Department for Business Innovation & Skills

ECONOMIC OPENNESS AND ECONOMIC PROSPERITY

Trade and Investment Analytical Papers
Topic 2 of 18

Department for International Development

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Summary

While economic openness is a key driver for prosperity, the challenges associated with it cannot be ignored. However the benefits of greater economic openness cannot arise without economic change. Like in the case of technical progress and innovation, trade openness produces efficiency gains through a Schumpeterian "creative destruction" process. Rather than trying to impede change it is much more preferable to accompany it by tackling the market imperfections and their consequences on people and economic structures. Policymakers can therefore try to identify and implement complementary short run and structural policies to maximise the benefits of economic openness.

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1. Economic openness is an important driver of economic prosperity

1.1 A few estimates

The weight of evidences is that openness to trade is good for economic prosperity. Hereafter few estimates of the economic benefits of trade openness:

- The long-term evidence from a broad sample of OECD countries indicates that an increase of 10% in trade exposure was associated with a 4% increase in output per working-age person[1].
- New evidence[2] shows that the complete withdrawal of the remaining barriers to trade inside the European Union could boost income per capita within the UK by 7% in 10 years, corresponding to £4,300 a year per British household.
- In 2009, the UKTI projects of new inward FDI created 53,358 jobs in the UK[3]*.* Inward investors account for some 40% of UK business R&D. In In 2008, about 40% of UK domestic patents were filed by foreign residents[4].
- According to the World Bank, in the 1990s per capita income grew more than three times faster for those developing countries that lowered trade barriers (5% per year) than for other developing countries (1.4% per year)[5]

1.2 Mechanisms linking economic openness and economic prosperity

Trade openness improves productivity and innovation – the two key drivers of economic growth in the long-term – through various channels:

- **Access to larger markets and hence, the possibility to reap the benefits of increasing returns to scale and specialisation.** Trade

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[1] OECD (2003)
[2] Aussilloux, V., et al. (2011)
[3] UKTI (2010)
[4] OECD.Stat Extracts - "International cooperation in patents"
[5] OECD, ILO, WORLD BANK, WTO (2010)

openness offers new opportunities for sales (i.e. exports), but also making available to producers the widest range of inputs at the highest quality and lowest prices. In 2005 the contribution of imports of intermediate goods to the total value of exports ranged from 19% in the UK to more than 50% in Luxembourg[6].

- **Enhanced competition leading to improved productivity of domestic firms**. These dynamic effects will occur through allocative efficiency (reallocation of resources across firms and most importantly inside firms), productive efficiency (reduction of managerial slack and increases in workers' efforts), and dynamic efficiency (increase in innovation)[7].
- **Removed distortion bias in domestic industries that protection would have created.** Trade openness reduces the rents and wasteful rent-shifting activities of local firms by reducing their market power. In addition, barriers on imports create a bias against exports by raising the domestic prices of imports relative to exports. Tokarick (2006)[8] indicates that on average, import tariffs in 26 low-countries were equivalent to about a 12.5 percent tax on their exports. Reducing import tariffs can indirectly promote exports, regardless of whether trading partners reduce their tariffs.
- **Dissemination of knowledge and innovation embodied in goods, services and investments.** Using a panel of over 23,000 European establishments through 2007, Bloom et al. (2009) find that Chinese import competition led to both within firm technology upgrading, and between firm reallocation of employment towards more technologically intensive plants. These effects are growing over time as Chinese trade volumes rise, accounting for up to 38% of technology upgrading in the most recent years. These results suggest that imports from low wage countries appear to have potentially large beneficial impacts on technical change.

Foreign investments contribute to economic prosperity too.

- **Inward investments** may crowd out a small element of domestic investment but the net result is to increase the capital stock of an economy, which is beneficial to growth and employment. Flows of investment also enable the reallocation of resources to more efficient and productive activities. Inward FDI can be a useful vehicle for the transfer of innovative technologies and processes. Through linkages with domestic firms it can have spillover effects that work to boost the productivity of both the industry and the wider economy.

  Regarding developing countries, the conventional wisdom is that the benefits of inward investment are dependent on countries reaching a threshold capacity in human capital and financial development. New evidence suggests however that at the level of the firm, the impact of

[6] European Commission (2010)
[7] Aussilloux, V., et al. (2011)
[8] Tokavock, S. (2006)

foreign direct investment on growth is systematically larger in low income countries than elsewhere. [9]

- **Investments abroad** can also bring important benefits to the home economy. If activities where the comparative advantage lies elsewhere are outsourced to more efficient locations, this can free up resources in the home to undertake more productive activities. Investment overseas may also have an export generating effect because the foreign investor uses parts of their established supplier chains in providing goods/services in the country they have invested in. Investment in fast-growing economies and industries abroad often bring high returns, improving the balance of payments. These returns can then be reinvested in higher skilled activities in the home economy, as firms often maintain head office and R&D activities in the home country, while exporting lower skilled activities. Outward investment also provides a good route for technology transfer to the home economy.

2. However the challenges associated with economic openness cannot be ignored

While theory and cross-country studies consensually suggest that economic openness increases overall welfare, greater economic openness will be likely associated with adjustment costs and greater risk of external shocks.

2.1 Costs of adjustments to greater economic openness

Adjustment costs for businesses - As productive resources are reallocated from less to more efficient producers, greater economic openness generates an overall increase in productivity. However, this is possible only if adjustments and changes arise. The most productive firms will gain access to foreign markets and get additional profits from their foreign ventures; they will have to cope with the additional activity it involves. Firms with intermediate levels of productivity are likely to survive but, not being productive enough to access foreign markets, are relegated to home sales only and their market shares fall. Finally sharper competition will force the least productive firms to exit as they start making losses in their home markets without gaining access to foreign markets. The reduction in mark-ups across Europe, particularly in the sectors most affected by the Single Market Programme (estimated at 3.9% in the 1990s[10]) illustrates the extent into which firms have to cope with increased competitive pressures.

Adjustments costs for workers - As a result of greater openness workers may experience job displacement, wage decrease, gross job destruction, and uncertainty through less secure employment and more volatile income.

[9] Randolph, B. and Campos, N. (2010)
[10] Griffith et al. (2006)

Adjustment costs appear to be higher for older workers, for workers with higher tenures and less educated[11].

Available empirical evidence suggests that experiences varied from case to case but that, on the whole, adjustment costs associated with transitional unemployment are not high and that unemployment duration is generally quite short[12]. Yet, whatever the overall size of the short-run labour market effects, the impacts will often be significant enough for those who lose their jobs. Losses incurred by some due to further trade openness are often concentrated while gains are often diffused and therefore less visible.

Potential increase in inequalities - Greater economic openness can generate inequalities by affecting wealth distribution through changes in wages and in relative prices[13].

- **Changes in wage** - The distributional effects of globalisation among population groups are too complex to draw any strong conclusions on the overall effects of globalisation on wage differentials. For example, Klein, M. et al. (2010) shows that while greater trade openness in the German manufacturing sector have increased wage inequality between low-and high skill workers, it has diminished inequality in terms of gender and nationality. Regarding developing countries, women, as 70% of the world's poor, have much to gain from the opportunities that trade offers to lift themselves and their families out of poverty. However, while it is well-proven that trade liberalisation is not gender neutral, the impact of trade on gender equality is by no means clear-cut and uniform across countries and sectors.

  On the other hand, OECD analysis[14] confirms that inequality has tended to increase in recent decades, but also suggests that globalisation contributed to only about 20% of rising wage inequality and that the impacts of other forces – most prominently technological change – have been more important.

- **Changes in relative prices** - Greater economic openness causes the price of traded goods and services to change. These price changes affect households as consumers and income earners, which in turn may generate inequalities. The impact of price changes on poverty and inequality will depend on whether poor people are net consumers or net producers of the goods in question. However, it is worth noting that in developing countries price changes may or may not be transmitted to poor people, depending on the existence of adequate physical and facilitating marketing infrastructures, market information, and households' behaviour[15].

Potential decrease in tax revenue[16] – In addition to protection, tariffs, especially in developing countries with a very low tax base, may aim at

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[11] OECD, ILO, WORLD BANK, WTO (2010)
[12] See Papageorgiou, D. et al. (1991), Matusz, S. & Tarr, D. (1999), and EPPI-Centre (2010)
[13] Goldberg P., K., & Pavcnik, N. (2007)
[14] OECD (2007)
[15] McCulloch, N., et al. (2001)
[16] EPPI-Centre (2010)

increasing tax revenue collections. The final impact of tariff reductions on tax income depends crucially on the size of initial tariffs, the sector compositions of these initial tariffs, the extent of tariff reduction, the structure of trade partners, complementary tax policies and the price elasticity of import demand. A DFID meta-analysis of the impact of trade liberalisation on tax[17] suggests that only in the case of very high import demand and substitution elasticities, the generated increase in imports would be sufficient to compensate for tariff cut. On the other hand, the impact in the medium-run could be positive, especially if complementary tax policies and increase in customs effectiveness are implemented.

2.2 Potential greater economic vulnerability to external shocks

A more open economy will face larger number of adverse shocks coming from the outside. The epicentre of the recent global economic crisis was the financial markets of the industrialised world, yet many developing countries were driven into recession as global demand and global trade volumes plummeted. Open economies heavily reliant on export revenues were among those hardest hit by the crisis[18].

However, an open economy is less constrained by the limits of domestic demand and more likely to be involved in a wider range of formal and informal insurance schemes (e.g. international lending, production diversification, and formal insurance contracts)[19].

An open economy can also more easily buffer the internal shocks by relying more on exports where domestic demand is depressed. The international market being deeper, the shock waves may be felt further away but this helps diffuse the adjustment in countries where the shock originates. Germany, one of the major world exporters, is a case in point. In the first quarter of 2009 the economy contracted by 3.4% but by the second quarter of 2010 it was expanding by 2.2%[20] thanks in particular to the sustained demand in emerging economies. The dynamism of these economies have avoided a steeper global recession and are leading now the recovery, illustrating that interactions among countries transmit the shocks but also help diffuse them.

The overall effects of trade openness on economic volatility would depend on country' income level, country size, and country export diversification and would also vary over time[21].

[17] Idem
[18] Haddad, M. et al. (2010)
[19] Haddad, M. et al. (2010)
[20] OECD, ILO, WORLD BANK, WTO (2010)
[21] See Haddad, M. et al, (2010); Di Giovanni, J. & Levchenko, A.A., (2008); Calderon, C. et al.(2005)

3. Complementary policies can help maximising the benefits of economic openness

While greater economic openness can generate sizable benefits through adjustment and changes, market distortions will make adjustments more difficult and more costly for workers and businesses. Thus policymakers are well-advised to adopt a comprehensive policy strategy to address adjustment problems and distributional concerns as well as to mitigate the risk of greater vulnerability to external shocks.

3.1 Adjustments are at the very nature of the destruction creation process, one of the core components of economic dynamism

Modern and dynamic economies need to constantly reallocate resources, including labour, from old to new products, from less efficient to more efficient firms. The process of resource reallocation is one of the key engines of productivity and economic growth and it is enhanced by trade openness.[22]

As stated by Rodrik (1998) in line with the Schumpeterian literature, "trade can generate sizable benefits only by restructuring economies - that is the essence of specialization according to comparative advantage and in the real world restructuring does not happen without someone bearing costs. The flip side of the gains from trade is the losses that have to be incurred by adversely affected workers and enterprises [. . .]. Simply put: no pain, no gain". Restructuring is an intrinsic feature of trade openness and reallocation processes. As such it entails the destruction of some parts of the existing productive capacity (and of the corresponding jobs), and the construction of something new to replace it[23].

3.2 Market failures are at the source of the flip side of the gains of economic openness

The magnitude of adverse effects of economic openness is a direct reflection of the speed at which the economy manages to redirect resources in response to liberalization and external shocks. For this reason, they depend importantly on the presence and magnitude of domestic distortions and transactions costs (i.e. distortions in product and factor markets; credit constraints; transactions costs)[24].

Freund, C. and Bolaky, B. (2008) and Kambourov, G. (2009) show that there is a positive relationship between trade and income per-capita in flexible economies, but not in economies that are highly distorted with regulations. This is in line with the main conclusions of Artuc, E. and McLaren, J. (2010). Using a structural model of trade shocks and labour adjustment and data for Turkey, they simulate the effects of hypothetical trade liberalization on the Turkish labour market. They find that the costs for workers of switching between industries are high. This makes adjustment slow: the post-liberalization steady state would only be reached after a decade or so.

[22] OECD, ILO, WORLD BANK, WTO (2010)
[23] Gaffard JL., Saraceno F. (2007)
[24] Porto, G., and Hoekman, B. (2010)

3.3 It is better to tackle market failures at source than seek to prevent economic openness.

Economic openness may not be beneficial where market failures prevent adjustments. However it is better to tackle market failures at source than seek to prevent economic openness.

Short-term adjustment costs are more than out-weighted by long-term benefits of economic openness. For example Takacs, W.E. and L.A. Winters (1991) estimate the adjustment costs and the long-run benefits from removal of the quantitative restrictions in the British footwear industry. Even under their most pessimistic scenario, the adjustment costs are almost negligible in comparison to the potential gains from trade liberalization – that is, slightly less than £10 million in losses compared to £570 million in gains.

In the long run, openness reduces unemployment. Felbermayr et al. (2009) find that a 10% increase in trade openness cut unemployment by 1% for a mix of developed and developing countries. There is also country-specific evidence suggesting that the potential employment creation following greater trade integration can be significant[25].

Supporting inefficient production through trade protection is an expensive way of maintaining jobs. In the US in 1990 the cost to the economy and consumers of keeping jobs in 21 highly-protected sectors was on average $170,000 annually per job saved – more than six times higher than average manufacturing wages at the time[26]. For the EU, the cost per job saved through protection in 1990 was even higher: protection across 22 highly-protected sectors was estimated to have saved around 250,000 jobs (roughly 3% of the total jobs in those sectors), at an average cost per job saved of around €220,000 – ten times the average wage for the sectors in question[27].

3.4 Complementary policies can help to gather pre-required conditions to maximise the benefits of economic openness

In the long-term, supply policies to reduce physical and institutional rigidities in the product, labour, and capital markets that improve the ability of firms and households to respond to new opportunities are key. Sound social policies, active labour market support, investments in infrastructure, property rights, mechanisms to disseminate market and technical information, development of markets for credit, agricultural inputs and services, trade facilitation measures help to keep adjustment costs to a minimum[28].

Short term action is also important to help workers move into new jobs. Young/better connected/better educated/more mobile elements of society tend to find it easier to adjust to changes and benefit more from their impact. Therefore interventions to facilitate the transition and smooth the adjustment process should focus on vulnerable groups: older workers, less skilled workers, deprived areas…These include adequate safety nets – typically in

[25] Hoekman B. and Winters, A. (2007)
[26] Hufbauer, G. and Elliot, K. (1994)
[27] Messerlin, P. (2001)
[28] Porto, G. and Hoekman, B. (2010)

the form of unemployment benefits – with clear job-search incentives and effective re-employment services[29].

There is a debate as to whether specific measures should be put in place to assist trade-displaced workers. A key argument for targeted programme is the important political purpose they can play. Those segments of civil society that are concerned by the potential disruptions resulting from greater economic openness, as well as those policymakers who represent those constituents may be less inclined to oppose opening measures if those initiatives are complemented by trade adjustment assistance programmes[30]. The key is for governments to take account of the ability of the immediate losers to cushion themselves against adjustment, whilst maximising their incentives to adjust.

Specific labour market and fiscal policies can help to manage negative but transitory external shocks. The recent crisis has shown that countries with sound social protection systems in place before the crisis were relatively well positioned to deal with its damaging effects. Labour demand promoting policies (e.g. short-term working schemes in Germany) have proved to be particularly effective in preserving viable jobs.

Government budgets are likely to come under pressure during crises. Creating fiscal space during phases of growth should be a priority for policymakers as it will allow them to act when a crisis hits[31].

Haddad, M. et al (2010) shows that the vulnerability of countries to external shocks should be reduced when these countries are better diversified in their exports. Domestically, policymakers can remove barriers to domestic market entry, and thereby encourage innovation and development of new markets by companies at home. Better trade facilitation can also be highly effective in improving competitiveness and promoting export diversification.

[29] OECD, ILO, WORLD BANK, WTO (2010)
[30] Idem
[31] OECD, ILO, WORLD BANK, WTO (2010)

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