**Revised Draft**

# Making Trade Work for Poor People

Nicholas Stern
Senior Vice President and Chief Economist
The World Bank

*Speech delivered at:*
*National Council of Applied Economic Research*
*New Delhi*
*November 28, 2002*

I am very grateful to Bernard Hoekman, Caroline Freund, Ekaterina Krivonos and Aaditya Mattoo for their contribution to the development and preparation of this speech, and to Shahrokh Fardoust, Sadiq Ahmed, Stephen Howes, Ijaz Nabi, Deepak Mishra, Jayanta Roy, Michael Carter, Uri Dadush, Richard Newfarmer, Gary Pursell, William J. Martin, Vlad Manole, Mark Sundberg and Priya Mathur for their contribution to an earlier draft.

**Abbreviations**

CAFOD: Catholic Agency for Overseas Development
CAP: Common Agricultural Policy
CUTS: Consumer Unity and Trust Society
EU: European Union
FDI: Foreign Direct Investment
GATS: General Agreement on Trade in Services
GATT: General Agreement on Tariffs and Trade
GDP: Gross Domestic Product
IMF: International Monetary Fund
MDGs: Millennium Development Goals
MFN: Most Favored Nation
NCAER: National Council of Applied Economic Research
NGO: Non-Governmental Organization
ODA: Official Development Assistance
OECD: Organization for Economic Cooperation and Development
TRIPS: Trade-Related Intellectual Property Rights
USA: United States of America
WTO: World Trade Organization

## Introduction

Annual per capita economic growth in India increased from less than one percent per year over the 1960s and 1970s to around 3 percent per year in the 1990s. As a result, we have seen about a one-third increase in consumption per capita over the last decade, and a 5 to 10 percentage point reduction in national poverty rates.[1] Trade policy reform in India played a major role in spurring economic growth during this period. But there is much more work to be done — not just in India, but around the globe — if we are to achieve the Millennium Development Goal (MDG) of reducing income poverty by one-half between the years 1990 and 2015.

I have argued recently in my lecture at the Center for Economic Studies in Munich that a credible poverty reduction strategy should rest on two pillars: the creation of a good investment climate to propel growth, and the empowerment of poor people to enable them to take part in that growth through enabling their access to health and education, and by fostering mechanisms for their participation in the decisions that shape their lives (Stern, 2002). Trade reform is a key part of the first pillar of improving the investment climate. Thus, throughout the developing world, trade reform will continue to be an important ingredient of any poverty reduction strategy. The experience of a large number of countries demonstrates a strong positive correlation between openness to trade, income growth and poverty reduction. In particular, the experience of both India and China over the last two decades shows how an increased openness to trade can stimulate growth and poverty reduction.

---

[1] Ferro, Rosenblatt and Stern (2002).

While the importance of trade for the investment climate and growth is the focus of this lecture, I would not want it inferred from this that the second pillar of empowerment and inclusion is less important than the first for poverty reduction. Evidence from around the world, including from India, shows the importance of empowerment in general and education in particular for growth to be pro-poor — in the Indian context, see, for example, Ravallion and Datt (1998) — and I have addressed this extensively elsewhere: for example, Ferro, Rosenblatt and Stern (2002) and Stern (2002). My focus, however, in this lecture is specifically on the trade-related policy reforms that are needed in both rich and developing countries to make trade work for poor people. I will first discuss the post-Doha trade-reform agenda, with a particular emphasis on the sectors that are most important for many developing countries: agriculture and textiles. In order for developing countries to realize the potential of gains from trade, they have to be able to export. The agricultural subsidies of rich countries as well as the barriers to agricultural and textile exports from developing countries erected by Europe, Japan, and the United States prevent many developing countries from fully exploiting their comparative advantage. Removing these barriers will expand the market for the products from the developing world, increase growth and most importantly, enable more people to improve their lives and escape from poverty.

Although the gains from industrial country reform are large, developing countries are likely to have a still greater impact on their own welfare through their own policy reform. I will therefore also discuss developing country policies that limit both trade and the gains from trade. In particular, I will focus on what India has done to leverage trade for growth and what remains to be done. India has made substantial progress over the last

decade. However, India has much further to go if it is to reap in full measure the rewards of trade in terms of both growth and poverty reduction. The final section of this paper summarizes what I see as the key priorities confronting the international community in general, and India more specifically, in making trade work for poor people. This will be particularly important in light of the current Doha round of WTO (World Trade Organization) trade negotiations.

There are four messages I want to emphasize for the international community:

- There is a huge market access agenda that must be given priority in the WTO. Trade restrictions in both OECD (Organization for Economic Cooperation and Development) and developing economies lower incomes in developing countries. Agriculture is key here: OECD subsidies exceeding US$ 300 billion a year are not only very costly to OECD taxpayers, but more importantly, impose a high burden on farmers and rural households in developing countries.

- Second, while the WTO is an important mechanism to negotiate removal of trade-distorting policies, much of the gains from reform can be obtained through unilateral action, which does not have to wait for WTO negotiations.

- Third, reciprocity in the WTO negotiating process creates the potential for perverse incentives — holding back on doing what is good for development (that is, liberalization). This makes far-reaching trade reform by OECD countries even more important — it will help the governments of developing countries pursue beneficial domestic reforms. More active engagement by stakeholders — including Non-Governmental Organizations (NGOs) and church groups involved with development — is required to accelerate progress in OECD countries.

- Fourth, the ‘trade agenda’ extends far beyond traditional trade policy — tariffs and quotas. ‘Behind-the-border’ policies that affect the operation of infrastructure, service industries and government bureaucracy are major determinants of competitiveness. Whilst most of this policy agenda is national, more aid in these areas can help firms benefit from improved market access.

As regards India, there are four points I want to emphasize:

- First, India stands to benefit significantly from lowering tariffs still further. Whilst tariffs have fallen in the last decade, an average tariff of 35 percent is simply too high. India’s economic size suggests that trade could and should be US$ 150 billion higher than it is today — with concomitant benefits in terms of higher incomes and employment in productive activities, and positive spillovers on economic activity in neighboring countries.

- Second, both past and future liberalization is in danger of being eroded by other forms of protection such as anti-dumping action. India has become the second largest user of anti-dumping in the world after the USA. Disciplining the use of ‘substitute’ instruments of protection is urgent.

- Third, policies that do not directly affect trade, but that improve the investment climate are key to reaping the gains from trade. First and foremost, these will promote domestic investment, including in trade-related areas, but these will also encourage greater Foreign Direct Investment (FDI) that is urgently needed. Such reform will require numerous ‘behind-the-border’ policy changes to facilitate

entry by new investors and to reduce transport, customs and port clearance costs and time — to give just two examples.

- Finally, existing barriers to entry and exit of firms must be the focus of policy attention. These barriers, by exacerbating the costs of adjustment, reduce competitiveness, entrepreneurship and the growth of productivity, and thereby diminish India's ability to respond to new opportunities.

*Trade is good for growth*

First, by way of introduction, let me discuss trade and the gains from trade from a broader perspective than India alone. At the beginning of the new century, the value of global trade in goods and services stood at nearly US$ 8 trillion (thousand billion), about 25 percent of world Gross Domestic Product (GDP). This is a dramatic increase over the past 30 years; in 1970, total trade of goods and services were just US$ 1.5 trillion in current dollars, and made up about 13 percent of GDP. Today, at just over US$ 6 trillion, trade in goods accounts for the lion's share of global flows, followed by trade in commercial services, which represent another US$ 1.5 trillion. Although global trade flows are dominated by exchanges within and between Europe, North America, and East Asia — which currently make up about 65 percent of world trade — trade flows involving developing countries have expanded significantly. Developing countries have also increasingly become producers and traders of manufactures. The share of manufactures in total exports of developing countries reached 70 percent in the 1990s and is projected to rise to 80 percent in 2005. Moreover, around 40 percent of all developing country exports are destined for other developing countries — South-South trade is increasingly important (Hertel and Martin, 2000).

The expansion of trade has been driven primarily by unilateral (autonomous) economic reforms — including the liberalization of trade and investment flows — during the 1980s and 1990s. Cross-border trade and investment flows have been a major engine of growth — they can be regarded as 'machines' that allowed countries to transform one set of goods and services into another set that they valued more highly. The resulting increase in openness and integration into the world economy is not only beneficial for the countries involved but also for the world as a whole. While academic debate continues on the magnitude of the impact of trade on growth and poverty, the experience of many countries in recent years shows a strong positive relationship between openness to trade and income growth, raising the living standards for poor as well as rich people. Indeed, the one robust finding in the growth literature is that openness to trade is associated with faster income growth. In a recent study, Frankel and Romer (1999) found that an increase of one percentage point in the ratio of trade to GDP raised income by at least one-half percent. Their results further suggested that trade increased income by spurring investment in human and physical capital, and by raising productivity growth. The effect of openness on reducing poverty is likely to be especially strong in the developing world, where enhanced globalization will generate increased demand for workers in labor-intensive industries. Results from recent work on the relationship between trade and poverty imply that openness helps poor people at least as much as rich people.[2]

*There is more to growth than trade*

Not all countries have been successful in integrating into the world economy. Nor is openness a sufficient condition for economic growth. Relatively few countries have been

[2] World Bank (2001) and Dollar and Kraay (2000).

able to attain and sustain growth rates that would be high enough to result in convergence with the per capita income levels of industrialized nations. Reasons for this are complex, but one common trade-related factor that characterizes the incidence of convergence is the intensity (depth) of trade integration. Countries that trade intensively with each other tend to exhibit a relatively high incidence of income convergence.[3] Of course, there is much more to the story than trade and trade policy, even though a liberal trade and investment regime is a crucial element. Very much depends on policies that define the business environment — investment in human capital (education), infrastructure, entry and exit regulations, and the quality of public and private sector governance. Much also depends on fundamental endowments such as location. Small land-locked countries surrounded by other low-income countries inherently face much greater challenges than countries that are in close proximity to large industrialized economies.

Although the term 'globalization' is used incessantly, the world economy still is far from being integrated. Only 5 to 6 percent of the labor force in OECD countries is involved in the production of goods for developing country markets. The OECD share of the capital stock in the developing world does not exceed 11 percent, an amount that constitutes less than two percent of the capital stock of the rich nations. Truly global industries such as electronics and aerospace co-exist with a much larger set of industries that retain a regional or purely national character. Trade in goods continues to be impeded by tariffs as well as non-tariff measures such as agricultural subsidies, anti-dumping duties and threats, product standards and rules of origin. The global economy

[3] See Sachs and Warner (1996) and Ben-David (1996) for evidence supporting the role of trade in income convergence. In contrast, in a recent paper, Slaughter (2001) finds little evidence of convergence using a difference-in-difference approach. Ben-David (2001), however, notes that Slaughter's results are misleading because they rely too much on dates of formal trade policy announcements and not enough on trade policy changes.

remains characterized by severe restrictions on international movement of labor. Even between high-income countries, labor tends to be less mobile than it was in the nineteenth century.

Greater openness to trade, like any major technological change or other policy reform, gives rise to dislocation and adjustment costs. Essentially, taking advantage of new opportunities means moving resources and changing ways of doing things. The process can put pressure on national systems of social assistance, environmental protection, national values and local communities. Global integration has cultural and social ramifications as well as economic dimensions. On the other hand, greater trade offers an enormous opportunity for eliminating poverty, hunger, and economic injustice. Multilateral cooperation in reducing trade barriers and assisting in the realization of the benefits of global integration is a major challenge for all governments and should be a vital component of any strategy to raise global living standards. The WTO has a major role to play in this connection. As discussed further below, India must continue to be a prominent actor in the WTO.

## I. India has gained from more open trade

A driving contributor to India's growth over the last decade has been its increased participation in global markets, both as a buyer and a seller. Trade liberalization during the 1990s resulted in productivity gains associated with increased competition, innovation, and acquisition of new knowledge and technologies, all of which have contributed to raising living standards in the country. The gains from trade are apparent in India's economic performance in the recent period of greater openness. The average growth rate in the ten-year period since India initiated an intensification of the process of

reform from 1991 has been around 6 percent, making India one of the fastest growing developing countries in the 1990s.[4] Furthermore, several studies document a significant decline in poverty in this reform period, of at least one percentage point per year in terms of the fraction of the population living below a dollar a day.[5] Given that one-third of the world's poor people live in India, this is an achievement of real significance for world poverty. Despite this progress, around 300 million people still live in poverty; India cannot relax efforts to provide more opportunities for its poor people.

India's improved economic performance in the 1990s was at least partly a result of productivity gains resulting from enhanced import competition: techniques of production and management improve, new products are developed, and capital and labor are reallocated across sectors and to the most efficient firms within an industry. Indian exports registered a quantum jump since the liberalization efforts beginning in 1984. This was accelerated by the bold structural reforms launched in June 1991. Prior to 1984, exports were largely confined to traditional areas. Economic structures and policies prevented India from realizing its dynamic comparative advantages. India has real strengths in skill-intensive activities; if India is to be able to realize its comparative advantages, then imports and other inputs need to be available to exporters at world prices.

*Success stories include gems and software*

Two major success stories are now activities that are among the country's largest foreign exchange earners — software and gems and jewelry. Ensuring the availability of high

[4] Ahluwalia (2002).
[5] Datt and Ravallion (2002).

quality machines at world prices enabled India to become a top exporter of gems. This sector is now the most important contributor to India's export earnings. The bulk of the earnings come from exports of polished diamonds. India imports rough diamonds, cuts and polishes them using its abundant skilled labor, and exports the polished gems. Key to this industry are the services of high quality machines, which were not available domestically and were subject to heavy import duties prior to liberalization of the trade regime. Reducing tariffs and allowing access to these key inputs was a major factor in the growth of this industry.

The story is similar for another major export item — software. Discarding the inefficient import substituting electronics policy of the early 1980s and allowing more liberal use of satellites and leased telecommunication lines was critical to the export drive. Other important liberalizing measures included allowing easy access to imported computers and entry of private Internet service providers. The main impetus provided by government was the creation of software technology parks. This allowed exporters duty- and tax-free access to imported inputs, principally computer and communication hardware, and was accompanied by reductions in tariffs — with the added benefit of reducing incentives for equipment to leak into the domestic economy.

Another specific example comes from the machine tool industry. From the 1950s to the early 1990s, it operated in a protected environment, with tariffs as high as 100 percent. After 1992, tariffs fell sharply to around 15 percent and import competition threatened the viability of domestic producers. Because the variation in productivity among Indian firms was very large (by a factor of more than 4), the least productive firms simply could not compete in the new pricing environment. The more efficient Indian

firms, however, were competitive with imports, and over time their output expanded while imports declined. More importantly, the quality of tools produced improved and productivity in the Indian machine tool industry increased. This story illustrates the vital role that import competition can play as a source of market discipline.[6] It has been a very big part of change in India.

***Agriculture has also benefited***

Agriculture has also been a beneficiary of the trade reforms pursued in the 1990s. The reduction in trade restrictions (and the accompanying depreciation of the exchange rate) resulted in rising relative prices for agricultural produce. The domestic agricultural terms of trade — the price of agricultural output relative to manufactures — increased by around 20 to 30 percent during the 1990s,[7] resulting in an expansion in output and exports, and contributing to the decline in poverty. However, one disturbing trend in the 1990s has been an increase in inequality both between and within rural and urban areas. In their recent work, Deaton and Dreze (2002) find that while agricultural wages rose in the 1990s by about 2.5 percent per year, GDP growth was even faster. Furthermore, in the rural areas of some of the poorest states, per capita household expenditure saw negligible increases from 1993-1994 to 1999-2000.[8] During the 1990s, public sector salaries grew at almost 5 percent per year, suggesting that the public sector has been a part of the problem. Public sector employees tend to reside in urban areas, earn more than agricultural workers, and have experienced more rapid income growth. A key function of the public sector should be to direct resources to the poorest areas. Failure on this front

---

[6] Sutton (2000).

[7] Ahluwalia (2002) finds an increase of 30 percent. World Bank data show an increase of about 20 percent in the 1990s and an increase of about 30 percent since the 1980s.

[8] Deaton and Dreze (2002).

will diminish the capacity of reform to reduce poverty. Still, it is unclear whether the increase in income inequality would have been more or less severe in the absence of enhanced openness to trade, nor whether the trend will continue. If China's experience with market orientation can serve as a guide, it can be expected that income inequality will continue to increase. That said, the silver lining for India has been in the form of social indicators of inequality; the rural-urban gaps in life-expectancy and school participation rates have narrowed.

*Adjustment costs and the political economy of reform*

The role of social policy in complementing trade reform is important because the net gains from trade liberalization are unlikely to be distributed equally across the population. In the example of the machine tool industry above, liberalization brought gains to consumers of machine tools in the form of lower prices and higher quality. Moreover, some of the more productive plants fared well and even expanded in the new pricing environment. At the same time, some of the least productive plants were forced out of the market. While the burden that falls on some industries, firms, or individuals in a dynamic economy is likely to be far smaller than that associated with measures restricting competition, well-known political economy problems impede reform. Losers know with greater certainty how they will be affected by reform than those who stand to gain. The latter will also be more dispersed and confront the prospect of relatively small individual gains. Such political economy factors help explain why reforms became less vigorous in India in the second half of 1990s. Tariff reduction of the early 1990s did not continue although average tariffs continue to be very high by international standards. At 35 percent, they are more than double those applied by China and other South-East Asian

countries. It is important to recognize that the slowdown in reforms has come at a significant cost. The result has been a slower pace of growth and substantial opportunity costs in forgone income and poverty reduction.

In the short run, trade adjustment assistance policies aimed at alleviating the unevenness of the burden — rather than at restricting trade — will smooth the adjustment process and allow people more generally to achieve improved living standards. Adjustment programs are needed to help assure the political viability of liberalization and to ensure that the most vulnerable are not affected negatively. Around the world — from Delhi to Dublin, from Ouagadougou to Washington — the products of some interest groups have been granted special protection. Such policies are very costly, not just for the foreign producers, but also for the domestic consumers who are forced to pay high (and distorted) prices. We must recognize these difficulties of adjustment and develop an assistance strategy that addresses these concerns, so that the benefits of integration are achieved at the lowest possible cost. This is vital because the income growth and poverty reduction that greater openness can generate are significant, even considering the pains and political difficulties that reform will entail.

## II. The Global Agenda: Progress is Critical

There is large outstanding agenda of policy reforms that can and should be undertaken by high-income countries that will generate significant benefits for ordinary people in developing countries. This agenda includes:

- Reducing the large number of very high tariffs — so-called tariff peaks — that restrict imports from developing countries. In part this is because of associated tariff escalation, whereby tariffs increase depending on the stage of production.
- Reducing trade-distorting policies in agriculture. Total OECD support for farmers is over US$ 300 billion, almost one-third of total farm receipts, and recent developments — the U.S. Farm Bill and Franco-German agreement on European Union (EU) farm support — represent a retreat from needed reform.
- Disciplining non-tariff measures that restrict trade — examples are anti-dumping duties that too frequently target developing countries and food safety standards that are more stringent than is recommended internationally.
- Removing restrictions on the temporary movement of natural persons supplying services, an activity where developing countries have a clear comparative advantage.

What follows elaborates on these points.

The potential welfare (real income) gains from further global trade policy reforms are large. Although inherently imperfect, the best global trade models we have suggest that by 2015 developing countries stand to gain annually around US$ 75 billion in real income from unilateral liberalization of merchandise trade by OECD countries, and around US$ 120 billion from own liberalization (Table 1). These gains far exceed total official development assistance, which has been relatively flat over the past decade at US$ 50-60 billion per annum. Thus, development aid only partially offsets the damage caused by protection in the industrial countries. Such models tend to understate the gains from trade because they do not take into account possible dynamic gains or the benefits

from liberalizing services and eliminating non-tariff barriers. These additional gains could be very large relative to the gains calculated here (for instance, taking into account *dynamic effects* of merchandise trade liberalization by all regions can lead to gains for developing countries that are almost 3 times higher, and world gains that are more than 2 times higher). Two points are evident. One, the gains to developing countries from removing their own barriers to trade outweigh the gains from the removal of barriers in rich countries. Two, the primary source of gains is from agricultural liberalization. These conclusions also hold for India, where the models suggest that some 60 percent of the total gains will come from own and developing country liberalization (Anderson *et al*, 2002). Most importantly, global trade reform is critical to the attainment of large-scale poverty reduction. According to World Bank analysis, more rapid growth associated with a global reduction in protection could reduce the number of people living in poverty by as much as 13 percent in 2015 (or 300 million people). This would play a key role in meeting the Millennium Development Goals (MDGs) (World Bank, 2002a).

Results from the World Bank model imply that a removal of agricultural tariffs and subsidies by all WTO members (on a subset of supported products) would generate an increase in developing country exports of 15 percent and an increase in imports of 12 percent; India would experience an increase in exports of 13 percent and in imports of 11.5 percent. World prices of wheat are expected to rise by about 10 percent and prices of rice are expected to rise by about 16 percent. As an exporter of both rice and wheat, India therefore stands to gain significantly from terms-of-trade improvements. Another study which looks at longer run effects of liberalization finds that removal of protection by

high-income countries would lead to a long run increase in prices of about 6 percent for rice and 12 percent for wheat.[9]

**Table 1: Gains to Developing Countries from Removing Barriers to Trade**
(1997 US$ billion, additional income in 2015 as compared with baseline income) [1]

| Liberalizing Region: | Agriculture & Food | Textile & Clothing | All Others | Total |
|---|---|---|---|---|
| High Income only | 31 | 19 | 26 | 76 |
| Developing only | 114 | 7 | -5 | 116 |
| All Regions | 142 | 24 | 20 | 184 |
| **Memo:** | | | | |
| Gains to High-Income Countries: | | | | |
| From their own unilateral liberalization | 73 | -3 | -25 | 49 |
| From liberalization by All Regions | 106 | 17 | 50 | 171 |
| World Gains from liberalization by All Regions | 248 | 41 | 70 | 355 |

**Notes**: (1) Baseline scenario incorporates only those changes to the global trading regime up to 1997. Simulations based on phased elimination of import tariffs, export subsidies, and domestic production subsidies over 2005-10. Results reported in this table do not include gains from productivity improvements, liberalization of services, and removal of non-trade barriers.
**Source**: World Bank (2002a), p. 171.

The trade agenda spans much more than just trade in goods. Although developing countries have much to gain from further liberalization of agricultural and manufactures trade — by the OECD and by themselves — the potential gains from service sector liberalization are also very large. Indeed, they may be larger in the aggregate. The model implemented by economists here at National Council of Applied Economic Research (NCAER), for example, implies that a 33 percent reduction of tariffs and trade barriers standards in agriculture, minerals, and services would result in welfare gains to India of

[9] Beghin, Roland-Holst and Van der Mensbrugghe (2002).

about US$ 11.4 billion, or 2.7 percent of GDP (Chadha *et al*, 2001). Liberalization of services is responsible for the lion's share of the welfare gain. Within the manufacturing sector, wearing apparel and mining will experience large output growth, while agricultural output remains virtually unchanged. While most of these gains are generated by *own* policy reforms, actions by partner countries, in particular OECD nations, can do much to increase the gains. In the area of services, a key area where OECD countries must take the lead is liberalization of temporary movement of natural persons providing services — the so-called fourth mode of supply distinguished in the General Agreement on Trade in Services (GATS). For example, the welfare gains to both the developing and industrial countries would be large if more computer programmers, construction workers, and nurses could at least temporarily work and live in countries, where there is a shortage of workers with these skills.[10] It is imperative that high-income countries take vigorous action to eliminate remaining barriers to trade with developing countries. India, like other developing countries, confronts serious obstacles in realizing the full promise of trade integration because of barriers imposed by rich nations (Chanda, 2002; and Chadha, 2002).

***Bad Practices in Industrial Countries***

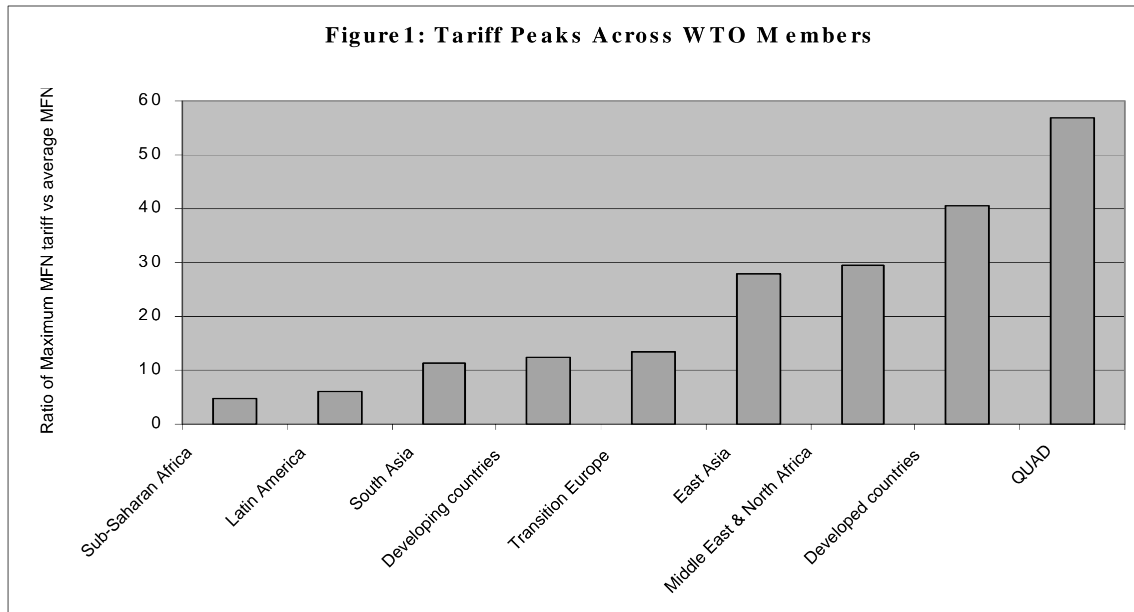
Despite recurring rounds of trade liberalization under GATT (General Agreement on Tariffs and Trade)/WTO auspices as well as unilateral reforms, many developing countries have not been able to integrate into the world economy. This reflects both internal and external factors. Among the latter, trade restrictions — tariff peaks, tariff escalation, subsidies, ever tighter product standards, rules of origin, etc. — reduce the

[10] See Walmsley and Winters (2002) for estimates of the magnitude of Mode 4 gains.

ability of developing countries to exploit their comparative advantage. From the perspective of the poorest countries, a multi-pronged strategy is required that recognizes that much of the agenda lies outside the scope of the WTO and must be addressed by governments and by the development community. Time constraints preclude me from devoting the attention that should be given to the investment climate and empowerment agenda that is critical in many countries (although I will return to this theme as it relates to India), an important part of which are 'behind-the-border' institutional and regulatory factors that inhibit trade. These include infrastructure, such as roads and ports, that directly promote trade, as well as the regulatory bodies, such as for customs clearance and product standards, which if not well structured will impede trade. Instead, I will focus on the contribution WTO members can make. These are twofold: improving market access conditions for goods and services, and ensuring that multilateral trade rules are useful to developing countries.

A major source of potential welfare gains to India and other developing countries is enhanced market access in industrial countries. Although the industrial countries boast average ad valorem tariffs of less than 5 percent on manufacturing goods, these countries still have very high tariffs on many products important to developing nations. These so-called tariff peaks, which apply mostly to agricultural products and textiles and apparel, are especially harmful to exports from the developing world. On average, the highest tariffs are 40 times the average tariff in the OECD countries (Figure 1). In contrast, among developing countries the average is 12, though of course their average tariffs are significantly higher. Total imports of products subject to tariff peaks in Europe, Japan, the United States and Canada were nearly US$ 100 billion in 1999, of which more than

60 percent were from developing countries.[11] In Canada and the United States, the average Most-Favored-Nation (MFN) tariffs — that is, tariffs that apply to all WTO members — are close to 20 percent on articles of apparel and clothing — India's number-two export. This compares with an average manufacturing tariff of about 3 percent.




Tariff peaks are also a reflection of tariff escalation, which implies that market access for more processed products (embodying greater value added) is more restricted. For example, fully-processed manufacturing food products face tariffs twice as large as products in the first-stage of processing in the EU and Japan, with final goods confronting an average MFN tariff of 24 and 65 percent, respectively. In Canada the ratio is even higher: tariffs on fully processed food products are 12 times higher than for 1st stage processed products (the MFN tariff on fully processed is 42 percent). For example, the U.S. tariff on fresh tomatoes is 2.2 percent, the tariff on dried tomatoes in a package is 8.7 percent, and the U.S. tariff goes to up to 11.6 percent if the tomatoes are in a sauce.

[11] Hoekman, Ng, and Olarreaga (2002a).

There is also discrimination against lower value added varieties of products. Thus, in the US, a decorated glass with a value under US$ 0.30 has a MFN tariff of 38 percent. However, glasses with a value over US$ 5 incur only a 5 percent tariff. The use of specific tariffs for lower-cost glasses discriminates against producers of lower-cost glasses in developing countries and against the broad mass of consumers in the industrial countries. Since lower-priced glasses are likely to come from poorer countries, the impact on these countries is likely to be particularly adverse.

In order for the Doha Round to truly be a development round, it must address tariff peaks and escalation. The best way of doing this is through a formula-based approach to negotiations that incorporates a specific target or benchmark regarding the goal to be achieved. An example would be to require every WTO member to have a ratio of maximum to average tariff of less than 5, up to a maximum tariff of, say, 50 percent. It is important that whatever negotiating modalities are chosen by WTO members, these will move countries towards a substantial reduction in current tariff peaks (Francois and Martin, 2002). In addition to giving exporters — especially those in developing countries — greater market access, lower variation in tariffs will benefit consumers in the importing countries because prices will more accurately reflect the market value.

*Trade-distorting policies are especially apparent in agriculture*

Making significant progress in reducing agricultural trade-distorting policies maintained by OECD countries is critical from a development and poverty reduction perspective. So far very little has been achieved on agriculture. Total OECD support for agriculture amounted to US$ 311 billion in 2001, with producer support estimated at almost one-third of total farm receipts (Table 2). Prices received by OECD farmers were on average

31 percent above world prices (measured at the border). The absolute level of producer support was largest by far in the EU, although, as a share of farm receipts, support levels in Iceland, Japan, Korea, Norway, and Switzerland were substantially higher. A large share of support is directed at temperate zone agriculture (grains, oilseeds, dairy), but support for products of interest to tropical suppliers is often particularly high as a share of producer receipts (sugar, rice, cotton, and tobacco).

**Table 2. Indicators of Agricultural Support, Selected OECD Members, 2001**

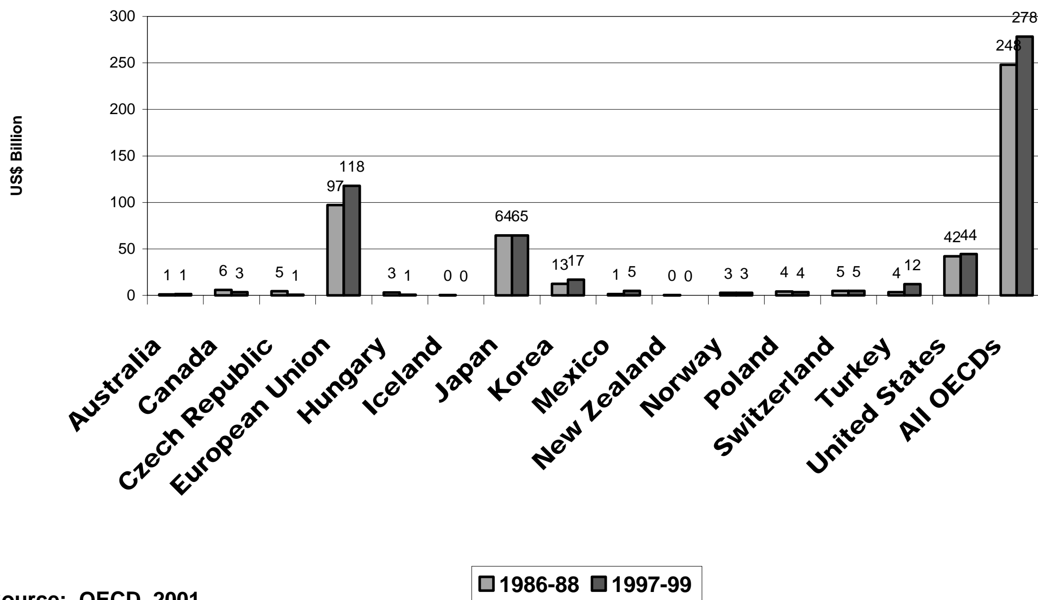
| Country | PSE (US$ Mn) | Percentage PSE | NPC | NAC |
|---|---|---|---|---|
| Canada | 3,928 | 17 | 1.11 | 1.21 |
| European Union | 93,083 | 35 | 1.33 | 1.54 |
| Japan | 47,242 | 59 | 2.36 | 2.46 |
| Korea | 16,838 | 64 | 2.64 | 2.76 |
| Mexico | 6,537 | 19 | 1.17 | 1.23 |
| Norway | 2,173 | 67 | 2.27 | 3.00 |
| Switzerland | 4,214 | 69 | 2.39 | 3.21 |
| Turkey | 3,978 | 15 | 1.15 | 1.18 |
| United States | 49,001 | 21 | 1.15 | 1.27 |
| OECD | 230,744 | 31 | 1.31 | 1.45 |

**Notes**:
PSE: Producer Support Estimate: an indicator of the annual monetary value of gross transfers from consumers and taxpayers to support agricultural producers. The percentage PSE is the ratio of the PSE to the value of total gross farm receipts.
NPC: Nominal Protection Coefficient: an indicator of the nominal rate of protection for producers measuring the ratio between the average price received by producers and the border price.
NAC: Nominal Assistance Coefficient: An indicator of the nominal rate of assistance to producers measuring the ratio between the values of gross farm receipts including support and gross farm receipts valued at world market prices without support.
**Source**: OECD (2001)

Many OECD countries have protection levels that remain comparable to pre-Uruguay Round levels — indeed, in the major OECD members (EU, US) support levels have risen (Figure 2). While support to agriculture as a percentage of GDP has decreased in most OECD nations, *so too has farm value-added and the number of farmers*. As a

result, contrary to widespread perceptions, support as a percentage of value-added has declined only slightly, and support per active farmer has even increased, by 25 percent and 50 percent in the US and EU, respectively, since the late 1980s. Meanwhile consumers in industrialized countries are spending on average one-third less of their income on food and are increasingly concerned with health and the environment, making them simultaneously less eager to oppose farm protectionism that increases prices, and more supportive of government assistance to farmers for produce that supposedly is healthier and less damaging to the environment. However, a more efficient and equitable policy that would achieve these objectives involves providing developing country farmers with the opportunity to supply OECD consumers with organic or pesticide free or other types of desirable types of food products.

**Figure 2: Producer Support Estimates (PSEs) in OECD Countries**




Source: OECD, 2001

It is helpful to focus on specific examples. Take the case of milk — one of the most heavily subsidized agricultural products in virtually all the developed countries. Agricultural policies in Japan (including trade policies) added almost 400% to the domestic price of milk, whereas in the US and the EU the market price was inflated by 71% and 76%, respectively. Support measures in the US include minimum prices, government purchases of dairy products, export subsidies, high import tariffs and tariff-rate quotas. This hurts developing countries such as India, with a potentially strong capacity to supply dairy products. Note that distance should not be a big issue, New Zealand has exported butter to the European markets for decades.

Not surprisingly, those who lose from restrictive policies for dairy imports include consumers in the relevant OECD countries. Indeed, the policies are regressive, as low income families tend to spend a larger share of their income on milk and other dairy products (Table 3). Traditionally, price supports to dairy farmers have been justified on the grounds that dairy farmers are a vulnerable, low-income group in the developed countries. However, the scale of this industry has greatly increased in recent years, with dramatic increases in herd size. An average dairy farmer in the US today has more than 100 cows (American Farm Bureau Federation), assets of over a million dollars and a net income of almost US$ 80,000 (USDA-Economic Research Service), making him or her an implausible target as a recipient of government welfare payments.

Or, take the case of wheat. In a logical world, much of the demand for wheat in the land-scarce industrial countries of Europe and East Asia would be supplied by developing countries better endowed with land and labor for wheat production. Recent modeling work suggests that many developing countries would be large exporters of food

grains in the absence of trade policy distortions, particularly the agricultural policy distortions in industrial countries (Anderson et al, 2001), that Europe would become a large net importer, and Japanese grain imports would rise dramatically, creating major opportunities for exports from India and Latin America.

**Table 3: Dairy Expenditure by Income Quintile in 2000**

| | Quintiles of Income before Taxes | | | | | |
|---|---|---|---|---|---|---|
| | **0 - 20** | **20 - 40** | **40 - 60** | **60 - 80** | **80 - 100** | **All** |
| Total annual expenditure | 17,940 | 26,550 | 34,716 | 46,794 | 75,102 | 38,045 |
| Annual expenditure on dairy products | 197 | 290 | 344 | 393 | 474 | 325 |
| Share in total expenditure, % | 1.1 | 1.1 | 1.0 | 0.8 | 0.6 | 0.9 |
| Annual expenditure on milk and cream | 92 | 124 | 142 | 151 | 181 | 131 |
| Share in total expenditure, % | 0.5 | 0.5 | 0.4 | 0.3 | 0.2 | 0.3 |

**Source**: Consumer Expenditure Survey, Bureau of Labor Statistics

Even though the United States is the largest wheat exporter in the world, it provides lavish supports to its wheat farmers. Producer support in the US accounted for 48% of the total farm receipts of wheat producers in the US — which corresponds to agricultural policies adding 91% to wheat farmers' incomes! The numbers for the EU are similar, while those for Japan are even higher, with government support more than six times market prices (Table 4). As noted earlier, removal of wheat protection by the high-income countries is estimated to lead to a rise in the price of wheat by upwards of 10 percent. The removal of support in combination with the price increase will lead to a shift in production away from high income countries to the low income countries.

Finally, consider OECD policies towards rice, a major Indian crop. Some of the most egregious distortions in world agricultural trade are seen in the rice markets of the

high-income East Asian economies. Japanese rice growers received support equal to more than 7 times the world price of their output in 2001! The Japanese market remains virtually sealed against imports. Almost 90 percent of total farm revenue is from government transfer payments, and not much over 10 percent comes from the market value of their output at world prices. The main policy instruments used are administered prices, supply control and import restrictions. Although quantitative restrictions prohibiting imports above a certain quantity were lifted in 1999, exports in excess of the quota now face extremely high tariffs. The over-quota tariffs of US$ 2,807 per ton in 2001 is more than 10 times the import price. While India joins Thailand, Vietnam, and China as one of the largest rice exporters, it is the smaller countries that are most dependent on rice exports. Over 10 per cent of total exports from Suriname (by value) are from rice.

**Table 4: Government Support to Producers of Wheat**

| | **EU** | | **Japan** | | **USA** | |
|---|---|---|---|---|---|---|
| | **1999** | **2000** | **1999** | **2000** | **1999** | **2000** |
| Producer Support Equivalent (US$ mn) | 11,329 | 9,124 | 736 | 912 | 5,718 | 5,344 |
| Share of PSE in total farm receipts, % | 55 | 46 | 86 | 86 | 50 | 48 |
| *Ad-valorem* equivalent of total support[1], % | 121 | 86 | 621 | 616 | 100 | 91 |

**Note**: (1) Indicates the rate by which the value of gross farms receipts including support exceeds gross farm receipts without support valued at world market prices.
**Source**: OECD

Given the large subsidies by industrialized countries, liberalization, particularly in heavily distorted product lines, is likely to be regarded as being "unfair" and detrimental to developing countries base of production. Political realities are such that it will be quite

difficult for developing country leaders to pursue own reforms in the absence of far-reaching reform of domestic support and export subsidy policies by OECD nations. The developing country agenda will mostly involve tariff reductions, given that trade policy is the primary tool used to protect agriculture.

One simple measure of the cost of domestic support is the extent to which countries export product lines that receive subsidies by WTO members. While only about 3 percent of industrialized country agricultural exports are in supported product lines, nearly 18 percent of the agricultural exports of the least developed countries are in these lines. In the case of India, about 8 percent of exports of agricultural products are in supported lines, as compared with only 2 percent of imports (Hoekman, Ng and Olarreaga, 2002b). This suggests that the removal of subsidies will have a significant positive effect on the Indian economy, as the potential for exporters to gain from price increases will outweigh the losses that importers will face as a result of higher costs. This means that, in principle, India can use the public distribution system to make everyone better off. Agricultural subsidies by other WTO members impose a cost on India and other developing nations. It is therefore important that domestic support in the OECD countries becomes decoupled from production and that export subsidies be eliminated.

In addition to subsidy programs of various kinds, there are many cases in which the same product lines that are supported domestically are also granted excessive protection through tariffs. For example, the average tariff in the Quad countries on products receiving support (subsidies) is 48 percent, with a maximum tariff of 557 percent![12] Protection is often in the form of specific tariffs, rather than the *ad valorem*

[12] Hoekman, Ng, and Olarreaga (2002b).

tariffs which are the rule in manufacturing. About one third of EU and US farm tariffs are specific or include a specific tariff component. In addition to being non-transparent, specific tariffs are heavily biased toward low-priced farm products that are more likely to originate in developing countries, and hence are disproportionately harmful to low income countries. For example, the ad-valorem (only) tariff for paddy rice in the EU is 8.4 percent, but there is a specific tariff of €211 per metric ton, which translates into an actual ad valorem tariff of about 79 percent. Similarly, on wheat the simple average ad valorem tariff is nil, but there is a specific tariff of €148 per ton, which translates into an ad valorem tariff of about 123 percent.

*Agricultural protection in the OECD increases the volatility of world prices*

A major additional burden induced by domestic support programs, export subsidies, and market access limitations is that they increase the volatility of agricultural markets. These policies essentially insulate the domestic markets of the protecting or subsidizing country from world markets, and thereby force the rest of the world to accommodate changes in supply or demand conditions. Thus, shocks that would result in relatively modest changes in price if spread out over a large number of producers and consumers, result instead in very large swings that have a much larger impact on those exposed to world prices. The shocks are exacerbated by the nature of agricultural markets, which are characterized by relatively inelastic demand and supply conditions, at least in the short term, and by dependence of production on weather. These policies also have a more indirect de-stabilization effect on other countries' markets when the large surpluses are "dumped" as food aid. It has been a common complaint that some food aid decisions have been driven more by the stock situation in the OECD countries than by legitimate

needs of poor people in times of food crises. When this happens, the effect is to punish producers, importers, and those who are storing food.

Industrialized country consumers and taxpayers stand to gain the most from policy reform in OECD countries. Such reform will also have beneficial distributional consequences as the current allocation of agricultural subsidies is heavily skewed towards large farmers. In Europe, the largest 17 percent of farms receive 50 percent of public support, whereas the bottom 50 percent receive 8 percent. In the U.S., the largest 9 percent of farms receive 41 percent of public support, whereas the bottom 81 percent receive 34 percent (ABARE, 2000).

That said, it must be recognized that serious reforms will give rise to adjustment costs in OECD countries. It is generally true that the gainers from liberalization will benefit more than the losers will lose, so that the former can afford to compensate the latter and still be ahead. Although complete compensation may have an adverse effect on incentives, social safety nets and general assistance policies (such as retraining, income support, mobility premia) need to be developed and funded in order to facilitate adjustment. Moreover, account must be taken of the fact that, in practice, economic dislocation due to dismantling of protectionism in OECD countries should be manageable, given that any reforms will only be implemented gradually over a period of time and will involve a small fraction of people. In Japan, the fraction of the population employed in agriculture has fallen from about 8 percent in 1975 to about 2 percent today;

in the EU from 5 percent in 1975 to about 2 percent today, and in the U.S. from about 2 percent in 1975 to 1 percent today.[13]

*Recent developments in the EU and US represent two steps in the wrong direction*

Despite this, the prospects for reform remain rather bleak. The recent US Farm Bill significantly *raised* spending limits for farm subsidy programs, as opposed to sending a signal that the US is planning to reduce its intervention in agricultural markets. Projections by the US Congressional Budget Office are that the extra cost of the Bill equals some US$ 80 billion over the next ten years. More than half of this money will be channeled through the new counter-cyclical payments for crops and dairy products and direct payments as an extension of existing programs. The remainder will go to marketing assistance loans, loan deficiency payments and special programs for dairy, sugar and peanuts. A new peanut program alone will cost US$ 4.9 billion. While the US argues that the support in the Farm Bill is not tied to production, and therefore will not distort production incentives, making it consistent with its WTO obligations, even such "so-called" decoupled support can influence aggregate production in the long run. This is because it influences the farmers' decision to continue planting to qualify for future support. Thus, the Farm Bill provides two direct attacks on free trade, the first is greater support for domestic producers, and the second is a further distortion of production incentives.

Even more worrying is the recent agreement between France and Germany to maintain the current expenditures under the EU Common Agricultural Policy (CAP) unchanged through 2013. The European Commission had initially proposed to launch

[13] Calculated from World Bank (2002b).

CAP reform starting in 2004, consistent with the Doha negotiating timetable. However, under the Franco-German deal forged at the October 2002 EU Summit in Brussels, the CAP budget will be maintained at a minimum of €30 billion a year, and from 2007 to 2013 the EU farm spending allows for a one percent annual increase to make up partially for inflation. The previously agreed target for 2006 is €30 billion, and if this agreement stands, it sends a clear signal that the Doha Development Agenda will not deliver the goods in an area that is of critical importance to developing countries. Under the agreement, the EU is going to maintain generous subsidies for farmers, at a level at or above any previous WTO agreements. Hypocrisy is not too strong a word to use in this connection, as it is clear that the objective seems to be to ensure that European farmers will remain safely sheltered from competition from developing countries. The cost is great to the domestic tax payer, it is regressive for the domestic consumer, it damages the environment, it undermines Doha, and it is deeply damaging to developing countries. It is a disturbing agreement and I hope it will not last.

*Other instruments of protection cannot be ignored*

In addition to tariffs, and subsidies in the case of agriculture, a variety of other policies restrict access to markets or raise the cost of doing so. Anti-dumping charges are frequently used to target products from developing countries. Nearly 80 percent of anti-dumping initiations reported to the WTO in the mid-1990s by the United States and the European Union were against products from low and middle income countries.[14] Indeed, since 1995 India has been among the top ten countries affected by anti-dumping initiations. Such measures have especially detrimental effects on developing nations

[14] Hoekman and Kostecki (2001).

because they tend to proliferate during global economic downturns, worsening income volatility and leaving exporters that much more vulnerable. For instance, the number of anti-dumping initiations against imported steel products in the United States surged as the global economy slowed and world price of steel plummeted. Indeed, weakness in the domestic sector, and not an import surge, was ultimately what allowed U.S. steel producers to obtain broad protection through the escape clause. A disturbing new development is that India and other developing countries have also begun to use anti-dumping legislation, and also tend to target other developing countries. These are discussed further below.

Increasingly, the barriers that developing countries face in the major world markets are often opaque, making them more difficult for developing countries to respond to. In particular, many agricultural exports are required to meet food safety standards that are more stringent than internationally recommended. For example, standards on aflatoxin contamination limit the access of cereals and nuts from India and 30 other countries (including 19 other developing countries) to markets in Europe, Japan, Australia and Canada. (Cereals, dried fruits and nuts can develop aflatoxin when kept in humid and unclean conditions.) Scientific experiments indicate that the gains in terms of enhanced public health from meeting these more stringent standards, as compared with international standards, are very small. World Bank estimates suggest that if all nations move to the internationally recommended standards of the Codex Alimentarius Commission, there would be about a 50 percent increase in exports from the affected countries. Food safety standards are important but we should not assume that tightness of

standards is always beneficial.[15] A rational approach requires looking carefully at both the costs and the benefits. Meeting more stringent standards is too costly for many countries, as it would require considerable investment in storage, processing lines, transportation, distribution measures and quarantine testing. In other words, the aflatoxin standards in several counties are not justifiable from a medical standpoint and adversely affect exports from many developing countries.[16]

Unfortunately, food safety standards are especially effective at limiting the exports of the least developed countries, because they do not have funds to take a trade dispute to the WTO. An example of this comes from camel cheese in Mauritania. After winning a prize in a German trade fair for their cheese, the Mauritanian dairy producer, Tiviski, quickly found a German distributor and the cheese was to be sold at luxury shops such as Fauchon in Paris and Harrods in London. Export sales would help to alleviate poverty, as the main ingredient, camel milk, is collected from nomad producers, most of whom live below the international poverty line of US$ 1 per day. But sanitary requirements in the EU led to the blocking of all exports of camel cheese from Mauritania because EU regulations require mechanical milking for imports of dairy products. In a nomad society with camels that are 300 kilometers away from the main ports, this is a prohibitively costly proposition. If the case had been brought to the WTO, the EU might have been found not to have "sufficient scientific evidence" to support the ban on imports of camel cheese. But the US$ 3-5 million in planned export earnings did not justify incurring the cost of bringing a case to the WTO.

---

[15] See Saqib (2002) for detail on India's standards institution.
[16] Wilson and Otsuki (2001).

*Liberalizing temporary movement of service providers: a huge opportunity*

In addition to restrictions on the movement of goods, limitations on movement of natural persons who are service providers — the so-called mode 4 under the GATS — places undue costs on developing countries. India's service sector has been the main engine of export growth over the last decade. Services accounted for only one-fifth of India's exports in 1990, but now account for nearly one-third of total exports; in contrast, during the same period share of services in exports worldwide has remained roughly constant at about 20 percent. More specifically, India's high-tech sector is a major success story that would benefit dramatically from enhanced temporary movement of service suppliers. While new technology has enabled many technical services, such as software design and data processing, to be supplied across borders, about 60 percent of Indian exports are still supplied through the temporary movement of programmers to the client's site overseas. Lowering barriers to temporary migration is also important in areas like construction, where developing countries have comparative advantage, but are prevented from exploiting it fully.

*Determining the value of multilateral disciplines on 'behind-the-border' policies*

Finally, let me briefly touch on the issue of the 'rules of the game' that are set in the WTO. One example of the move by the WTO to address policies that have little if any bearing on market access was the introduction of rules requiring the enforcement of specific minimum standards of intellectual property protection. These have proven to be very controversial. Indeed, the rules and disciplines that were introduced in this area in the WTO as a result of the Uruguay Round were strongly resisted by India. Since the conclusion of the Uruguay Round, an increasing number of observers have concluded

that the types of rules embodied in the WTO on intellectual property may not be in the interest of low-income countries. Recent research suggests that the projected additional transfers to the US from payments for patents exceed total ODA granted by the US, that is, US$ 19 billion vs. US$ 9.9 billion (World Bank, 2002a). Even allowing for overestimation of the patent-related transfers, these figures illustrate the importance of careful analysis of the implications of negotiating multilateral rules on regulatory policies.

The experience with intellectual property has important lessons for new efforts to embody regulatory disciplines in the WTO. Examples that are currently being proposed for inclusion into the WTO include trade facilitation, transparency in government procurement, investment policy and competition law. These are all important elements of domestic policy that are determinants of the overall investment climate and business environment. However, it is not clear what role, if any, the WTO can fruitfully play to assist governments to improve policies and outcomes in these areas. As is argued in World Bank (2003), a general principle that should be applied for domestic 'behind-the-border' policies to be subjected to WTO disciplines, is that these have direct implications for market access or impose significant negative externalities on other countries.

Such externalities certainly exist in the area of investment and competition policy. Thus, OECD investment incentives are detrimental to developing countries by reducing FDI outflows. Antitrust exemptions granted by the authorities of rich countries for export or maritime shipping cartels increase the price of goods imported by developing country consumers (Fink, Mattoo and Neagu, 2002). The priority in the WTO should be to discipline such practices rather than seek to impose additional requirements on

developing countries that will give rise to implementation costs and may have a low return on investment.[17]

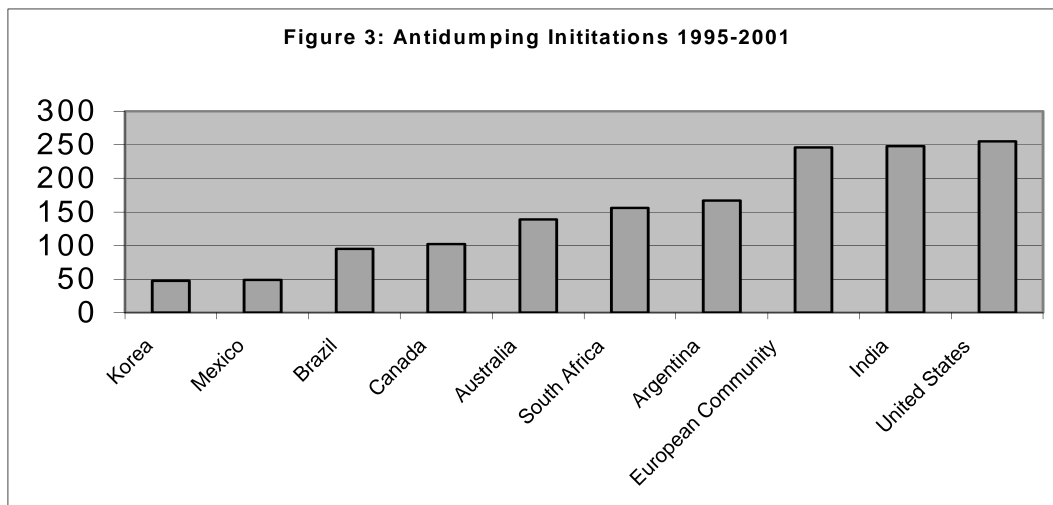
## III. Developing Country Policies Also Limit the Gains from Trade

Developing country markets are more protected than industrial country markets. Their protection impedes the ability of neighboring countries to use mutually beneficial trade to increase trade and growth. As important, if not more so, is the behind-the-border agenda in developing countries since own reforms to improve efficiency through greater competition and more effective regulation will determine the ability of domestic firms to compete.

The average tariff faced by developing countries on their exports of manufactures to other developing countries is, at 12.8 percent, almost four times as high as they face in industrial country markets. Given the increasing importance of developing country markets for their exports of manufactures and the expansion that has been observed in South-South trade, reductions in these barriers are of particular importance. To give one specific example, intra-developing country trade accounts for about half of their total exports of textiles and 20 percent of clothing exports. A recent simulation of the impact of full global liberalization of textile and clothing imports, in both industrial and developing countries, suggests that removing developing country tariffs would contribute a large share (53 percent) of their own gains in income and exports, though it would have a comparatively lower impact on industrial countries (IMF and World Bank, 2002).

[17] See Finger and Schuler (2002) on the need to analyze the magnitude of implementation costs associated with WTO agreements dealing with regulation.

As is true for OECD countries, the trade policy agenda in developing countries spans more than tariffs. A noteworthy and disturbing development has been the growth in the use of anti-dumping in major developing countries. As noted by Finger, Ng and Wangchuk (2001), not only have developing countries become frequent users of anti-dumping, but on a per dollar of import coverage basis they are the most intensive users of anti-dumping. India is unfortunately a leading member of this group. Since 1995 it surpassed the European Union to become the number two initiator of anti-dumping claims, second only to the United States (Figure 3). A large proportion of Indian anti-dumping duties are protecting highly concentrated industries, and providing new scope for rent-seeking that the abolition of quotas was meant to eliminate.




Restrictive trade policies do not only hurt Indian consumers and inhibit growth of productivity and quality for producers. They also impede the ability of neighboring countries to use mutually beneficial trade to increase growth and reduce poverty. India is of course a large country, especially in the South Asia regional context, and can play a major role in expanding trade opportunities within the region.

*The behind-the-border agenda is vital for developing countries*

While traditional trade policy reform remains critically important for many developing countries, much of the agenda is 'behind-the-border'. A supporting legal and regulatory environment is vital for trade liberalization to serve as an engine of growth. Elements of the associated 'behind the border' *trade* agenda that affect the investment climate include policies and institutions that support the participation of national firms on international markets and measures to enhance their competitiveness by ensuring access to crucial services inputs, both public and private. Improvements which help local markets to function better are also likely to help trade and foreign investment. For instance, access to a reliable communications network is important to domestic firms, foreign firms, and importers. Similarly, policies which discourage domestic investment, such as the reservation policy in India, which protects small scale industries, also discourage foreign investment.

Key areas in many low-income countries are product standards and services. Modernization of standards systems, including institutions and infrastructure for certification and conformity assessment, is needed to operate in the current global trade environment (Wilson, 2002). Meeting international standards for quality, health and safety is increasingly a precondition for contesting international markets and has become a major factor constraining the ability of many exporters in developing countries from benefiting fully from preferential access initiatives. Many low-income countries are not adequately equipped to deal with rapidly tightening product standards and labeling requirements and confront major investment requirements in order to do so.

The availability of low cost, high quality services is a critical determinant of the competitiveness of national firms. An efficient, diversified and well-regulated financial sector is necessary to fund investment needs and allocate resources to where they have the highest returns. Telecommunications are both a vital intermediate input and crucial to the dissemination and diffusion of knowledge. Transportation costs are a major determinant of competitiveness — the cost of international transport is often above the applicable tariff in export markets, and intra-national transport costs can be a multiple of international costs. Research has shown that measures aimed at reducing the cost of services that facilitate trade can easily have economy-wide welfare benefits that are a multiple of those associated with merchandise liberalization and, indeed, may be a precondition for benefiting from such liberalization (Hodge, 2002).

Initiatives to strengthen private and public service institutions that support export development — access to credit, modernization of product standards conformity assessment systems — and to reduce the cost of key inputs (transport, telecoms, insurance, finance, etc.) should be pursued in the context of an overall national strategic framework that identifies where the payoff to reform and public investment is largest. Careful policy analysis is needed to identify both priorities and options for reform. In many cases, pro-competitive reforms will be needed, as greater competition (contestability of markets) is a major engine for reducing prices and increasing the variety of goods and services. The competition agenda is often a complex one that involves numerous policy instruments, from liberalization of trade and elimination of entry restrictions through pro-competitive regulation and enforcement of competition law.

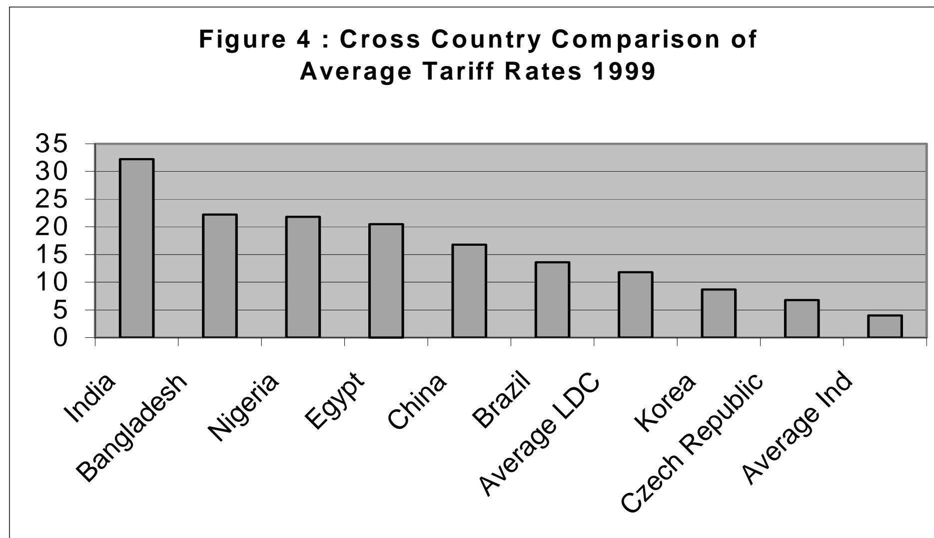
## IV. What Should India Do to Leverage Trade for Growth?

While the potential gains to developing countries from trade reforms in the industrialized world are substantial, the potential gains from domestic reform are even greater. Trade reform in India has made progress, but there is still a long way to go. Tariffs and subsidies, especially in agriculture, are still very high. Further trade reforms could bring great rewards to India, but to work well would need to be complemented by policies to improve the competitiveness of firms and farmers.

India has made great strides in trade reform over the last 10 years: the simple average tariff fell from 80 percent to around 35 percent between 1991 and 2001. In addition, there was a large reduction in the number of products covered by quotas and export restrictions. As a result of both trade liberalization and a real depreciation of the rupee, exports' share of GDP doubled from just 7 percent in 1991 to 14 percent in 2001. But, with trade barriers among the most restrictive in the world, there is still great potential in India for further reform (Figure 4). To get an idea of the magnitude of the barriers that remain, we can examine India's potential trade: that is, how much India would be expected to trade if its level of protection (and any other "uncontrolled for" characteristics) were similar to that in other developing countries. One way of estimating a country's potential trade is to use the so-called gravity model, which predicts trade based primarily on a country' income, population, and geography. Estimates from a gravity model suggest that during the period 1995-1998 India traded 70-80 percent less than would have been expected.[18] This implies that if India traded as much as other countries with similar geography and income, it would have about US$ 150 billion

[18] Chauffour (2002).

greater total trade (exports and imports). Furthermore, the degree to which India under-trades seems to have risen in the 1990s, suggesting that India's liberalization may not have kept pace with the liberalization of other countries.




Part of the reason that the effects of India's liberalization have been limited is that in several instances other forms of protection have appeared, filling the gaps that liberalization opened. In addition to the surge in anti-dumping protection initiations I mentioned earlier, the textile sector, for example, has benefited from recently introduced specific tariffs — where the ad valorem equivalent already ranges from 50 to over 100 percent. Some tariffs were also increased with the 2000/2001 budget, including on second hand automobiles (180 percent) and tea, coffee, copra, and coconut (70 percent). In part, because of this substitutability between instruments of protection, very little progress on agricultural liberalization has taken place. For instance, following the elimination of quantitative restrictions on imports in 2001, there was a shift to higher tariff rates and other forms of protection. Tariffs are similar to subsidies in that they tax consumers and reward domestic producers. The key difference between a tariff and quota that yields the

same level of imports is that the tariff generates revenue for the domestic government while the quota generates rents for the foreign producers and holders of import licenses. One extreme example of non-tariff protection was a short-lived port-of-entry restriction: in May 2001, the government declared that imports of 300 sensitive commodities could be routed only through 6 designated ports in India.[19] Uproar by importers who had invested heavily in other ports ultimately caused the order to be withdrawn, but several other measures that restrict imports remain in place.

In the pre-1991 period, there was a very marked anti-agriculture discrimination, reflecting high levels of manufacturing protection and an overvalued exchange rate, as well as export restrictions on agricultural produce, most notably rice. Input subsidies for agriculture (irrigation, electricity and fertilizers) were not sufficient to offset this discrimination. However, the anti-agriculture bias began declining during the late 1980s as a result of the real Rupee devaluation in the mid-80s. It declined further following the partial removal of quantitative restrictions in 1991-2 and the more general tariff reductions that were implemented through 1996-7. The end result was a marked improvement in the internal terms of trade for agriculture from the mid-1990s onwards. The most immediate and obvious effect was an expansion in agricultural exports, including processed foods. However, the improvement in the internal terms of trade for agriculture was also due in part to steadily increasing support prices for wheat and rice, which helped to create the present very large surplus stocks. For the past year, the government has been trying to reduce these stocks by exporting them at prices than are below those prevailing in the domestic market. Thus, in 2002 it is expected that India will

[19] Gulati and Narayanan (2002).

export more than 6 million tons of rice, over 20% of world trade in rice. Whilst this is an understandable response to excessive stocks, given the subsidy involved, this is not in India's long term interests.

Being on the whole a relatively efficient and low cost agricultural producer and exporter, India has much to gain from active participation in WTO efforts to curb trade-distorting agricultural subsidy policies. It is disturbing that while 300 million people live in poverty in India, lacking easy access to food, the government holds large food stocks (estimated at 55 million tons in September 2002), some of which are rotting in storage (Gulati and Narayanan, 2002).[20] Over time, these artificially administered prices are even more damaging because they distort incentives for future investment and may cause environmental damage from excessive use of water. While protecting farmers from risks is important from a social standpoint, support prices involving high subsidies, the benefits of which go to bigger farmers and which lead to rotting or dumped stockpiles, are unlikely to be a cost-effective way to fight poverty or implement social protection.

*Other Complementary Policies and Priorities*

Trade policy is by no means the only priority. Customs administration and inefficient trade logistics have also been a major deterrent to international business. It takes about three times as long to clear goods through customs in India than in the average OECD country. In addition, there is huge variation in the amount of time that customs clearance absorbs — increasing uncertainty and forcing firms to keep large inventories on hand. The longest delay for a typical firm in India in the past year was 21 days, compared with

[20] While holding some inventories in order to prevent famine is advisable, current levels are well beyond what is required.

12 in China.[21] In part reflecting poor infrastructure, transport costs are also much higher in India than in neighboring countries. For example, the transport costs of shipping a container from India to the United States are 35 percent higher than from China and 20 percent higher than from Thailand.[22]

Policies that do not directly affect trade, but that improve the investment climate are also key to reaping the gains from trade. Recalling the machine tool example above, an obvious question raised by the large variation of productivity is: Even in the absence of foreign entry, why didn't the more productive Indian firms simply drive the least productive firms out of the market? The answer to this question is that in addition to restricting foreign competition, government policies limited the extent of domestic competition through labor regulations and restrictions on entry and exit. The machine tool industry was non-competitive, with incomplete adjustment and prices well above world prices. As India reforms, openness will help move prices close to efficiency values, but improved domestic policies — discussed below — are also needed to facilitate adjustment, providing good firms with incentives to grow and poor firms with the ability to contract or close. The benefits of import competition will be greatly diminished in a setting where efficient firms cannot easily expand (or enter) and the poor firms cannot exit. It is therefore vital to complement trade liberalization, with reform in other areas, especially entry and exit and the reservation policy, whereby certain industries are reserved for small scale operation.

One study finds that the variation of firm productivities within an industry in India is about double that of several other Asian countries where the Bank has conducted

[21] World Bank (2002c).
[22] ibid.

surveys, indicating that severity of entry and exit restrictions.[23] Indeed, another study finds that India ranks poorly in terms of starting a new business. For example, because of the extensive number of procedures involved, it takes 95 days to start a business in India, as compared with 2 days in Canada, 34 days in Chile, and 72 days in China. The procedures are not just costly in terms of time. It costs nearly half of GDP per capita to start a business in India, as compared with less than one percent in Canada and about 13 percent of GDP in both Chile and China.[24] The insolvency procedures in India prove to be even more cumbersome. Such extensive barriers to entry and exit will exacerbate the costs of adjustment to any reforms or shocks and diminish India's ability to respond to new opportunities in international markets and at home.

In addition to these impediments to entry and exit, policies protecting artisan and small-scale firms will prevent India from taking full advantage of trade liberalization. Currently 749 products are reserved for production by small-scale firms (Pursell, 2002).[25] Tax exemptions and production subsidies also favor small producers. Although small-scale reservations are waived for export-oriented firms, the difficulties in obtaining the necessary exemptions, and the barriers placed in the way of small firms graduating from the domestic market into exports as they grow are significant. Furthermore, these policies have the perverse incentive of encouraging successful firms to split into smaller units as they grow. For example, the garment industry was reserved for small producers until recently. As a result of the reservation policy and fear of labor problems, the industry is niche-based, focusing on variety without the volume. But, becoming a major player in

[23] ibid.
[24] Djankov *et al* (2002); also see the World Bank Doing Business website.
[25] Small scale firms are firms with fixed assets valued at less than US$ 200,000.

the global industry requires the production of large volumes of uniform quantity. Indeed, all of the countries with very successful garment exporters have a lower level of subcontracting than India (Kathuria, Martin and Bhardwaj, 2002). In order for Indian firms to be able to compete with foreign firms, they must play by the same rules, that means being allowed to grow if the optimal size of a firm in an industry is large.

Adjustment is also made more difficult by restrictions on hiring and firing workers in India. Survey evidence indicates that the typical Indian firm has 17 percent more workers than it desired and labor regulations were the main reason that it could not adjust.[26] A specific example of how this might affect trade comes from the textile and apparel industry, where India's rigid labor policies are likely to reduce the benefits of MFA withdrawal since firms will be slow to adjust. This is an example where the short-run benefits of a policy to "insiders" seem to dominate policy decisions, notwithstanding the much greater costs to those in the country who are not insiders and are usually much poorer.

## V. Moving Forward to Make Trade Work for Poor People

The key priority on the trade-related policy front for developing countries is own reform: to borrow a phrase from Alan Winters, to a large extent, 'what you do is what you get' (Winters, 1999). This is also the case for India, which cannot afford not to pursue further trade liberalization. In addition, reforms that complement trade liberalization, such as removal of the small-scale industry reservation policy (mentioned above) and reducing barriers to domestic entry and exit, are necessary for India to realize the potential gains from trade liberalization. But also important, not just economically but ethically, are

[26] The World Bank (2002c).

actions by rich countries to open their markets to goods and services produced by developing countries. In light of the commitments made at Doha, Monterrey, and Johannesburg, surely it is unacceptable that policies applied by industrialized countries in sectors ranging from agriculture to labor-intensive manufactures and services impose costs on developing countries that are a multiple of the Official Development Assistance (ODA) flows provided by these countries. What is needed is more trade *and* more aid for trade.

The WTO offers a mechanism to design and implement a gradual trade reform program, as commitments can be made to achieve specific liberalization goals in a phased manner. An added benefit of the WTO negotiating mechanism is that own reforms — desirable in their own right — will be complemented by improved access to export markets, both industrialized, high-income country markets and those of other developing countries. The WTO is an especially important forum for countries like India, which are not part of a natural trade union with high income countries. Here the agenda and priorities are relatively clear: dealing with agricultural protectionism, eliminating tariff peaks, substantially increasing access to markets for developing country service providers — including for relatively unskilled services — and ensuring that the regulatory 'rules of the game' are consistent with development priorities. Far-reaching trade reform by OECD countries is important not just for the sake of OECD consumers — who will be the primary beneficiaries — but also to support reforms by developing countries. There is a danger that the WTO creates perverse incentives for governments to hold back on beneficial reforms if OECD nations do not liberalize. Beyond this effect through the WTO, the subsidies and protectionism of OECD countries are mistakenly used by

governments in developing countries to make the arguments against pursuing reforms that will benefit their citizens. The argument runs "If they see subsidies and protectionism as in their best interest then so should we". The argument is simply wrong — the protectionist policies of OECD countries inflicts damage on them and it is deeply misguided for a developing country to react by damaging itself.

It goes without saying that it is critical that India and other developing countries negotiate hard in the WTO. This must include a willingness to make liberalization commitments. The recent agreement between President Chirac and Chancellor Schröder to maintain CAP spending through 2013 illustrates how important the WTO process is. It is the primary vehicle through which developing countries can create incentives and pressure for the EU and the US to reform policies that are highly detrimental to developing countries (to say nothing about their own taxpayers and consumers). India is one of the two political giants of the developing world. India must speak up and act for the developing world as a whole, as well as its own interests.

That said, most of what needs to be done — both by India and by partner countries — can and should be pursued outside the WTO. Reform is in the own interest of developing economies, and, of course, a huge amount of reform has been implemented unilaterally in the last two decades by many countries. Thus, an added element of the equation must be that mechanisms are developed in the WTO — so-called 'negotiation modalities in WTO-speak — that will give countries 'credit' for unilateral policy reforms that have already been undertaken.

We must recognize that the negotiating power of developing countries is inherently limited. An implication is that active engagement is needed by non-trade

groups in society in both the North and South — development organizations, churches, and NGOs with a commitment to reducing global poverty. The private sector also has a major role to play. Such entities will have to engage actively in the process and in the domestic debates to support reform and liberalization in OECD countries. To do this effectively, analysis is needed that points to specific examples of how current policies hurt poor people and the benefits of adopting less trade-restrictive policies. Recent efforts in this regard by Oxfam and Catholic Agency for Overseas Development (CAFOD) are admirable; in India, the activities of the Consumer Unity and Trust Society (CUTS) is playing a helpful role in raising awareness and more informed participation by citizens and consumer groups in the debate.

Finally, a word on development assistance. Overseas development assistance levels have been on the order of US$ 50-60 billion over recent years, roughly equivalent to the estimated income effect on developing countries of removing barriers to trade only in textiles and clothing. Although trade is much more powerful and important for sustainable development than aid, an increase in development assistance must be part of the world program for poverty reduction we should work towards. 'Aid for trade' is necessary to help address the many institutional and infrastructure constraints and bottlenecks that reduce the competitiveness of firms in developing countries.

India is well-positioned to continue to be a leader in the WTO Round. India is a large country and has both a lot to offer in terms of market access, as well as a lot to gain from trade liberalization abroad. Moreover, the two major areas slated for deeper liberalization in the upcoming Round — agriculture and services — are critical export sectors in India. India has demonstrated its leadership in WTO negotiations; we need

only look back to last year when India played a major role in the Doha WTO ministerial meeting with respect to numerous issues, ranging from Trade-Related Intellectual Property Rights (TRIPs) and health to implementation-related issues and concerns. India's vocal opposition to the inclusion of investment and competition policy also resonated loudly. India should be tough but constructive. Any threat to retreat to isolation would be deeply damaging to India and to the whole process. One key advantage of India is the understanding that exists on trade issues. Only a few developing countries have the policy research capacity to carry out their own analyses of potential liberalization initiatives. India should lead by example and demonstrate its commitment to moving forward through action on unilateral trade liberalization and open support for reciprocal trade liberalization in the upcoming round. The poverty-reducing benefits from liberalization will accrue not just to India, but will also spill over to neighboring developing countries, which have borne part of the burden of India's restrictive trade policies.

To conclude, expansion of trade opportunities is an important ingredient of any poverty reduction strategy. If India's own targets for poverty reduction are to be met, as well the Millennium Development Goals for poverty worldwide, there will need to be an acceleration in trade liberalization both in developed countries and in India itself. India can and should, by its advocacy and its actions, be in the vanguard in the reform of world trade so that trade can work still more strongly as a force for poverty reduction around the world.

## References


ABARE (2000). "U.S. and EU Agricultural Support: Who Does It Benefit?" *Current Issues*, October, Australian Bureau of Agricultural and Resource Economics, Canberra.

Ahluwalia, M.S. (2002). "Economic Reforms in India Since 1991: Has Gradualism Worked?" *Journal of Economic Perspectives*, Vol. 16, pp. 67-88.

Anderson, K., B. Dimaranan, J. Francois, T. Hertel, B. Hoekman, and W. Martin (2002). "The Cost of Rich (and Poor) Country Protection to Developing Countries." *Journal of African Economics*, Vol. 10, No. 3, pp. 227-57.

Beghin, J., D. Roland-Holst, and D. Van der Mensbrugghe (2002). "Global Agriculture Trade and the Doha Round: What are the Implications for North and South." Paper presented at the OECD/World Bank Forum on Agriculture, May 23-24.

Ben-David, D. (1996). "Trade and Convergence Among Countries." *Journal of International Economics*, Vol. 40, pp.279-298.

Ben-David, D. (2001). "Trade Liberalization and Income Convergence: a Comment." *Journal of International Economics*, Vol. 55, pp. 229-234.

Chadha, R. (2001). "Services Issues and Liberalization in the Doha Round: A Case Study of India," in R. M. Stern (ed.), *Services in the International Economy*. University of Michigan Press, Ann Arbor.

Chadha, R., D. Brown, A. Deardorff, and R. Stern (2001). "Computational Analysis of the Impact on India of the Uruguay Round and the Forthcoming WTO Trade Negotiations." NCAER, mimeo.

Chanda, R. (2002). *Globalization of Services: India's Opportunities and Constraints*. Oxford University Press, New Delhi.

Chauffour, J. (2002). "Where is India in Terms of Globalization." International Monetary Fund, mimeo.

Datt, G. and M. Ravallion (1998). "Why have some Indian States done better than others in Reducing Rural Poverty." *Economica,* Vol. 65.

Datt, G. and M. Ravallion (2002). "Is India's Economic Growth Leaving the Poor Behind?" *Journal of Economic Perspectives*, Vol. 16, pp. 89-108.

Deaton, A. and A. Drèze (2002). "Poverty and Inequality in India: A Re-Examination." *Economic and Political Weekly*, 7 September, pp. 3729-3748.

Djankov, S., R. La Porta, F. Lopez-De-Silanes, and A. Shleifer (2002). “The Regulation of Entry.” *Quarterly Journal of Economics*, Vol. 117, pp. 1-38.

Dollar, D. and A. Kraay (2000). “Trade Growth and Poverty.” Policy Research Working Paper 2199, The World Bank, Washington, DC.

Ferro, M., D. Rosenblatt and N. Stern (2002). “Policies for Pro-Poor Growth in India.” The World Bank, mimeo.

Finger, J. M. and P. Schuler (2002). “Implementation of WTO Commitments: The Development Challenge” in B. Hoekman, A. Mattoo and P. English (eds.), *Development, Trade and the WTO: A Handbook*. The World Bank, Washington, DC.

Finger, M., F. Ng and S. Wangchuk (2001). “Anti-dumping as Safeguard Policy,” Policy Research Working Paper 2730, The World Bank, Washington, DC.

Fink, C., A. Mattoo and I.C. Neagu (2002). "Trade in International Maritime Services: How Much Does Policy Matter?" *World Bank Economic Review*, Vol. 16, pp. 81-108.

Francois, J. and W. Martin (2002). “Formula Approaches for Market Access Negotiations.” The World Bank, mimeo (www.worldbank.org/trade).

Frankel, J. and P. Romer (1999). “Does Trade Cause Growth.” *American Economic Review*, Vol. 89, No.3, pp. 379-399.

Gulati, A. and S. Narayanan (2002). “Liberalization and Managing Import Competition: A Case Study of India.” IFPRI, mimeo.

Hertel. T. and W. Martin (2000). “Liberalizing Agriculture and Manufactures in a Millennium Round: Implications for Developing Countries. ” *The World Economy*, Vol. 23, pp. 455-470.

Hodge, J. (2002). “Liberalization of Trade in Services in Developing Countries,” in B. Hoekman, A. Mattoo and P. English (eds.), *Development, Trade and the WTO: A Handbook.* The World Bank, Washington, DC.

Hoekman, B. and M. Kostecki (2001). *The Political Economy of the World Trading System: The WTO and Beyond*. Oxford University Press, Oxford.

Hoekman, B., F. Ng, and M. Olarreaga (2002a). “Eliminating Excessive Tariffs on Exports of Developing Countries.” *World Bank Economic Review*, Vol. 16, pp. 1-22.

Hoekman, B., F. Ng, and M. Olarreaga (2002b). “Reducing Agricultural Tariffs versus Domestic Support: What’s More Important for Developing Countries?,” Policy Research Working Paper 2918, The World Bank, Washington, DC.

International Monetary Fund and The World Bank (2002). "Market Access for Developing Country Exports — Selected Issues." September, Washington, DC.

Kathuria, S., W. J. Martin, and A. Bhardwaj (2002). "Implications of MFA Abolition for India and South Asia," in A. Mattoo and R. M. Stern (eds.), *The WTO for Development: A Strategy for India*. Oxford University Press, New York, forthcoming.

OECD (2001). *Agricultural Policies in the OECD Countries: Monitoring and Evaluation*. OECD, Paris.

Pursell, G. (2002). "Trade Policies in South Asia: An Overview." The World Bank, mimeo.

Sachs, J. and A. Warner (1995). "Economic Reform and the Process of Global Integration." *Brookings Papers on Economic Activity*, Vol. 1, pp. 1-118.

Saqib, M. (2002). "Technical Barriers to Trade and the Role of Indian Standard Institutions," in A. Mattoo and R.M. Stern (eds.), *The WTO for Development: A Strategy for India.* Oxford University Press, New York, forthcoming.

Slaughter, M. (2001). "Trade Liberalization and Per Capita Income Convergence: A Difference-in-Differences Analysis." *Journal of International Economics*, Vol. 55, pp. 202-228.

Stern, N. (2002). "Dynamic Development: Innovation and Inclusion." Munich Lectures in Economics, 19 November, Center for Economic Studies, Ludwig Maximilian University, Munich (http://econ.worldbank.org/view.php?id=22048).

Sutton, J. (2000). "Rich Trades, Scarce Capabilities: Industrial Development Revisited." Keynes Lecture, British Academy, October.

Walmsley, T. and L. A. Winters (2002). "Relaxing Restrictions on Temporary Movement of Natural Persons: A Simulation Analysis." University of Sussex, mimeo.

Wilson, J. (2002). "Standards, Regulation and Trade: Developing Country Concerns," in B. Hoekman, A. Mattoo and P. English (eds.), *Development, Trade and the WTO: A Handbook*. The World Bank, Washington DC.

Wilson, J. and T. Otsuki (2001). "Food Safety and Trade: Winners and Losers in a Non-Harmonized World." *Journal of Economic Integration*, forthcoming. (www.worldbank.org/trade).

Winters, L.A. (1999). "Trade Policy as Development Policy," presented at the UNCTAD X High-level Round Table on Trade and Development (www.unctad.org).

World Bank (2001). *Globalization, Growth and Poverty: Building an Inclusive World Economy*, Policy Research Report. The World Bank, Washington, DC.

World Bank (2002a). *Global Economic Prospects and the Developing Countries: Making Trade Work for the World's Poor*. The World Bank, Washington, DC.

World Bank (2002b). *World Development Indicators*. The World Bank, Washington, DC.

World Bank (2002c). "Improving the Investment Climate in India", mimeo.

World Bank (2003). *Global Economic Prospects and the Developing Countries: Investing to Unlock Global Opportunities*. The World Bank, Washington, DC, forthcoming.