II

Analytical Framework and Elements of Trade Reform

A liberal trade regime is an important factor in encouraging economic growth and efficient resource allocation. The case for open trade policies and consequent resource allocation improvements and enhanced medium-term growth prospects are well known and supported by a large body of theoretical and empirical work (Box 2).

The success of trade reform depends on complementary macroeconomic policies. In particular, there are strong and mutually supporting links between trade reform, an appropriate level for the real exchange rate, and a liberal exchange system, because exchange and trade restrictions often act as substitutes and the benefits of liberalizing one may not be fully realized without liberalizing the other. In one direction, an open trade regime is needed so that international price signals promote efficient resource allocation for a country with an appropriate real exchange rate and a liberal exchange regime. In the other direction, an appropriate exchange rate and a liberal exchange regime are needed so that the tradables sector can exploit its comparative advantage and maintain the momentum of trade liberalization efforts and macroeconomic stabilization. In particular, if the exchange rate is overvalued, then a real depreciation may be an important complement to trade liberalization. If the exchange rate is maintained at an artificially high level or there are equivalent exchange sys-

Box 2. Trade and Growth

The economic rationale for trade policy reform is based on the improved efficiency of resource allocation and enhanced growth prospects. An open trade regime expands trade and investment options and allows countries to specialize in and export those products in which they have a comparative advantage. Trade barriers to imports result in higher prices for imported commodities and cause inefficiency as consumers shift to higher cost domestic substitutes or forgo use or consumption of products they would otherwise prefer. Import barriers also give rise to an anti-export bias through higher costs to exporters, the impact on the exchange rate which tends to be more appreciated, and because import-competing industries tend to bid workers and capital away from would-be exporters or other potentially more efficient economic activities.

The efficiency benefits of an open trade policy also apply to economic growth. In common with other economic distortions, trade policy distortions shift an economy to a less efficient mix of investment, production, and consumption. They create incentives to produce and invest in goods for which the economy's rate of return is below the rate of return for the individual enterprise. These distortions depress economic growth prospects and their removal therefore improves growth prospects. Indeed, it is even possible in a distorted trade regime that new investment or increases in other factor supplies can reduce national income—so-called immiserizing growth.[1]

The empirical literature on trade and growth confirms and underscores the theoretical case for open trade policies; namely, that countries with open trade policies grow faster than countries that are more inward oriented.[2] These findings have been emphasized by a number of recent studies, including work using very extensive time series data (Summers and Heston, 1991), and also by new developments in the theory of economic growth such as endogenous growth theory that has highlighted dynamic gains from trade liberalization. Moreover these findings provide further credibility and confirmation that trade openness is consistently associated with higher rates of economic growth, as measured by trade-to-GDP ratios (Barro and Sala-i-Martin, 1995); trade protectionism (Sachs and Warner, 1995); more indirect techniques designed to control for reverse causality and other statistical anomalies (Frankel, Romer, and Cyrus, 1996); and when growth is measured by per capita GDP growth or by productivity measures (Coe and Helpman, 1993).

[1]See Bhagwati and Srinivasan (1983) for a summary and further elaboration in the context of other trade distortions and Brecher and Diaz-Alejandro (1977) for the case of mmiserizing foreign investment inflows in the context of trade policy distortions.

[2]The general results and summaries of the literature have been included in World Bank (1987 and 1991); the IMF (1993); World Bank (1993); and Kirmani and others (1994b).

Box 3. Political Economy and Trade Reform

In the extensive economic literature on the political economy of trade policy, a seminal article by Anne Krueger (1974) presents estimates showing the "windfall" transfers of resources ("rents") resulting from the effects of successful lobbying and similar legal or illegal activities that influence trade policy (5 percent and 15 percent of GDP in examples from India and Turkey, respectively). She presents a model in which "rent seeking" (comprising both legal activities such as lobbying and illegal activities such as bribery) lowers the efficiency of the economy, particularly when quotas are used instead of tariffs. The resources used in rent seeking to encourage governments to adopt inefficient trade policies and to allocate valuable licenses to the seekers are wasted for the economy because they are not available for productive uses. Tariffs are preferable to an equivalently restrictive quota because the rents associated with the windfall gain to holders of quota rights will encourage more rent seeking than a tariff, where the tariffs on imports are captured by the government in the form of tariff revenue.

In the years since, a large and complex literature has evolved on the political economy of economic policy formation that heavily focuses on trade policies. Important extensions to the literature have been made by Bhagwati (1982), and a large part of the literature has been summarized at book length with many original contributions by Magee, Brock, and Young (1989). Summaries of still more recent contributions as well as original material can be found in Krueger (1993), Williamson (1994), Rodrik (1995), and Leidy (1995). The *1997 World Development Report* (World Bank, 1997) provides an extensive applied discussion of the interactions between economic policy (including trade policy) and political economy considerations. Some general, although diverse, lessons do emerge from this literature. First, political intervention by economic interest groups cannot be relied upon to bring about efficient trade policies. As noted in the study, there is a tendency for the relatively concentrated and organized import-competing producers to be more successful in obtaining protection than for the relatively dispersed consumers in resisting it; empirical support for the influence of these factors and for the tendency of protection to be higher for products in which import-competing producers have declining profits and sales can be found in Baldwin (1985). Indeed, under some assumptions it can be relied upon to result in inefficient economic policies. Second, complex and nontransparent trade regimes are particularly vulnerable to both bad policies resulting from rent seeking and to the waste of resources used in rent seeking. Even though interest groups need to expend more effort to modify complex and nontransparent systems, the more narrowly focused rents and the difficulties in monitoring rents for society at large can raise the cost-benefit ratio to the rent seeker. This is part of the basis for the argument for a uniform tariff. Third, policies that generate private windfalls rather than government revenue (e.g., quotas or tariff exemptions rather than tariffs) are particularly conducive to the distortions induced by rent seeking. Finally, recent literature (see Krueger, 1993 and Rodrik, 1995) has emphasized the virtuous circle that can develop as vested interests in rents from trade policy distortions are reduced and vested interests in exporting are increased.

The tendency toward adverse policy outcomes and wasted resources from rent seeking suggests a role for an outside agency such as the Fund. For Fund-supported programs, the implications of the political economy literature described above on quotas versus tariffs and simple versus complex systems support moves toward simpler and more transparent tariff-based systems on the path to overall liberalization. Finally, the literature on turning vicious circles of rent seeking into virtuous circles of liberalization underlines the need for sustained efforts toward trade liberalization.

tem distortions, the political and economic support for open trade policies can be undermined.[3] There are also strong and mutually supporting links between trade reform and fiscal policy, which are discussed in Section III. In general, the beneficial effects of trade reform are best realized in an appropriate macroeconomic environment and in tandem with other structural reform policies to improve the efficiency of resource allocation.

Elements of Trade Liberalization

The main goal of trade reform should be to improve economic efficiency by creating a transparent and neutral system of incentives that eliminates anti-export bias, direct impediments to trade, and economic distortions caused by the trade regime. This would involve removing export barriers and quantitative restrictions (QRs) and other NTBs[4] on imports,

[3]Exchange rate policy and exchange reform are linked in important ways to trade policy but generally fall outside the scope of trade liberalization, narrowly defined, and hence are generally excluded from this study, except where such restrictions act as binding trade restrictions.

[4]Nontariff barriers are defined here as measures that restrict trade by either limiting quantities that may be traded or inserting administrative discretion in the export-import process that acts as a barrier to trade. Such NTBs include quantitative restrictions, quotas, bans, restrictive licensing requirements, restrictive foreign exchange practices, state trading monopolies, restrictive technical and phytosanitary standards, and restrictive customs procedures.

reducing tariff dispersion through introducing low and relatively uniform tariffs[5] administered in a transparent and evenhanded manner, and establishing neutral treatment of imports and domestic goods under domestic economic policies.[6] Trade reform is often sequenced so that initial action on import barriers focuses on QRs and other NTBs,[7] which tend to be the most distortionary trade restrictions. Measures to reform import tariffs include reductions in the maximum and higher tariffs and in the number of tariff bands; conversion of specific tariffs into ad valorem rates; consolidation of other import taxes or charges into a single rate; and reduction or elimination of tariff exemptions for individuals, organizations, or groups. Trade reform may also include other measures to ensure equal treatment of domestic and imported goods, and it implies an absence of controls on domestic trade, such as price or marketing controls.

Transparency, Governance, and Political Economy

Trade liberalization is intended, in the first instance, to improve resource allocation and economic welfare; it also has important beneficial effects on the transparency of the trade system and the quality of governance. Because of their highly disaggregated nature, trade policies are particularly suited to the redirection of resources by the government to narrow interest groups (Box 3). Transparency is an issue because those adversely affected by trade policy are often affected indirectly and may not be aware of the effect. Liberalization and simplification can reduce this adverse impact and improve the ability of those affected by the policy to detect and understand the impact of the remaining trade policy instruments. Even beyond legal but inefficient and nontransparent rent seeking, complex and discretionary trade policy regimes create opportunities for corruption (particularly in the case of discretionary licensing and tariff exemptions). Broad-based and comprehensive trade reforms, preferably preannounced, can contribute importantly to improved governance.

Usually, the most important impediments to trade reform are political economy factors.[8] In some cases, they may be a response to the economic adjustment costs and disruption that may be associated with significant policy changes that improve the efficiency of resource allocation. In trade reform, the most concentrated group of losers are usually readily identifiable producers facing the loss of existing sources of income, while beneficiaries are widely dispersed among consumers and potential exporters that may be difficult to identify. However, beyond adjustment costs, the often highly focused economic impact of trade policy makes it a particularly attractive target of rent-seeking behavior and lobbying, in many cases, by small well-organized groups, while the costs associated with restrictive trade policies are widely dispersed throughout the economy and are not transparent. These political economy factors, together with the government's commitment to liberal market-oriented reforms, "ownership" of the program, and garnering political support, are likely to be the most critical factors in effective trade reform.

[5]Uniform tariffs are preferable on political economy grounds since they reduce the incentive to lobby for a higher tariff rate. However, uniform nominal tariff rates need not imply uniform effective rates of protection if, for instance, domestic taxes are higher in some sectors; see Thomas, Nash, and others (1991).

[6]This includes equal tax treatment of domestic and foreign entities, equal tax treatment of imported and domestic goods and services, and equal technical and phytosanitary standards.

[7]Often import quantitative restrictions are replaced by tariffs.

[8]Political economy forces may be working in favor of trade liberalization, for example, to foster closer relationships with neighboring countries.