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# Institutions & Trade Liberalism

Countries are often advised to liberalize their trade with the rest of the world; when such advice is given it is usually interpreted to entail simple policy changes, such as reducing or eliminating import tariffs (i.e. the standard forms of tax on imports), removing non-tariff barriers that constrain imports, and – if necessary – removing licensing and other restrictions pertaining to exports. However, whether and how trade liberalization will be beneficial for a country, especially for a poor to middle-level developing country with a weak government and probably a deficient institutional framework too, depends on far more than this. Hence in this *Briefing Note*, I sketch the standard arguments for trade liberalization, review the empirical evidence for its beneficial effects, and examine some of the institutional factors that can complicate the presumed linkages between a policy of trade liberalization and its intended or desired effects. The outcome is some questions which need further research.

## Theory and evidence

Elementary arguments about trade liberalization draw heavily on models based on *free competition and perfect markets*. In that context, tariffs and other policy-determined trade restrictions are regarded as sources of inefficiency and free trade is then usually found to be welfare improving for the countries involved. So free trade is generally considered to be superior to highly restricted trade, but that does not quite imply that some trade liberalisation – falling short of complete free trade – will necessarily improve matters for a country. Economists arguing for partial trade liberalization, which is most often what we propose, are therefore taking the view that each step in 'the right direction' is likely to be an improvement.

More sophisticated arguments can be built up around models of imperfect competition, increasing returns to scale, and *trade in product varieties*. Such models also usually favour liberalised trading from the standpoint of maximising world economic efficiency.

All of these arguments are quite static in nature (e.g. they assume that each country is given production possibilities), but to make them more dynamic (i.e. allowing for innovation, investment and other ways of *shifting* a country's production possibilities), and hence more plausible and convincing, requires some of the institutional factors examined below.

The available empirical evidence on trade liberalization mostly consists of multi-country regressions of real GDP growth rates against measures of trade liberalization. The latter can either take the form of simple measures of openness, such as the trade ratio for a given country (measured as the sum of exports and imports, divided by GDP, or $(X + M)/Y$ in standard notation); or a *qualitative measure of liberalization* using a variety of indicators. Such regressions normally find, albeit with some qualifications, that on average around the world, faster growth of GDP is positively associated with more liberal trade conditions, however they might be measured.

Putting theory and evidence together would thus appear to yield some very simple policy advice, namely that wherever possible, countries should liberalize their trade. However, it turns out that this simple – and commonly offered – advice has some significant shortcomings and limitations when considered in the light of an institutional perspective.

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## Institutional factors

The above analysis suggested that a country can normally expect to enhance its economic growth by freeing up its international trade. While there are significant institutional issues on the side of imports, most countries can increase imports quite quickly once trade liberalization occurs, given suitable payment arrangements and an increase in the effective demand for imports. To maintain an acceptable or manageable trade balance, exports must also increase, and this is where many countries encounter some serious practical difficulties and barriers.

For all countries, the range of profitable export goods is far narrower than the range of goods imported. After all, this is just what international specialization means, with countries typically consuming pretty much the full range of goods (most being imported), and producing fewer, both for the domestic market and for export markets; hence the key to successful participation in the world economy is specialization in production combined with successful exporting. Here there are two basic models, each quite problematic though in different ways.

First, there are countries rich in key natural resources for which there is strong world market demand; countries such as Angola (oil), Nigeria (oil) and Botswana (diamonds) come to mind in this context. The resources exported by these countries are either homogeneous, or are graded according to a simple, internationally accepted scheme – either way, the country simply has to get the goods out of the ground and ship them. The need for institutional supports is usually quite minimal, and production is often wholly or partly in the hands of foreign companies, with the more technical tasks often performed by expatriate staff; linkages between the resource-producing 'enclave' and the rest of the economy can be close to zero, and the enclave provides the government with easy tax revenues or royalty income. This is why resource-rich countries often have terrible governance problems, since the government is scarcely dependent on the mass of the people for its funding, and can survive by offering few (or no) public services. At the same time, the resource wealth is easily diverted into private channels controlled by the elite, and the associated corruption seriously inhibits development. A prosperous ruling elite then stands above a country with few primary schools, poor health services, and poor conditions for private sector business development – the latter, because potential entrepreneurs are too insecure in their property rights, and fear that if they start to do well, their businesses will be stolen or destroyed.

Botswana is an interesting – though far from unique – exception to this malaise, since governments there have consistently fostered economic development since independence in the mid-1960s. Understanding how this success came about, and how it might be replicated elsewhere, has already been the subject of much research (e.g. see Acemoglu et al., 2003); however, we could certainly learn a great deal from those resource-rich countries no longer regarded as under-developed, such as Australia or Canada.

Second, there are countries lacking natural resources, seeking to succeed in some aspect of manufacturing. Even selling poor quality goods to a neighbouring developing country is not that easy, but selling high quality produce to an already highly developed and prosperous trading partner is a serious challenge. Examples would be textiles and clothing from Bangladesh, pre-packaged vegetables from Kenya, software services from India – for ventures like this to succeed, a lot of factors have to be in place along the entire value chain, including:

- entrepreneurs to set up the businesses, with an adequate legal and fiscal framework (which need not be well formalized to be effective) to support them;
- suitably skilled labour, with the local school and college system training people to have the right skills, at the appropriate levels (there is, of course, a 'chicken-and-egg' element here, since the schools are unsure what skills are needed until they see what sorts of business succeed, and conversely);
- suitable finance for investment, either from friends and family, or from banks, is essential to enable successful firms to expand rapidly;
- finance to support export credits and insurance services for exporters;
- adequate transport infrastructure to get goods to market on time and in good condition;
- market information and knowledge of international customers and their requirements;
- systems of quality assurance and standard setting (since reputation factors are critical for success in the world market);
- systems of research and innovation so that product quality and product range are constantly undergoing improvement (vital in a world market where other countries are certain to be seeking their own competitive niches – the point is that competitiveness has to be created and actively sustained);
- flexible entry and exit, so bad firms are quickly weeded out rather than being protected;
- supportive government either at provincial or national level or preferably both (but not in the sense of handing out easy subsidies).

These points are partly about supplying key resources to firms and partly about the 'rules of the game' under which resources are indeed supplied and the firms then operate. These 'rules' are what we mean when we talk about economic institutions; they can be either formal or informal and can employ a variety of enforcement mechanisms, including trust, reputation and informational 'signals' (such as people's qualifications when they seek jobs in the labour market). An additional factor, often cited in this context, is that of *market power* which countries (or their exporting firms) need in order to capture a share of the gains from trade sufficient to permit further investment and business development. The above represents a hugely demanding list of requirements that few countries meet in full. The more successful exporters usually only meet the requirements in their more dynamic sectors, and firms elsewhere may still function quite poorly, only serving domestic or other very local markets.

Agricultural produce appears not to fit neatly into either of the above two models, though nowadays it is closest to the second model, since even apparently simple, standard crops such as rice or cotton commonly involve highly complex production chains, very demanding technical conditions, skilled labour and difficult international marketing. At the same time, agriculture faces three additional problems: tough and largely uncontrolled international competition (e.g. the world coffee market), sometimes resulting in unstable prices; severe risks due to pests, disease, and weather conditions; and for some products, highly distorted markets due to protection by the advanced countries. Few developing countries possess the full range of institutions needed to cope with such diverse hazards, either in agriculture or indeed in any other sectors.

## Further research

From the above sketch of what successful exporting entails, two important research questions emerge:

1. How do resource-rich countries put in place and sustain the governance mechanisms that enable them to use their resource revenues to foster wide-ranging economic development, rather than dissipating the proceeds through corruption and waste?

2. How do countries lacking natural resources develop successful export sectors and what institutional framework do they need and how can it be nurtured? This can be studied through examples of successful practice, contrasted with failed attempts to develop an exporting capability.

To conclude, then, we outline a specific project that could be developed to explore question 2. Consider the ready-made garment (RMG) sector in Bangladesh, one of the countries already chosen for further research within the IPPG Programme. Our initial paper on the country already reviewed the RMG sector in general terms, but carrying out a deeper, more institutional analysis entails studying one or more of the links in the chain that runs from the raw material (mostly cotton) through to the eventual customers, both in Bangladesh itself and overseas; for instance, how do RMG firms pay for the cloth they use? Is there trade credit? Who provides it? What are the normal terms? Is this business based on regular transactions and trust between firms, rather than on formal, legal processes? Do suppliers, on the other hand, expect 'cash-in-advance'? Thus by exploring the question we could examine the respective roles of formal and informal institutions and practices in facilitating (or possibly impeding) normal trade between suppliers and customers. This could be investigated through a mix of surveys and interviews with a sample of the firms involved in order to discover what forms of contract linked them with their suppliers, what enforcement mechanisms were available and/or actually used, what costs are incurred along the value chain, and to assess the roles of personal factors and trust.

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