy of economic isolation. Under the leadership of Deng Xiaoping, the government de-collectivized agriculture, freed foreign exchange transactions, allowed private entities to trade, and permitted foreign investment. Although reforms

9“To achieve the goal of a self-reliant industrial economy, domestic industry was protected from foreign competition by direct controls on imports and investment and administrative allocation of foreign exchange combined with an overvalued currency. These policies, enforced by central planners and a central foreign trade monopoly, built an airtight wall between the domestic economy and the world economy.” Shirk 1994, 8.
were gradually introduced over the 1980s and 1990s and went well beyond trade policy alone, the opening of China’s economy to the world was a critical component of these changes. In 1992, the weighted average tariff on manufactured goods was over 45 percent. Since China joined the WTO in 2001, the country’s average tariff will eventually fall to less than 7 percent.  

The results have been stunning. China’s exports and imports have soared, as figure 3.1 illustrated. China’s share of world trade rose from about 1 percent in 1980 to more than 8 percent in 2006. Foreign investment in China has grown from virtually nothing in 1979 to more than $600 billion in 2006. As figure 6.1 shows, China’s real per capita income has grown at near double-digit rates since the 1980s, making it one of the fastest-growing countries in the world. As a result, the official rate of poverty fell from 28 percent in 1978 to 9 percent in 1998.  

Of course, China did not just open up to trade, it fundamentally changed the way its economy was organized. Yet the decision to open to

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For reference:

10 Ianchovichina and Martin 2004, 9.
11 Bhagwati and Srinivasan 2002.
the world was not inevitable; it had a large internal market and could have pursued import substitution or industrial policies. But its trade policy reforms were a vital component of its broader reforms and have played a critical role in its economic success.

India is another example of a country that dramatically improved its economic performance after moving to freer trade policies. For about four decades after becoming independent in 1947, India pursued a policy of self-sufficiency and industrial planning that required elaborate and complex import restrictions. Importing anything that was not explicitly on a government list of approved items was forbidden. Imports of “non-essential” consumer goods were banned, and those deemed “essential” (food, pharmaceuticals, etc.) were imported and sold only by state agencies. A labyrinth of government requirements—permissions, licenses, and certifications—had to be met before intermediate and capital goods could be imported.

Bureaucrats and politicians justified these draconian policies on several grounds. Government control over industry and trade was deemed essential to conserve resources and eliminate wasteful competition. The scarcity of capital was held to justify government approval for investment projects. The shortage of foreign exchange, it was believed, meant that hard currency should be allocated by government officials rather than by the market to ensure its use for projects in the “national interest.” The fear of foreign domination lurked behind many of these policies and created resistance to market-based solutions in favor of government-directed ones.

Unfortunately, the outcome was a disgrace—sluggish growth, persistent poverty, inefficient industry, and lagging modernization. According to one quip, India suffered from four hundred years of British imperialism and fifty years of the Fabian socialism of the London School of Economics—and it is not clear which did more damage.¹²

However, an economic crisis in 1991 forced reluctant policymakers to undertake a radical shift in policy.¹³ India abandoned parts of its

¹²In the early and middle twentieth century, the London School of Economics was home to Fabian socialist ideas that influenced generations of Indian policymakers. Moore 2003, 132.

¹³The collapse of Communism and China’s success in opening up its economy also helped convince Indian policymakers that state planning was a failure.
central planning system and abolished the requirement of government permission for all industrial investment expenditures, with some exceptions. Indian firms were permitted to borrow on international capital markets, the rupee was devalued and made convertible, quantitative restrictions on imports were abolished, export subsidies were eliminated, and import duties were cut from an average of 87 percent in 1990 to 33 percent in 1994. Nontariff barriers covered 95 percent of all imports in 1988 but just 24 percent in 1999. The “license raj”—the rigid and complex system of import controls and foreign investment restrictions administered by government bureaucrats—was dismantled, unleashing the private sector from red tape but also exposing it to international competition.

The outcome has been astonishing. As figure 6.2 shows, growth in real per capita income in India began to pick up in the mid-1980s, when some tentative steps toward reducing import barriers and investment controls were taken, and accelerated after 1991. The reduction in

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**Figure 6.2**

Real per Capita GDP in India, 1950–2004. Major trade reform was initiated in 1991.

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15 There is some controversy about the timing of the acceleration in growth and what triggered it. Srinivasan and Tendulkar (2003, 23) argue that “growth performance was distinctly better in the 1980s than in the earlier period” because of a real exchange rate depreciation rather than trade liberalization. “This surge in growth, however, was supported on the demand side by unsustainable fiscal policies, and it ended with an economic crisis in 1991.” Rodrik and Subramanian (2004) argue that an attitudinal shift toward a more
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Trade barriers have also been linked to higher productivity; by one estimate, India experienced a 20 percent increase in aggregate productivity growth and a 30–35 percent increase in intraplant productivity following tariff liberalization.16 Most important, the poverty rate has fallen from 45 percent in 1983 to 26 percent in 2000, improving the lives of tens of millions of Indians.17

The power of economic reform is illustrated by considering seven entrepreneurs who in 1981 started a small business in India with $250 of seed capital. The Indian government created huge obstacles to the setting up of the business. As one of the founders later recalled, “It took us a year to obtain a telephone connection, two years to get a license to import a computer, and 15 days to get foreign currency for travel abroad. . . . The first ten years of our marathon seemed interminable and frustrating. Although we managed to keep our heads above water, we were floundering.”

The lifeboat that rescued the firm and allowed it to flourish was India’s deregulation and economic liberalization in 1991. That firm is Infosys Technologies Ltd., now one of the largest and most successful software companies in the world, and that entrepreneur is N. R. Narayana Murthy, the chairman and CEO of Infosys. According to Murthy, the economic reforms of 1991 “changed the Indian business context from one of state-centered, control orientation to a free, open market orientation, at least for hi-tech companies.” That allowed the company to grow so that it could eventually employ thousands of Indians at relatively high wages. “We at Infosys . . . have never looked back,” Murthy says. “The lesson from the Indian experience is a clear clarion call for all who are willing to listen: free trade can bring great benefits to society.”18

China and India provide dramatic illustrations of the improvement in economic circumstances that can result when poor economic policies are replaced with better ones, particularly with respect to international pro-business stance on the part of the government accounts for the pickup in growth after 1980, prior to economic liberalization, the importance of which they downplay. Panagariya (2008) argues that liberalization in the late 1980s played a crucial role in increasing growth, but that it remained fragile and solidified only after the 1991 economic reforms.

16Sivadasan 2003.
17World Bank 2003, 7.
trade. Higher incomes translate into tangible improvements in the well-being of millions of people. This improvement in well-being cannot be measured in terms of dollars and cents alone, but in the lives that are saved as a result of moving people away from the knife edge of poverty, where a bad harvest or the loss of a job can spell malnourishment or even death. Hunger and malnutrition, illiteracy, and infant mortality persisted for decades after China adopted central planning in 1949 and India received political independence in 1947. Because of the economic opportunities that opened up after the 1978 and 1991 reforms in China and India, respectively, hundreds of millions of people have a chance to join the middle class.

Thus, the higher income that comes with freer trade is important not just for crass material reasons, but because it can lead to a better life. With higher incomes, families can pay for more and better food, gain access to medicines and better health care, and afford schooling for their children. One study examined the direct connections between trade openness and a society’s health outcomes, specifically infant mortality and life expectancy. Even after controlling for a country’s per capita income, average years of schooling, number of doctors per capita, and other factors, people in countries with lower tariffs had longer life expectancy and lower infant mortality. For example, an eleven-percentage-point reduction in the tariff rate—a change of about one standard deviation in the sample—is associated with between three and six fewer infants dying per thousand live births. Such findings are a powerful reminder of the life-and-death stakes of good and bad economic policies.

The tragedy of India is that, by delaying economic reforms for so many decades, it contributed to the impoverishment of its people for so long. One Indian businessman writes with dismay:

Most people remember the Emergency [suspension of democracy between 1975 and 1977] because it represented a generalized loss of liberty. They do not understand that by suppressing economic liberty for forty years, we destroyed growth and the future of two generations. For the average citizen it was a great betrayal. Lest we forget, we lived under a system where a third of the people went hungry and

19Wei and Wu 2003.
malnourished, half were illiterate while the elite enjoyed a vast system of higher education, and one of ten infants died at childbirth. Our controls and red tape stifled the entrepreneur and the farmer, and the command mentality of the bureaucrat, which fed the evil system, continues till today to frustrate every effort at reform.”

India has paid a very heavy price in human lives for delaying its reforms. But what China and India have accomplished is stunning. Though both countries still have a long way to go, the improvement in human well-being achieved over the past generation is mind-boggling.

Of course, not all of the improved economic performance of China and India can be attributed to more liberal trade policies. China moved away from a system of central planning and collective agriculture, while India freed up bureaucratic obstacles to domestic investment. Nonetheless, trade reforms were a key component of the overall economic reforms. Both countries deliberately shifted from closed economies to ones more open to international trade.

Trade Policy Reform: Successes and Failures

China and India are dramatic examples of the tangible benefits of economic reform and international trade. On a smaller but no less dramatic scale, other developing countries have changed their economic orientation to the world and have seen improvements in economic performance.

In the mid-1960s, Korea completely changed its trade strategy. The proportion of items automatically approved for import went from zero in June 1964 to 63 percent by December 1965. Korea’s currency (the won) was devalued by nearly 50 percent, and a unified exchange rate was adopted. In 1967, many import quotas were abolished and tariffs were sharply reduced. The effective tax on imports fell from nearly 40 percent in 1960 to 8 percent by 1967. Figure 6.3 shows the marked acceleration in Korea’s growth of per capita income from around the time of these changes.21

20 Das 2001, 175.
21 Frank, Kim, and Westphal 1975, 75.
In the mid-1970s, Chile also sharply changed its trade policy. Between 1975 and 1979, Chile eliminated all quantitative restrictions and exchange controls and reduced import tariffs from over 100 percent to a uniform 10 percent. After suffering a severe economic recession due to a banking crisis in the early 1980s, Chile continued trade liberalization. The payoff materialized in a 7 percent average annual growth rate for more than a decade after 1986.\(^\text{22}\)

In the middle and late 1980s, Vietnam adopted economic reforms that helped increase economic growth to an average of more than 7 percent in the late 1990s and early 2000s. As in China, agricultural land reform helped jump-start the growth process. But trade and foreign investment have been important components of Vietnam’s success. The poverty rate has been slashed in a remarkably short time. The share of the population living in absolute poverty fell from 75 percent in 1988 to 58 percent in 1993 to 37 percent in 1998 to 29 percent in 2002. The

\(^{22}\)Edwards and Lederman 2002.
opening of trade contributed directly to this process since exports of rice and labor-intensive manufactured goods are produced by poor households. After the implementation of a U.S.-Vietnamese trade agreement in 2001, Vietnam’s exports to the United States doubled in 2002 and again in 2003.

Unfortunately, not all countries that have liberalized their trade policies have enjoyed such dramatic successes. For example, Mexico significantly reduced tariffs and other trade barriers when it joined the GATT in 1985 and signed free trade agreements with the United States and Canada (NAFTA) in 1994 and the European Union in 2000. As a result, Mexico’s trade and foreign investment increased significantly. The share of trade (average of exports and imports) in GDP rose from 13 percent in 1985 to 32 percent in 2002. These reforms improved productivity in industries exposed to international competition, as described in chapter 2.

However, Mexico’s overall macroeconomic performance has been disappointing since NAFTA. Economic growth has been lackluster, employment is only slightly higher than before the agreement took effect, and real wages are actually lower. NAFTA opponents blame open trade for Mexico’s problems. These critics say that NAFTA has harmed farmers and is responsible for the lack of improvement in the standard of living of workers.

The real source of Mexico’s malaise is macroeconomic. In December 1994, about a year after NAFTA went into effect, and for reasons not related to the trade agreement, Mexico faced a speculative attack on the peso and was forced to devalue its currency. The peso crisis stemmed from an inconsistency between Mexico’s monetary policy and its commitment to maintain a fixed exchange rate. The peso devaluation was a severe setback that slashed real wages overnight and sent the economy into a deep recession.

By keeping trade flows moving, NAFTA helped the Mexican economy through a difficult period. The continued expansion of trade promoted the country’s recovery from this traumatic shock. Yet since the initial rebound, the Mexican economy has been weak. The reason for this disappointing performance is not trade related, but a persistent and severe credit crunch, including a deterioration in contract enforceability.

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23 Dollar and Junggren 1997.
and an increase in nonperforming bank loans. Indeed, Mexico’s credit-to-GDP ratio fell from 49 percent in 1994 to 17 percent in 2002, preventing any broad-based economic recovery.  

A decade after NAFTA went into effect, a Carnegie Endowment for International Peace study concluded: “Put simply, NAFTA has been neither the disaster its opponents predicted nor the savior hailed by its supporters.” The report also noted that “NAFTA has accelerated Mexico’s transition to a liberalized economy without creating the necessary conditions for the public and private sectors to respond to the economic, social, and environmental shocks of trading with two of the biggest economies in the world.” This suggests that other complementary policies are required if trade liberalization is to succeed in improving welfare, a point that will be discussed below.

Unfortunately, Mexico is not alone. Other developing countries significantly reduced tariffs in the 1990s but also have not performed well. In Latin America, Colombia cut its tariffs by more than half in 1991, while Argentina and Nicaragua reduced them from over 100 percent to just 15 percent in one stroke in 1992. In Africa, Kenya reduced its import duties from over 40 percent in the early 1980s to under 15 percent by the late 1990s. Yet the people of these countries have not seen much improvement in their standard of living.

This disappointing performance is sometimes interpreted as indicating that trade liberalization and increased integration with the world have failed to help developing countries and that therefore the strategy should be abandoned. This is the wrong conclusion to draw. In the case of Argentina, for example, monetary and macroeconomic instability—arising from excessive borrowing abroad and the resulting buildup of foreign debt—have had devastating effects far beyond any good that open trade could bring. Colombia and other countries have had to endure “shock therapy” to end hyperinflation and hemorrhaging budget deficits, forcing the economy through wrenching adjustments that overwhelmed the impact of trade liberalization. Until the mid-1990s, the overvaluation of West African currencies tied to the French franc severely

constrained the ability of West African countries to stimulate growth through exports.\textsuperscript{27}

In its review of the economic reform and growth experience of the 1990s, the World Bank conceded that “the results of trade reforms have varied and sometimes fallen short of expectations.”\textsuperscript{28} It went on to say: “Trade reforms are most likely to stimulate growth when they are part of a comprehensive strategy. Important elements of an effective growth strategy can include sound macroeconomic management, building of trade-related infrastructure and institutions, economy-wide investments in physical and human capital, greater access to developed- and developing country markets, and maintenance of a sound rule of law. Because these elements are often difficult to implement, there has been excessive emphasis on trade policy alone, rather than as a component of an overall growth strategy.”

One recent lesson is that excessive regulation and a poor domestic business environment may prevent trade liberalization from stimulating growth. One study reports that increased openness to trade leads to higher incomes in flexible economies, but not in heavily regulated ones. Specifically, a 1 percent increase in trade is associated with a 1/2 percent rise in per capita income in countries that allow the free entry of firms into sectors that they choose, but has no positive impact on income in countries that restrict business entry.\textsuperscript{29} If excessive regulations prevent resources from moving to the economy’s most productive sectors and firms, then trade liberalization will fail to improve incomes. A sound domestic environment for business is required for countries to take full advantage of policy reforms that encourage global trade. Highly regulated economies are likely to perform better if they sweep away

\footnotesize{\textsuperscript{27}“Liberalization of trade in Argentina in the 1980s and 1990s, and in Chile in the early 1980s, for example, was accompanied by an appreciation of the real exchange rate, which reduced the competitiveness of domestic industries and incentive to export—with adverse consequences for the balance of payments and real economy. In many countries of the former Soviet Union and some in Eastern Europe in the 1990s, trade was liberalized while property rights were not well defined and the institutional base for a market economy was not well developed. These, and other institutional issues preventing the free movement of resources, often meant that trade reforms did not expand economic opportunities but restricted them instead.” World Bank 2005, 137.}

\footnotesize{\textsuperscript{28}World Bank 2005, 131, 137–38.}

\footnotesize{\textsuperscript{29}Freund and Bolaky 2008.}
domestic impediments to economic activity before embarking upon trade reforms.\textsuperscript{30}

Indeed, in some developing countries, administrative controls and poor infrastructure may be more important obstacles to trade than tariffs alone. Inefficient customs and tax administration have hampered exporters who require imported components and materials for production. For example, a business in the Central African Republic has to take fifty-seven days to complete all the export formalities, submitting eight documents to different government agencies, and spend $4,581 before a container can leave the port in Yaoundé, in neighboring Cameroon. In Angola, a ship arriving in the port of Luanda must wait an average of eight days before landing, a delay that can stretch to fourteen days during the rainy season. It is estimated that each additional day that an export product is delayed reduces exports by more than 1 percent, and the effect on time-sensitive agricultural exports is even more dramatic.\textsuperscript{31}

High transport costs and poor infrastructure can prevent trade liberalization from boosting trade in low-income developing countries. Landlocked countries are at a particular disadvantage in world trade since land transport charges have been estimated to be seven times greater than sea transport costs. Studies have found that higher transport costs and weak infrastructure explain much of Africa’s poor trade performance.\textsuperscript{32} For example, in sub-Saharan Africa, transport costs are five times greater than tariff charges.

Simply chopping import tariffs does not in itself solve these problems. If goods are stranded for weeks at port, or roads are impassable due to the rainy season, cutting tariffs from 20 percent to 10 percent will not make much difference. As formal barriers fall, the quality and reliability of transport infrastructure (including roads, railways, airports,

\textsuperscript{30}The World Bank has started to examine the high costs of business regulation in developing countries. “It takes two days to start a business in Australia, but 203 days in Haiti and 215 days in the Democratic Republic of Congo. . . . A simple commercial contract is enforced in 7 days in Tunisia and 39 days in the Netherlands, but takes almost 1,500 days in Guatemala. The cost of enforcement is less than 1 percent of the disputed amount in Austria, Canada, and the United Kingdom, but more than 100 percent in Burkina Faso, the Dominican Republic, Indonesia, the Kyrgyz Republic, Madagascar, Malawi, and the Philippines.” World Bank 2004, xiii.

\textsuperscript{31}World Bank 2007, 44–45.

\textsuperscript{32}Limão and Venables 2001.
and seaports) and related services (including telecommunications and business services such as finance and insurance) are increasingly critical to trade.

For this reason, trade facilitation has become a priority in international forums such as the World Trade Organization. Trade facilitation is simply the logistics of moving goods through customs and includes such mundane things as port efficiency, inspections and documentation, transparency of government regulations, and so on. Some policy changes can make a difference. For example, in the early 1990s Argentina began allowing private firms to operate public ports and invest in their infrastructure. As a result, cargo handling increased 50 percent between 1990 and 1995 and labor productivity surged, making Argentine ports among the cheapest in Latin America.33

In sum, trade liberalization is not a magic bullet guaranteed to bring about rapid growth in trade and higher incomes. The right conclusion to draw is that the case for free trade requires a caution: other policies in developing countries can prevent the full benefits of trade liberalization from being realized. Many other factors—political conflicts, macroeconomic instability, a poor domestic business environment—can stand in the way of the beneficial effects of trade and can prevent freer trade from yielding the ultimate payoff of higher living standards.

Industrial Policy and the East Asian Miracle

Despite the success that many countries have had with economic liberalization, developing countries still fear the consequences of opening their markets to the world. The old concerns about foreign domination and imports destroying important domestic industries continue to exist. Many people still cling to the view that import substitution and protecting infant industries is the right approach to trade and development.

Import substitution refers to a deliberate policy of encouraging domestic production of manufactured goods in place of imports. Such policies were common in the 1950s and 1960s when industrialization was viewed as the key to economic development. Such policies often succeeded in building up capital-intensive industries and sometimes led to

33 WTO 2004, Box IIB.5.
high rates of output growth. But they often failed to improve standards of living because the high investment rates required to maintain growth in the capital stock detracted from growth in consumption. In the case of Communist China, about a third of national income had to be reinvested to maintain growth in the capital stock, leaving little left over for consumers.\textsuperscript{34}

These policies often turned out to be self-inflicted wounds. In many instances, capital-intensive industries were unsuited for developing economies that had a comparative advantage in labor-intensive industries. These industries required ongoing government support to function profitably. By sheltering firms from import competition, protectionist policies inhibited export growth and firms became inward looking, focusing on the domestic rather than the world market. This resulted in small and inefficient firms, since the domestic market was not large enough or competitive enough to promote firms that would be successful on the world market. India is the classic example of a country that built up many manufacturing industries by sheltering them from foreign competition, but failed to deliver a high standard of living to its people.

Although import substitution is widely acknowledged to have failed in comparison to export-promoting policies, export promotion may mean something more than free trade. Many observers point to the stunning growth of several East Asian countries and point to government industrial policies as the key to their success. The economic achievements of Japan in the 1960s and the “four tigers”—South Korea, Taiwan, Singapore, and Hong Kong—in the 1970s have raised new questions about free trade. Many contend that, with the exception of Hong Kong, these countries grew rich not because of free trade, but through wise government use of selective protection and targeted industrial policies.\textsuperscript{35}

These countries did many things right—they enjoyed peace and political stability, encouraged high savings and investment rates,\textsuperscript{34}\textsuperscript{35}

\textsuperscript{34}One consequence of this rising capital intensity of production was that gains in per capita consumption were very modest for a country in which per capita output grew relatively rapidly. Between 1957 and 1977, per capita national income rose at an average annual compound rate of 3.4 percent in real terms. Yet, because the share of output that had to be reinvested to sustain that rate of growth rose by fully one-third (from 25 percent in 1957 to an average of 33 percent in the 1970s), improvements in real living standards were quite modest.” Lardy 1992, 34.

\textsuperscript{35}Wade 2004. For a recent critique of industrial policy, see Pack and Saggi 2006.
emphasized the importance of education and human capital accumulation, provided stable macroeconomic and exchange rate policies, and so on. Korea and Taiwan also pursued important land reforms early in their transition that led to rapid productivity growth in agriculture. In other words, these East Asian countries enjoyed many favorable conditions noticeably absent elsewhere, particularly in Latin America and Africa.

With the exception of Hong Kong, however, these countries did not pursue policies of nonintervention with respect to industry. To varying degrees, governments were involved in the allocation of capital and other resources to promote industrialization, and even employed the tools of trade protectionism. Some observers have concluded that, because the Japanese and Korean governments intervened in their economies to promote certain industries, their economic performance can be attributed to these interventions. In this view, the East Asian experience illustrates how careful industrial policy and protectionism, not free trade, promote economic development.

Yet there are reasons to be skeptical about this conclusion. It is always tempting to reach a conclusion about causality on the basis of correlation: because Japan or Korea intervened in its economy or used protectionist trade measures, the success of the economy is due to that policy. But assessing the contribution of industrial policy to economic growth is a difficult challenge. In a 1993 report on the East Asian miracle, the World Bank noted that

their interventions did not significantly inhibit growth. But it is very difficult to establish statistical links between growth and a specific intervention and even more difficult to establish causality. Because we cannot know what would have happened in the absence of a specific policy, it is difficult to test whether interventions increased growth rates.\textsuperscript{36}

Thus, when several factors promoting a good outcome exist simultaneously—a stable political environment, a good educational system, high savings and literacy rates, and so on—it becomes difficult to determine the precise contribution of any one specific factor, such as industrial policy, to the outcome. One cannot rule out the possibility that government

\textsuperscript{36}World Bank 1993, 6.
intervention actually detracted from the economic success of the country but was more than offset by the other good forces.\textsuperscript{57}

In the case of Japan, the country’s success after World War II is sometimes attributed to the selective interventions by the Ministry of International Trade and Industry (MITI). MITI used “administrative guidance” to promote investment in and acquire technology for selected industries. Some argue that MITI was involved not just in “picking” winners by diverting resources to selected high-growth industries, but in “making” winners by ensuring their success on international markets.

But the actual evidence on MITI’s contributions to Japan’s success is weak. The two industries that achieved the most notable success on world markets—automobiles and consumer electronics—did not benefit from extensive government support, unlike some other heavy industries such as chemicals and steel. MITI also had notable failures in promoting its biotechnology and computer industries. In fact, one statistical study of Japanese industrial targeting found that a disproportionate amount of support went to low-growth sectors and sectors with decreasing returns to scale. This study failed to find evidence that productivity was enhanced as a result of industrial policy measures.\textsuperscript{58}

Qualitative studies of Japan’s policies lend support to this skeptical view. The consulting firm McKinsey concluded that robust domestic competition was a source of Japan’s success. In many instances, MITI did not foster but actually tried to reduce competition by forming domestic cartels. (In the case of automobiles, for example, it discouraged Honda from entering the market in the 1950s, thinking that there were already too many firms in the industry.) However, in the case of machine tools, MITI helped standardize tolerances used in machines, thereby allowing large-scale assembly of machine tools and applied electronics technology. As

\textsuperscript{57}As Adam Smith once opined, “The uniform, constant, and uninterrupted effort of every man to better his condition, the principle from which public and national, as well as private opulence is originally derived, is frequently powerful enough to maintain the natural progress of things towards improvement, in spite both of the extravagance of government and of the greatest errors of administration. . . . But though the profusion of government must, undoubtedly, have retarded the natural progress of England toward wealth and improvement, it has not been able to stop it.” Smith 1976, 343, 345.

\textsuperscript{58}Beason and Weinstein 1996. Ohashi (2005) finds that there were few intra-industry knowledge spillovers in the case of Japan’s steel industry and that export subsidies did not help the industry’s growth.
one McKinsey analyst reported, “In all our studies of Japan, this is the only action by MITI that we found to have had a significant beneficial impact on the Japanese economy.”³⁹ If this is MITI’s one success, the importance of MITI has been vastly overrated.

South Korea may provide a better example of government industrial policy. Under the military dictatorship of Chung Hee Park, the Korean government employed competent technocrats who were directly involved in economic planning and investment allocation. These bureaucrats were insulated from political decisions and thus did not fall prey to corruption. The principal tool at their disposal was directed credit, which they used to promote capital-intensive industries such as chemicals, steel, and shipbuilding. While the government was involved in strategic decisions about the economy, it did not implement these decisions through state-owned firms or nationalized industries. Rather, once the government and private sector negotiated economic goals and the means to carry them out, the private firms were responsible for executing them. Furthermore, these firms were not insulated from competition; instead, they were encouraged to export and face the full brunt of international competition.

Still, as described earlier in this chapter, what jump-started the Korean economy in the mid-1960s was not industrial policy, but other reforms, including trade and exchange rate policy. One can also question the contribution of the technocrats to Korea’s rapid growth since that time. Despite the government’s emphasis on building up heavy capital-intensive industries, light labor-intensive industries increased productivity at a more rapid rate during the 1960s and 1970s. Indeed, during the 1970s, the most rapid growth in sectoral shares of value added occurred in lower-wage or low value-added per worker sectors.⁴⁰ Furthermore, as in the previously mentioned study of Japan, measures of Korean industrial policy (such as tax incentives and subsidized credit) are not correlated with productivity growth at the industry level.⁴¹ Korea’s use of directed credit to promote industrial growth has also led to problems. Korean industry suffers from gross overinvestment and is far too reliant on capital-intensive production methods. Nonperforming loans and

³⁹Lewis 2004, 40.
⁴¹Lee 1996.
weakness in the banking and financial system are related to major economic crises in 1979–81 and 1997–98.

Several points stand out from the Korean experience. First, private firms were not shielded from competition but rather exposed to it and forced to meet the test of international markets. The reforms that put Korea on the path of export-led industrialization “did not achieve this result by the conventionally prescribed approach, which is to reduce greatly (if not eliminate) the domestic market's insulation from import competition.”

Second, bureaucrats were insulated from political pressures to allocate resources to politically favored projects. The implementation of plans took place by relying on free market institutions and was negotiated with, not imposed on, private firms.

Because of the special historical, political, and cultural circumstances of Korea, even a leading proponent of the view that Korea’s economy benefited from government industrial policy has concluded that “one has to be extremely skeptical about the prospects for replicating the Korean government’s use of selective intervention.” Indeed, the political prerequisites for such judicious intervention are lacking in other Southeast Asian countries, such as Malaysia, Thailand, and Indonesia. The economies of these countries have performed well in recent decades, but corruption and rent seeking have given industrial policy there a bad name. In those countries, industrial policy is virtually synonymous with arbitrary interventions to help out political cronies. In Malaysia and Indonesia, there are “important recent instances of almost capricious selective industrial policy by the executive, with the technocracy having little say in its elaboration. . . . Such efforts did not attempt to achieve international competitiveness or to provide support for other industries seeking to achieve international competitiveness, even in the long run.”

These countries have welcomed foreign investment in labor-intensive export industries and have not sought to promote investment in heavy industry to the same degree as Japan or Korea.

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42 Rather, it established a “virtual free trade regime for export activity” that also “entailed tremendous openness to imports of raw materials, intermediate inputs, and capital goods.” Westphal 1990, 44.

43 Westphal 1990, 42.

44 Jomo 2001, 473.
Thus, there is no single East Asian model of economic development. Singapore and Hong Kong are small island states, the latter pursuing an almost pure free market approach. Japan and Korea employed more activist industrial policies, but there is little evidence demonstrating their precise contribution (positive or negative) to the country’s development. Malaysia and Indonesia have weaker political institutions that do not keep industrial policy free from corruption and rent seeking. Yet, for the most part, all of these East Asian countries have enjoyed macro-economic stability, relied on private enterprise and market competition, stressed investment in human capital, and adopted outward-oriented policies rather than import substitution. These are the common elements cutting across the countries’ vast differences.

A tentative conclusion regarding government’s role in trade is that it should facilitate private sector development. Most developing countries that have shifted from the production of primary products to nontraditional activities have done so with the cooperation of the public sector. The government is not picking the sectors into which resources should move, but should clear obstacles and reduce uncertainties relating to investment—in general, facilitate private sector activities. Whether one considers Chile’s diversification away from copper into fruits and salmon, Costa Rica and ecotourism, Bangladesh and garments, Colombia and cut flowers, governments have almost invariably played an important supporting role.\textsuperscript{45}

Unfortunately, governments in many developing countries do not facilitate or support the private sector but instead create obstacles for its growth. Even worse, in many countries, particularly but by no means exclusively in Africa, economic success is best achieved by political power and connections rather than by commercial ability or effort.\textsuperscript{46} Corrupt regimes that provide no security to economic transactions and throw

\textsuperscript{45}Hausmann and Rodrik 2003.

\textsuperscript{46}The Economist’s Africa correspondent argues that personal advancement in Africa is easier to achieve through political success than commercial success. In his view, to become rich, or even minimally prosperous, one must either seek political power or cultivate and become a client of those in power. The more that African bureaucrats and politicians extort and expropriate, the less there is to extort and expropriate, which makes the competition for power even more desperate and violent. Guest 2004.
obstacles in the way of business formation and commerce are perhaps the single greatest problem in promoting economic development.47

Recent experience has demonstrated that the economic status of developing countries is not immutably fixed by nature. Neither the geography nor the institutions of China or India or Korea changed when they embarked upon their policy reforms, and yet their economies have been utterly transformed by changes in government policy. Unfortunately, economic policies that stifle development are still pervasive around the world.

_______Developed Country Trade Policies

While developing countries have yet to reach their full potential in large part because of their own policies, trade barriers and subsidies in the developed world have not helped matters. Development nongovernmental organizations have excoriated the developed countries for keeping their markets closed to imports from developing countries. As an Oxfam report cries out, “the harsh reality is that [developed country] policies are inflicting enormous suffering on the world’s poor. When rich countries lock poor people out of their markets, they close the door to an escape route from poverty.”48 This statement is exaggerated but contains some truth. Whether it is closed markets for agricultural goods, high barriers on the importation of labor-intensive manufactures, or efforts to require developing countries to adopt labor standards, many developed country policies are contrary to the interests of developing countries.

In terms of agriculture, the rich countries of the OECD maintain high trade barriers for agricultural products and heavily subsidize their farmers. For every dollar earned by OECD farmers, about 23 cents comes from government policies. In 2007, the OECD subsidized domestic farm producers by $258 billion, of which $126 billion came from high prices

47 Adam Smith once stated that “Little else is requisite to carry a state to the highest degree of opulence from the lowest barbarism but peace, easy taxes, and a tolerable administration of justice: all the rest being brought about by the natural course of things. All governments which thwart this natural course, which force things into another channel, or which endeavour to arrest the progress of society at a particular point, are unnatural, and to support themselves are obliged to be oppressive and tyrannical.” Unfortunately, all too many developing countries lack these three simple requirements. Smith 1980, 322.

resulting from tariffs and export subsidies and $132 billion was transferred by taxpayers through government payments to farmers.\textsuperscript{49} The value of transfers to OECD farmers is greater than the entire GDPs of many developing countries. Because these domestic subsidies and trade barriers have a huge impact on world agricultural markets, they in turn affect developing countries, where agriculture is a very large sector, employing about 60 percent of the labor force and producing about 25 percent of GDP in low-income countries. Indeed, most of the rural poor in developing countries work in the agricultural sector.

Studies have shown that the reduction of agricultural tariffs and trade barriers by OECD and developing countries would produce substantial benefits for both sets of countries. If high-income countries alone opened their markets to imported agricultural goods, their welfare would rise by almost $32 billion and developing country welfare by $12 billion (2001 dollars).\textsuperscript{50} Most of the benefits of trade liberalization accrue to the developed countries themselves because their consumers are footing most of the bill. (Similarly, if developing countries reduced their own agricultural trade barriers, which can be much higher than those in developed countries, they too would capture most of the benefits for themselves.)

However, the same mutual benefit does not hold true if industrial countries eliminated domestic and export subsidies to their agricultural producers. Many developing countries are net importers of agricultural goods and actually benefit from these subsidies. Because these subsidies reduce the prices of the goods that they buy on world markets, many developing countries would lose by their elimination. If high-income countries eliminated domestic and export subsidies without touching import barriers, then those countries would gain $3 billion in welfare, but developing countries as a whole would lose nearly $1 billion.\textsuperscript{51} The gains from eliminating agricultural subsidies accrue mainly to the country that eliminates the subsidy.

\textsuperscript{49}OECD 2008, 12.
\textsuperscript{50}Hertel and Keeney 2006.
\textsuperscript{51}Hoekman, Ng, and Olarreaga (2004) similarly find that a 50 percent cut in tariffs improves welfare for industrial, developing, and least developed countries alike, but a 50 percent cut in domestic subsidies helps industrial countries but harms developing and least developed countries.
Thus, from the perspective of developing countries, there is a strong stake in reducing barriers to agricultural trade in developed countries and in their own countries as well. (As table 3.1 showed, developing countries impose very high tariffs on agricultural imports.) However, the impact of removing developed country export subsidies has more varied effects on developing countries depending upon whether one is a net importer or net exporter of those goods. If one cares about poor consumers in developing countries, then low prices for agricultural goods is desirable; if one cares about poor agrarian producers in developing countries, then high agricultural prices are desirable. (Developing countries seem to care more about producers given the tight restrictions they impose on agricultural imports.)

However, an overall liberalization of all policy instruments by developed countries would increase household income among the poor in developing countries. The greater market access in rich country markets would compensate the poorer countries for the higher food prices they would have to pay on some products. Indeed, research has shown that eliminating border measures such as tariffs will produce changes in world prices that are many times greater than from eliminating domestic agricultural subsidies. Thus, from the standpoint of agricultural-exporting developing countries, market access (lower import barriers) is much more valuable than domestic subsidy reduction in developed countries.

Still, subsidies to specific crops can impose tremendous hardship on poor farmers in particular developing countries. Cotton is a prime—if exceptional—example. The United States and European Union heavily subsidize domestic cotton growers. In 2004–2005, government subsidies to America’s 25,000 cotton farmers amounted to $3.6 billion, double the level a decade earlier. This is more than the entire GDP of the West African country of Burkina Faso. The European Union also subsidizes cotton producers by almost $1 billion per year.

World cotton prices fell by more than half between 1997 and 2002, although they have rebounded since then. The United States accounts for about 20 percent of world cotton production, so any expansion of U.S. production tends to reduce the world price. These subsidies

52Hertel, Keeney, Ivanic, and Winters 2007.
53Hoekman, Ng, and Olarreaga 2004.
have inflicted great harm on cotton producers in Central and West Africa and elsewhere, intensifying poverty in already very poor countries. Cotton exports account for 40 percent of exports in Burkina Faso and Benin and 30 percent of exports in Uzbekistan, Chad, and Mali. Cotton also accounts for over 5 percent of GDP in these countries. Because cotton is such an important source of foreign exchange earnings for these countries, any decline in the world market price—due to subsidies or other reasons—has a tremendous negative ripple effect through their economies. The livelihood of more than 10 million poor farmers is at stake.

Some studies estimate that the elimination of U.S. cotton subsidies would reduce U.S. production by more than 25 percent, reduce U.S. exports by nearly 40 percent, and increase world cotton prices by about 12 percent. This translates into a gain of roughly $80 million in producer surplus for the four key cotton exporting nations in Africa. The case of cotton illustrates the stark impact of the concentrated harm that can be done by agricultural subsidies in the OECD. The United States recently lost a case in the WTO dispute settlement process about the legality of its cotton subsidies, but the 2007 Farm Bill maintains subsidies for cotton. In August 2008, Brazil requested WTO permission to retaliate for this non-compliance by imposing duties on up to $4 billion in U.S. exports.

In the case of manufactured goods, developed countries have low tariffs on average but much higher tariffs on labor-intensive manufactures, particularly textiles and apparel. These are precisely the goods in which developing countries have a comparative advantage. Developing countries have long complained about the Multi-Fiber Arrangement, but even with its abolition they still face very high tariffs. In the United States, for example, the exports of Mongolia, Bangladesh, and Cambodia, among the poorest countries in the world, faced an average tariff of about 15 percent. Meanwhile, the exports of Norway, France, and Singapore faced an average tariff of 1 percent. In 2006, Bangladesh paid $494 million in customs duties to get its goods into the United States; France paid $367 million. Yet Bangladesh exported just $3 billion, while France exported over $37 billion.

54 Baffes 2005.
55 Alston, Sumner, and Brunke 2007.
56 Gresser 2007.
U.S. policy does not deliberately attempt to stifle the trade of developing countries in favor of richer countries, but it does so implicitly by virtue of the tariffs it levies on different goods. Industrial products generally face very low import duties, whereas labor-intensive manufactured goods, such as clothing and consumer products, face much higher tariffs. The developing countries could have much better success in world trade if they did not confront these higher barriers in OECD markets. One study found that recent reductions in trade barriers in developed countries had a pronounced positive impact on export performance and economic growth in developing countries.57

Ironically, many in the developed world who are concerned about poverty and economic underdevelopment elsewhere do not focus on U.S. import tariffs as much as they do on working conditions provided by multinational firms in developing countries. This leads us to the controversial question of whether workers in developing countries are being exploited by foreign firms and, if so, what should be done about it.

Sweatshops and Labor Standards

Many multinational corporations have invested in low-wage developing countries to produce labor-intensive goods, such as clothing and shoes. This foreign investment has generated controversy, with companies such as Nike being accused of earning high profits by exploiting cheap labor in Asian sweatshops. Student activists, human rights groups, and other NGOs have decried the poor working conditions and treatment of labor in developing countries, and are sharply critical of multinational corporations for their failure to pay a “living” wage to workers there. Labor unions in the developed countries have long maintained that countries with lower labor standards have an unfair competitive advantage in trade and that they attract jobs and investment at the expense of countries with higher standards.

These groups fault world trade negotiators for neglecting to include labor standards in trade agreements and thus failing to protect the interests of workers. Yet most developing countries strenuously object to any linking of trade policy and labor standards. They fear that if devel-

Developed countries are allowed to restrict imports from countries deemed not to have adequate labor standards, they will have yet another excuse for denying low-wage countries access to their markets, thereby preventing developing countries from taking advantage of their comparative advantage in labor-intensive goods.

Before asking whether trade agreements should include provisions on labor standards, it is worth examining the perennial claim that low wages give a country an unfair advantage in trade. The key economic lesson is that low wages reflect low labor productivity. Workers in developed countries enjoy high wages and benefits because of their high productivity. Figure 6.4 illustrates the strong relationship between labor costs per worker (a measure of wages and benefits that firms must pay) and value added per worker (a measure of productivity) in manufacturing for sixty-three countries during 1995–99. The correlation is striking:

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**Figure 6.4**
the higher a country’s average productivity, the higher the country’s average wages. Econometric evidence has regularly shown that labor productivity alone explains about 70–80 percent of the cross-country variation in average wages in manufacturing. After also accounting for differences in per capita GDP and in price levels across countries, over 90 percent of the variation in wages between countries can be explained.\(^{58}\)

Since average wages reflect average productivity, the cost advantage of low wages is generally offset by the cost disadvantage of low productivity. This implies that unit labor costs are roughly comparable across countries. Figure 6.5 depicts this relationship. In India and the Philippines, for example, average wages are less than 10 percent of those

\(^{58}\)Even though these purely economic variables explain almost all of the differences in wage rates across countries, Rodrik (1999) finds that indicators of political freedom contribute some additional explanatory power.
in the United States. But the average productivity of workers is also less than 10 percent of that in the United States. Thus, the unit labor cost—the effective cost of hiring labor—is roughly comparable between the two countries. And, in fact, multinational corporations searching for cheap labor find that you get what you pay for: low wages imply a less productive workforce. Thus, multinationals generally find it profitable to turn to developing countries only for unskilled labor-intensive activities, particularly those in which the productivity of workers is comparable to that in developed countries but the average wage is much less.\(^59\)

As developing countries improve the productivity of their workers, through the acquisition of better technology or other mechanisms, competitive pressures bid up average wages. As a result, the growth in domestic wages tracks the growth in domestic productivity. Indeed, a country’s average wage rate is determined almost exclusively by domestic productivity performance. As figure 6.6 shows, for example, the acceleration of productivity in South Korea in the 1980s was accompanied by a dramatic rise in labor compensation. By contrast, the Philippines has been much less successful at increasing productivity and therefore has not seen a comparable rise in wages. The evidence is clear: countries that successfully increase productivity experience a rise in wages, while countries whose productivity is stagnant see little change in wages.

Countries with low wages tend to specialize in unskilled labor-intensive goods. Beyond this, there is little empirical evidence that low labor standards, in themselves, exert an important influence on trade flows. Several studies have failed to find a strong relationship between measures of labor standards and international trade flows (such as export performance in labor-intensive goods) or direct investment flows (such as whether countries with low standards attract more foreign investment).\(^60\) The OECD has concluded that “empirical findings confirm the analytical result that core labor standards do not play a significant role in shaping trade performance. The view which argues that low-standard

\(^59\) Of course, overall productivity depends not just on a worker’s output, but the economy’s infrastructure, the availability of technical and support personnel, and other factors. There are many examples of multinationals relocating production back in the United States because, despite the availability of inexpensive labor in other countries, the general environment for business made it difficult to make effective use of that labor.

\(^60\) See, for example, Rodrik 1996.
countries will enjoy gains in export market shares to the detriment of high-standard countries appears to lack solid empirical support.”

Low wages and poor working conditions in developing countries have sparked protests from concerned citizens in developed countries. The Worker Rights Consortium, established by students, unions, and human rights groups, has accused the athletic shoe manufacturer

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OECD 1996, 33. The OECD (2000, 33) concluded that “this finding has not been challenged by the literature appearing since the 1996 study was completed.”
Nike and other multinationals of subjecting workers to sweatshop conditions and not paying a living wage. Working conditions in many developing countries are indeed horrible by the standards of developed countries, and everyone wants to see those standards of living improve. These activists have changed working conditions for the better by putting companies in the spotlight of bad publicity if their contractors treat their workers poorly.\textsuperscript{62}

Still, the best and most direct way to raise wages and labor standards is to enhance the productivity of the workers through economic development. Trade and investment are important components of that development, and therefore efforts to limit international trade or to shut down the sweatshops are counterproductive. For example, most foreign-owned firms pay substantially higher wages than comparable domestic firms.\textsuperscript{63} In Vietnam, for instance, while the general population (mainly employed in agriculture in rural areas) could afford per capita expenditures of $205 in 1998, people working in foreign-owned business spent $420 that year.\textsuperscript{64} Poverty rates are much lower for those holding jobs with foreign-owned firms. While 37 percent of the Vietnamese workers were classified as poor in 1998, only 8 percent of those working in foreign-owned businesses were considered poor. And although 15 percent of all workers were classified as “very poor,” none of the workers in foreign-owned textile and leather-goods businesses were in that category.

The fact that foreign-owned “sweatshops” in poorer countries pay above-average wages in the local labor market may explain the low turnover (or quit) rate of workers at such firms. It may also explain why these jobs are so desirable that, in some instances, workers must pay one month’s salary as a bribe to employment officers at such firms in order to get hired. And even though the wages are low, the savings rate of factory workers is much higher than that of workers elsewhere in the economy—an interesting fact in light of the accusation that such firms are not paying

\textsuperscript{62}Elliott, Kar, and Richardson (2006) examine the views of activists in developed countries that are pressing for better treatment of labor in developing countries. See also Harrison and Scorse 2004.

\textsuperscript{63}See Aitken, Harrison, and Lipsey (1996) for a study of foreign firms in Mexico, Venezuela, and the United States. Lipsey and Sjöholm (2001) show that foreign-owned firms in Indonesia pay higher wages than locally owned firms.

\textsuperscript{64}Glewwe 2000.
a living wage. In fact, in Vietnam and elsewhere, workers often request overtime, as they are seeking to maximize their income. International codes and rules that limit hours of work may interfere with the desire of these individuals to earn more money.

Even if the wages and working conditions in developing countries are dismal by the standards of the present-day United States, these multinational firms are at least providing employment opportunities and incomes that might not otherwise exist, enabling the poor to support their families. Two reporters for The New York Times provide a vivid example. When they were first assigned to cover Asia, they, like most people, were outraged at the sweatshop conditions. They later changed their opinion: “In time, though, we came to accept the view supported by most Asians: that the campaign against sweatshops risks harming the very people it is intended to help. . . . Those sweatshops tended to generate the wealth to solve the problems they created. . . . it may sound silly to say that sweatshops offer a route to prosperity, when wages in the poorest countries are sometimes less than $1 per day. Still, for an impoverished Indonesian or Bangladeshi woman with a handful of kids who would otherwise drop out of school and risk dying of mundane diseases like diarrhea, $1 or $2 a day can be a life-transforming wage.”

Most of the sweatshop workers are young women, many of whom have gone to industrial cities from rural villages. By Western standards, they endure long hours, low pay, and poor conditions. And yet, despite the monotony of factory work, they found it a vast improvement over the back-breaking monotony of field work, according to a sociologist who lived with migrant factory workers in southern China. Many of these women earned seven to eight times what their fathers earned working in rural agriculture in their home village, and could send money back to their families. Yet the motivation for these young women leaving their homes was much more than financial. They left behind a patriarchal order in which their fathers could marry them off to the village idiot without their say in the matter. With their factory work, they gained freedom and independence, as well as dignity and self-respect. It enabled them to spend their lives and their money the way they wanted, such as shopping,

65 Kristof and WuDunn 2000, 70–71.
66 Lee 1998.
going to see a movie, or taking English or computer classes at night—things that would have been impossible in their rural communities.

The fundamental problem facing workers in developing countries is not the existence of sweatshops, but the lack of good alternative employment opportunities. Efforts to stop exports from low-wage countries, to prevent investment there by multinationals, or to impose high minimum wages or benefits beyond the productivity level of the domestic workforce will simply diminish the demand for labor in those countries and take away one of the few opportunities that workers have to better themselves and their families. Opponents of sweatshops have failed to consider what alternative opportunities for employment can be created.

Should Trade Agreements Have Labor Standards?

Can including labor standards in trade agreements help improve labor conditions in developing countries? The United States has been virtually alone in pressing for such standards in trade negotiations. And yet there is a great deal of ambiguity about which standards should be included, their precise definition, and how they should be enforced.\(^67\) Two categories of labor standards are typically discussed. “Core” standards are related to fundamental human rights and can be universal in their application, such as a prohibition on forced labor. “Economic” labor standards, by contrast, are tied more closely to a country’s level of economic development and include minimum wages and working conditions.

Core labor standards have been defined by the International Labor Organization (ILO), an international body created in 1919 and composed of member governments, employers, and workers. In 1996, the ILO issued a Declaration on Fundamental Principles and Rights at Work stating that all countries, regardless of their level of economic development, have an obligation to promote the following principles and rights: freedom of association and the effective recognition of the right to collective bargaining; elimination of all forms of forced or compulsory labor; effective abolition of child labor; and elimination of discrimination in respect of employment and occupation.

\(^67\) Bhagwati and Hudec 1996.
Although such core labor standards are generally recognized and attract wide support, there is (with the exception of slavery) remarkably little international consensus on the precise definition of these standards and the method of implementing them. The ILO oversees over 180 conventions on various aspects of labor rights and practices, but very few of them have been ratified by all of the ILO members. As of 2008, for example, the United States had ratified just fourteen and had agreed to only two of the core conventions (on the abolition of forced labor and the prohibition of the worst forms of child labor). The United States has ratified few conventions partly because domestic labor law is largely the prerogative of state governments and partly because the language of the conventions may conflict with national policy. For example, convention number 111 seeks to abolish employment discrimination on the basis of sex and race, but has not been ratified by the United States because it might conflict with affirmative action.

Other countries have also failed to adopt ILO conventions because they are perceived to be inflexible or irrelevant to local circumstances. For example, conventions number 87 and 98 deal with the right to organize and collective bargaining. The United States has not ratified these conventions because many states allow the hiring of replacement workers, which under the ILO convention could be viewed as interfering with the right to strike. Many developing countries are simply indifferent to these conventions. As one economist has noted, “for an overwhelming majority of poor workers in developing countries whose dominant mode of employment is self-employment in rural agricultural activities or in the urban informal sector, unionization has little relevance. Even where relevant and where the freedom to form unions has been exercised to a significant extent, namely in the organized manufacturing and public sector in poor countries, labor unions have been promoting the interests of a small section of the labor force at the expense of many.”

Child labor has been a particularly controversial issue, and one that illustrates the limits of using ILO conventions and trade policy to reduce this practice. Convention number 182, signed by President Clinton at the WTO summit in Seattle in 1999, aims to eliminate the worst forms of child labor, such as slavery, the sale of children, forced labor, prostitution,
and illicit activities. The United States prohibits imports of goods made with forced or indentured child labor, but does not have a generic ban on imported goods made with child labor. Indeed, dealing with nonexploitative child labor is a more difficult issue. The ILO charter establishing minimum ages of work has not been ratified by the United States, Canada, or other developed countries because of differing national views on the details. For example, Canada chooses not to prohibit work at night for children under age thirteen.

Of course, child labor is a major issue in developing countries, and some activists have suggested that developed countries should refuse to import any goods made with child labor. But just as trade policy is an inefficient instrument for achieving environmental objectives, as chapter 2 suggested, it is also an inefficient instrument for raising labor standards. An import ban on goods made with child labor might stop the use of children to produce goods for the U.S. market, but it would not put an end to child labor. Only about 5 percent of working children are employed in the export sector in developing countries. An import ban might simply shift them to other sectors of the domestic economy (about 80 percent are employed in the primary agricultural sector). At worst, an import ban could push them into less desirable or more hazardous work, or even leave them without work and thereby condemn them to starvation. Import bans fail to address the root cause of child labor or offer any resolution to the underlying conditions that create it.

The most effective way of eliminating child labor is to attack the fundamental causes, which are poverty and the lack of affordable or adequate educational opportunities. As figure 6.7 indicates, the incidence of child labor is strongly related to per capita GDP. In fact, about 80 percent of the international variation in child labor is explained by this variable alone. Child labor virtually disappears once a country’s annual per capita income reaches $5,000. Developing countries can help reduce

69“Caroline Lequesne of Oxfam, a British charity, has just returned from Bangladesh, where she visited factories to determine the impact of American retailers’ human-rights policies. She reckons that between 1993 and 1994 around 30,000 of the 50,000 children working in textile firms in Bangladesh were thrown out of factories because suppliers feared losing their business if they kept the children on. But the majority of these children have, because of penury, been forced to turn to prostitution or other industries like welding, where conditions pose far greater risks to them.” Economist, June 3, 1995, 59.
Chapter 6

Child labor by raising rural incomes through agricultural price liberalization. Evidence from Vietnam suggests that when the domestic price of rice rose after the government permitted more rice exports, farmers responded by reducing the use of child labor.

Developed countries can help developing countries raise their income by allowing them to sell their products more easily in the markets of the richer economies. Compulsory education laws that mandate school attendance have also proven effective in reducing child labor and are more easily monitored than direct bans on imports.

The WTO is not the proper forum for dealing with the issue of core labor standards because these standards are not directly related to

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**Figure 6.7**
Child Labor and GDP per Capita, 2000.

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70 Edmonds and Pavcnik 2006.
71 Rising income and compulsory education accounted for the decline in the employment of children in the United States, and can do so in developing countries as well. The United States, it should be noted, did not ban child labor until the Fair Employment Act of 1938, a point when per capita income was well above that in many developing countries today.
international trade. Even if a country did not engage in international trade but suppressed worker rights, labor standards should still be an issue because of the universality of core labor standards. To put it differently, if a country had a problem with the treatment of child labor but did not use that labor in exported goods, that practice should still be a source of global concern. Furthermore, the WTO lacks the institutional expertise and resources to deal with labor issues. As the WTO membership itself declared at the 1996 ministerial meeting in Singapore, the ILO is the competent body to set and administer labor standards. The effort to push labor standards onto the WTO’s lap would undermine the ILO as well as burden the WTO with something it is not well equipped to handle.

The WTO has been tagged with the issue of labor standards primarily because trade sanctions are believed to be the most effective way of enforcing such standards. As we have seen, however, the threat of trade sanctions to enforce labor standards in developing countries risks harming the very workers we are trying to help. As Paul Krugman puts it, “even if we could assure the workers in Third World export industries of higher wages and better working conditions, this would do nothing for the peasants, day laborers, scavengers, and so on who make up the bulk of these countries’ populations. At best, forcing developing countries to adhere to our labor standards would create a privileged labor aristocracy, leaving the poor majority no better off.” At worst, those export industries would be shut down, causing those workers to lose their jobs. Furthermore, the threat of using trade sanctions to enforce labor standards is precisely why developing countries are so afraid of including them in the WTO. Developing countries adamantly oppose efforts to link trade and labor standards, which is why pressing this issue is asking for a stalemate in the WTO.

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72 Krugman 1998a, 84. Economic development is the only known way to increase wages. The alternatives—massive foreign aid, stronger demands for social justice—are unrealistic or ineffective. As Krugman comments, “As long as you have no realistic alternative to industrialization based on low wages, to oppose [trade and industrialization] means that you are willing to deny desperately poor people the best chance they have of progress for the sake of what amounts to an aesthetic standard—that is, the fact that you don’t like the idea of workers being paid a pittance to supply rich Westerners with fashion items.”

73 At the 1996 WTO ministerial meeting in Singapore, the United States pressed for the creation of a working group on labor standards. After sharp opposition by developing countries, the WTO membership agreed that the ILO instead was the appropriate venue.
To the extent that international cooperation in the ILO is considered useful, how should ILO charters be enforced? The problem is that if countries lack the political will to adhere to international rules, then the enforcement of those rules is beside the point. "Bad" regimes are unlikely to be moved by trade sanctions. Furthermore, under ILO rules, a government can only bring a complaint against another government if both have ratified the relevant convention. Through its failure to ratify many of the ILO conventions, the United States has effectively forfeited its right to use that organization to enforce labor rights abroad. For those countries that have ratified ILO charters or agree to accords on labor standards, enforcement is best carried out by embedding the ILO commitments in domestic law and enforcing them through civil actions and punitive judgments (such as fines) in the domestic legal system.

If dealing with "core" labor standards is difficult enough, there are political pressures in developed countries to go beyond core standards and into the realm of "economic" standards. Labor unions and other NGOs have pressed for standards that include minimum wages, employment hours, occupational health and safety regulations, minimum age of employment, and so on. Without these economic standards, it is argued, developing countries will attract investment and gain jobs at the expense of developed countries, which will then face pressures to reduce labor standards. Such economic standards, however, have no place in a trade agreement because they are a function of economic development.74 Labor unions' role in this push is worrisome from the standpoint for considering labor standards. Despite this agreement, the United States again called for an examination of labor standards in the WTO at the 1999 Seattle ministerial meeting. Developing countries were completely hostile, and even Canada failed to support the United States, while the European Union was willing to consider greater cooperation between the WTO and the ILO only if any linkage between labor standards and market access was ruled out. When President Clinton let slip the idea that labor standards should be included in trade agreements and enforced with trade sanctions, developing countries accused the United States of bad faith (ignoring the Singapore declaration) and were galvanized to oppose any new trade round on this basis. The president's statement almost single-handedly ensured the failure of the Seattle meeting.

74As Robert Reich (1994), the secretary of labor in the Clinton administration, stated, "It is inappropriate to dictate uniform levels of working hours, minimum wages, benefits, or health and safety standards. The developing countries' insistence that they must grow richer in order to afford American or European labor standards—that they must trade if they are to grow richeris essentially correct."
of developing countries because all too often unions have simply sought to block trade.

As a result, while most advocates of higher labor standards are genuinely motivated by concerns about workers in developing countries, the politics of labor standards are such that attempts will be made to use them to limit the market access of low-wage developing countries. In January 1999, the United States signed an agreement with Cambodia that promised a 14 percent increase in Cambodia’s annual quota for textile shipments if the country agreed to meet certain core labor standards. Although the Cambodian garment industry established high minimum wages and agreed to paid vacations, unionization rights, and a ban on child labor, the Union of Needletrades, Industrial and Textile Employees (UNITE) wrote to the U.S. Trade Representative (USTR) opposing any increase in the quota. Following this, and without consulting other views, USTR ruled in December 1999 that Cambodia was not in “substantial compliance” with the agreement and denied the quota increase. The Cambodian government and garment industry were shocked because they believed they had gone beyond the agreement in improving standards. Five months later, USTR agreed to a smaller increase, of 5 percent, after Cambodia and the ILO established a program to monitor work conditions.75

Unions such as UNITE, the Teamsters, and the AFL-CIO also opposed legislation that gave African countries the same tariff preferences that the United States had previously extended to Caribbean and other poor developing countries. The African Growth and Opportunity Act of 2000 aimed to help the continent by giving duty-free access to the U.S. market in selected goods. Instead of being viewed as a small way of helping African countries improve their economies, labor-backed opponents dubbed the legislation as “NAFTA for Africa.” The proposal to allow African textile producers duty-free access to the U.S. market proved to be quite controversial even though Africa’s share of U.S. apparel consumption was only 0.45 percent. The U.S. International Trade Commission concluded that the impact of removing the quota on the U.S. apparel industry would be negligible and that, at most, only 676 U.S. jobs would be affected.76 Other analysts have suggested that the preferences

75Cooper 2000.
might have an even smaller domestic impact because it would simply improve the position of Africa at the expense of China. Their staunch opposition to free trade with Africa fuels suspicions that labor unions are not really interested in helping poor African workers deeply mired in poverty, but oppose any measure that promises to increase trade.

Experience has shown that it is all too easy to mask an antitrade agenda with labor and environmental concerns, as is evident by many anticommmercial NGOs and anti-import labor unions. This is regrettable because there are deep and legitimate questions about using trade measures to enforce labor and environmental standards, and therefore the possibility of common ground gets lost in the advocacy of extreme positions. Yet there are inherent flaws in giving the WTO a non-trade-related mission, such as enforcing environmental agreements or enforcing labor standards. The risk is that these poorly targeted and indirect instruments for improving environmental and labor conditions will fail to achieve their objective yet at the same time will expand the allowable rationales for trade barriers, thus undermining the liberal trading system without generating compensating benefits.

In conclusion, expanding world trade presents great opportunities for the world’s developing countries. While trade policies in developed countries often hinder the ability of developing countries to improve their condition, developing countries cannot blame all of their problems on foreign trade barriers. Trade restrictions and barriers are much more extensive in the developing world than elsewhere. Much of the blame for the lack of development falls not on the people of these countries, but on their governments and their poor policies that inhibit economic activity. As the examples of India and China dramatically demonstrate, not the rest of the world, but their own misguided policies, have been holding them back from achieving higher rates of economic growth and poverty reduction.