Adjustment Assistance for Trade Liberalization

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Most governments agree these days that a relatively liberal trade regime is an important part of the policy cocktail required for economic growth and development. To be sure economists argue about the exact degree of proof they can provide for this proposition and there is room for debate about exactly what ‘relatively liberal’ means, but in general the debate has moved beyond ‘whether’ to implement trade liberalization to ‘how’.

As we embark on a renewed effort to complete the Doha Round, one aspect of ‘how’ has leapt to the forefront—how to manage the adjustment process. This has two dimensions. First, and more traditionally, the gains from international trade largely depend on adjusting a country’s bundle of output. Hence almost inevitably, when countries liberalize their own trade regimes, some members of society will incur adjustment costs as their previous, protected, means of livelihood are no longer as profitable.

Second, and of more recent interest in the policy debate although economists have always recognized the possibility, some countries may be temporary or permanent losers from other countries’ liberalizations. If countries lose, so, inevitably, will some individuals within them. In some cases the transmission route for this harm is via world prices—for example, the fear that OECD agricultural liberalization will raise world food prices. In others it is that, as tariffs are reduced and quota regimes reformed, the value of tariff and trade preferences is eroded. That is, the prices at which the preferred exports can be sold fall as the importing country reduces its tariffs on non-preferred suppliers or domestic support prices are cut. In both cases the problem is that the adjusting country faces a negative terms of trade shock.

This article considers briefly what role the International Financial Institutions—particularly the World Bank—and the bilateral donors might play in easing these trade-related adjustment strains. The case for some assistance lies not only in concern for individuals who suffer, especially poor ones, but also in the ‘real politik’ of trying to

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ensure that short-run loses and distributional strains do not scupper a multilateral agreement that would bring large gains overall.

**Own Liberalization**

The case for financial support to underpin countries’ own liberalizations is the same as for any investment in change. Given that liberalization will boost national real income, short-term costs will be outweighed by long-term gains—often, research shows, by a large multiple—so that borrowing against the future income stream is perfectly rational. Of course, as happens in the process of negotiating a loan, especially from the World Bank, the borrower and lender need to work together to assure themselves that the long-run gains are attainable and that the adjustment path is realistic. The lender also needs reassurance that commitments to repay are credible: i.e., that the country’s overall burden of debt is manageable and that the government can appropriate enough of the gains from trade through taxation to service its debt. Then, provided that the borrowing will help to reduce poverty, and subject to various prudential limits, the World Bank is willing and able to lend under its existing facilities. Since the policy change increases national income, there is no more of a case for grant-based assistance here than for other programs of similar degrees of risk that Bank members undertake. That is, there is no presumption that countries should be able to borrow on better terms for these adjustments than they can for other programs.

**Global Liberalization**

The case of lending to finance adjustment to permanent shocks is conceptually rather similar, but practically much more demanding. A decline in the terms of trade cuts a country’s real income, but the losses can be reduced if the economy adjusts by switching its production towards a more favorable output bundle. Borrowing to support such adjustment may still be rational because it would allow higher future incomes than would otherwise be feasible. However, the practicalities of repayment would be much harder. Governments would need to be sure that they could appropriate additional debt service requirements out of an income stream that was lower than anticipated and possibly actually falling. Both borrower and lender would want to be doubly sure that the adjustment plan was good, for, if it failed, incomes would fall by the full amount of the shock and debt would be higher. But governments are human agencies and we all know the temptation to give ourselves the benefit of the doubt and to use borrowed funds to postpone rather than facilitate adjustment. Thus much of the burden of making these assessments falls on the lender—The World Bank.

The Uruguay Round’s ‘Decision on Measures Concerning the Possible Negative Effects of the Reform Programme on Least-Developed and Net-Food Importing Developing Countries’ committed the World Bank to consider lending for adjustment to trade-liberalization-related terms of trade shocks due to food price increases. This commitment still stands, as does the commitment to work with country authorities to formulate appropriate adjustment plans. But the Bank commitment is operationalized through existing lending facilities, whereas critics appeal for a new and additional facility triggered automatically by the shock of falling terms of trade or lost preferences.
I do not find the combination of additionality and automaticity persuasive (and neither did I before I recently rejoined the Bank!) World Bank loans have to be repaid. To borrow without a plausible adjustment plan is no answer to a permanent shock; it merely accumulates debt, which could even be termed odious in the future if it were obviously not going to ease adjustment. Similarly, an adverse shock is not the occasion to extend borrowing limits if they have already been fixed by the ability to repay, for, if anything, it reduces that ability. On the other hand, it is worth recalling that food price increases are not likely to be large, that for some countries increased food import prices will be partly offset by increased food export prices and that if net food imports are the result of local distortions (e.g., excessive taxes on agriculture) increasing import prices can actually be beneficial.

**Preference Erosion**

Turning to preference erosion one first needs to ask how much income is at stake. While developing countries export large amounts to preference-giving markets, it is easy to exaggerate the benefits that they derive from preferences. Many exports do not receive preferences because mfn tariffs are very low or zero, or because they are prevented from doing so by rules of origin. Even when tariff preferences are received the rents are commonly shared with importers in the developed country and/or wasted in excess production costs at home. And when rents do accrue to developing country exporters the incomes created frequently do not find their way to the poor.

However, there are undoubtedly some gains (equal, perhaps, to 1-2% of exports according to the IMF) and so what should we think when they are eroded? One consideration is whether their erosion was reasonably foreseeable, as, say, with the exhaustion of a natural resource deposit. If so, recipient governments should have been anticipating adjustment and while they may wish to borrow to help that adjustment, they have little case for seeking compensation. If, on the other hand, there is a degree of legitimate surprise in the erosion of preferences, one might feel that there is a corresponding case for some partial grant-based compensation. However, since permanent income transfers are neither credible nor attractive in terms of encouraging development, any such compensation should be temporary, and, since the loss of income results from a policy choice by the preference-giving countries, it is also a matter between the donors and recipients of preferences. Preferences were introduced as a way of transferring income to preferred suppliers, partly at the expense of the donor’s taxpayers (who had to make up the revenue shortfall through other taxes) and partly at the expense of non-preferred suppliers (who lost sales). If the developed country donors now wish to reduce those preferences and so benefit their own consumers or transfer the benefits to previously non-preferred suppliers in return for some other trade concession within the trade round, maybe they should provide any warranted compensation. (Even if the trade policies are liberalized in a negotiation at the behest of other countries, they are still altered by choice by the developed countries because they desire the deal of which the liberalizations are part.)

Two arguments are sometimes made for compensation being a global responsibility rather than just that of the preference donors. First, the major food exporters will be big
beneficiaries of OECD agricultural liberalization, and so, in return for these gains, they should be prepared to compensate the losers. I have no objection to this if this proves to be the best way of easing the path to liberalization. However, in trade negotiations ‘compensation’ normally takes the form of making reciprocal improvements in market access. If the food exporters opened, say, their services markets, the OECD countries would gain and would be more able and willing to compensate the losers from their agricultural liberalization in order to get a deal. The second argument is that since the world would be better off if we get a trade deal, the world had better pay the compensation. But it is not ‘the world’ that benefits or pays but specific countries, and it seems to me to complicate matters to let the paying (contributions to a global fund) get separated from the benefiting (the gains from the trade negotiation).

Compensation for preference erosion would not be so large as to seriously discourage liberalization. There is a danger, however, that it would just be taken from the ODA budget and hence occur at the expense of grants to poor people elsewhere. To reduce this danger, we need to link the compensation firmly to the trade negotiating process and to the policies to be liberalized, and keep it separate from aid policy more generally. In addition, compensation needs to be time-limited if it is really to encourage adjustment. One source that meets these criteria would be the preference-giving countries’ tariff revenues. A typical WTO deal cuts a tariff from x% to y% over a number of years. Preference givers could immediately cut their own revenue take to y%, and transfer to preference recipients the excess of the applied tariff over y% during the transition period. A second approach more suited to cases where few imports pay tariffs would be to devote, say, 25% of the funds saved by reducing trade-distorting agricultural support to a compensation fund over the transition period.

Clearly many details about how to define, collect and distribute these funds would have to be worked out. I would favor a single fund for all importers with disbursements related to the degree of loss from preference erosion, the difficulty of the adjustment/diversification required and some mild conditionality to ensure the monies helped adjustment. I certainly do not see tariffs or ear-marked subsidy-cuts as a long-run source of development funding, and I am not here advocating general trade-adjustment assistance. However, in terms of a pragmatic, time-limited, arrangement that addresses a current specific need, and which is more or less in the power of trade negotiators to agree themselves, I believe that proposals like this may have something to commend them.