

D GOVERNANCE AND INSTITUTIONS

The notion of an institution embodies several elements: formal and informal rules of behaviour, ways and means of enforcing these rules, procedures for mediation of conflicts, sanctions in the case of breach of the rules, and organizations supporting market transactions.¹⁶¹ Institutions are more or less developed depending on how well these different features operate. They can create or destroy incentives for individuals to engage in trade, invest in human and physical capital, and can bring about the incentives to engage in R&D and work effort.

The quality of institutions has long been recognized as an important component of a well-functioning market. Market activities involve the interaction of human beings, and institutions exist to reduce the uncertainties that arise from incomplete information concerning the behaviour of other individuals in this process of human interaction. Institutions can act through a number of channels:

- They decrease information asymmetries as they channel information about market conditions, goods and participants;
- They reduce risk as they define and enforce property rights and contracts, determining who gets what and when;
- They restrict the actions of politicians and interest groups, making them accountable to citizens.

Institutions are thus likely to have an important impact on economic activities in general. This Section, however, focuses on the importance of domestic institutions for the success of trade reform.¹⁶² In particular, the quality of institutions is likely to affect the amount of trade generated by trade liberalization, with implicit consequences for the welfare and growth effects of trade liberalization. A country's institutional set-up may also affect the level of social acceptance of trade reforms within the country. This is because certain individuals may in the short- and/or long-run lose from trade liberalization. How and to what extent institutions deal with these individual losses may affect public sentiment on trade liberalization in parts of the population.

1. DOMESTIC INSTITUTIONS AND THE SIZE OF TRADE FLOWS

(a) How do institutions affect trade: the role of contract enforcement

In order to understand the importance of institutions for trade in general and international trade in particular, it is interesting to have a closer look at the historical development of institutions that supported international trade. The problems traders encounter have not changed much over time, while the institutions that aimed at solving these problems have changed. Yet they have always needed to fulfil the same tasks and it is instructive to look at how historical institutions achieved this. This subsection will focus on the problem of contract enforcement.

An interesting example of an institution facilitating trade is the coalition that governed agency relations among the Maghribi traders in the Mediterranean area in the 11th century (Greif, 1993). At that time, a merchant organizing the supply of services required for the handling of his goods abroad, could either travel along with his merchandise or hire overseas agents to supply the services. Employing agents was more efficient, but carried the risk of being cheated by the agent who could embezzle the merchant's goods. To overcome this commitment problem, Maghribi traders tended to be associated with many other Maghribi traders residing in different trade centres. Within such a coalition traders exchanged trade-related information. As a result, the information that an agent had cheated a merchant would quickly be passed on to the other members of the coalition. The entire coalition would stop doing business with the unreliable agent and this represented a serious punishment for that agent in terms of lost earnings. The incentive to cheat was reduced significantly in this way, and collaboration between Maghribi merchants and agents flourished in the Mediterranean area.

¹⁶¹ See North (1994) and World Bank (2002). North (1990) makes a distinction between institutions and organizations, referring to the first as the rules and the second as the players. This distinction also plays a role in this section, although organizations are treated as forming part of the covering term institutions.

¹⁶² See for instance Frankel and Romer (1999), Acemoglu and Johnson (2003), Acemoglu et al. (2001) and Rodrik et al. (2002) for contributions to the relevant growth literature.

Nowadays contract enforcement can represent a problem in international trade. Trans-national networks can, even in modern times, have a role in facilitating trade as they build, or substitute for, trust when contract enforcement is weak or nonexistent. The following quotation regarding the modern network of overseas Chinese business owners, for instance, sounds intriguingly similar to the one discussed in the previous paragraph: "If a business owner violates an agreement, he is blacklisted. This is far worse than being sued, because the entire Chinese network will refrain from doing business with the guilty party."¹⁶³

Trans-national networks can thus facilitate trade when contract enforcement is weak. In the absence of such networks or other mechanisms to overcome problems of contract enforcement, the absence of an efficient legal system can have significantly negative effects on trade as discussed, for instance, in Bigsten et al. (2000). These authors examine the contractual practices of African manufacturing firms using survey data collected in Burundi, Cameroon, Côte d'Ivoire, Kenya, Zambia and Zimbabwe. It is shown that contractual flexibility is pervasive and that it is a rational response to risk – the riskier the environment, the higher the incidence of contract non-performance, and the higher the probability of renegotiation of a contract. Breaches of contracts and the use of lawyers and courts to enforce the original contract are rare, simply because of the absence of an efficient legal system. Instead, suppliers and clients fulfil their contracts, but in a "flexible" way – supplies occasionally arrive late or their quality is different from what was ordered, and clients sometimes pay late. Under these arrangements, foreigners are often taken by surprise by contractual delays and calls for contractual renegotiation. They are accustomed to functioning in a very different environment, and it may be hard for them to understand that seemingly unpredictable behaviour is a rational response to an inefficient system. This may explain why foreign firms find it difficult to operate in such environments, and why local manufacturers have a hard time breaking into export markets.¹⁶⁴

Another problem that plays an important role in trade is contract enforcement when the delivery of goods or services and their payment do not take place at the same moment in time. Trade typically implies the exchange of goods or services against money. The probability of transactions taking place increases if (commercial) credits can be used – that is, if it is possible to pay today for something that will be delivered in the future or to obtain goods today and to pay for them in the future. The problem is that the person giving the credit, either in the form of money or in the form of goods or services, needs to have some assurance that he or she will in the future get what was agreed upon when the deal was made. During the so-called Commercial Revolution in the 11th to 14th century, the use of credit was already quite common in Europe among people who lived near each other. Trading partners living near each other are likely to know each other and it is, therefore, possible to make a judgement on whether a person is trustworthy or not.

Credit arrangements were also frequent among merchants who did not live near each other. For example, around the middle of the 12th century traders from Asti (in what is now Italy) regularly sold Northern textiles imported from France's Champagne fairs on credit to Genoese traders (Greif, 2001). Similarly, contracts for future delivery among individuals from distant localities were common in England, France and Italy. How was contract enforcement guaranteed in situations where merchants were unlikely to know each other? What guarantee was given to a lender that a borrower would not enrich himself after obtaining a loan by simply not repaying his debt?

Evidence shows that long-distance traders were identified as members of a particular community. Such communities could take various forms. The most common ones were a hometown, a borough, and a merchant guild. These communities had the common characteristic that they had the ability to impose punishment on their members, mainly because the economic and social costs of leaving one's community were relatively high. For each community it was important to maintain the reputation of being trustworthy in order to be able to engage in trade with traders from other communities. It was, therefore, in the interest of the community to control the behaviour of individual traders within the community. If one trader cheated, for instance by not paying an outstanding debt, the community would reimburse the lender to maintain its reputation of being

¹⁶³ Weidenbaum and Hughes (1996) as quoted in Rauch (2001).

¹⁶⁴ Limited success in integrating into global markets may also have other explanations. Poor infrastructure is the main explanation (see Section IIB of this Report).

a trustworthy community. At the same time, the trader who had cheated would be punished. Because each trader knew in advance that this would happen, the incentive to cheat was reduced. At the same time, this system facilitated trade among different communities, because individual traders knew communities would guarantee the enforcement of contracts through a system of collective responsibility.

In the course of the 13th century, however, this system became less and less effective, mainly due to its own success. Trade flows had increased significantly and so had the number and the size of communities involved in trade. At the same time, communities were becoming more heterogeneous. This led to a number of problems, one of them being that it became easier for traders to give false information concerning their origin. It became more costly for the community to check whether a trader who was accused of defaulting on a debt actually belonged to the community. Slowly but surely contract enforcement based on collective responsibility was replaced by a system based on individual responsibility.

It is interesting to compare this European experience with existing lending systems in developing countries. Collier and Gunning (1999), for instance, discuss the absence of adequate state-provided enforcement mechanisms for the reimbursement of loans in certain African countries. As a consequence, the social institution deciding on the credit-worthiness of a project is often restricted to the kin group. It has been argued that this restricts business to the small group of firms known to the network and often to a restricted number of activities. Switching to new activities may turn out to be difficult, even if it would be profitable. This may be a disadvantage for the firms concerned when it comes to adjusting to changes in trade policy or changes in the global environment.

A particular type of collective lending also seems to have played a role in the success of China's township and village enterprises (TVEs). These enterprises are one of the most distinctive institutional features of China's economic transition. The national output of TVEs – defined as all rural collectively owned enterprises – grew more than six-fold in real terms between 1985 and 1997. This phenomenon was accompanied by a steady expansion of rural lending from state financial institutions to TVEs, from 17 per cent in 1985 to 33 per cent in 1994 (Park and Shen, 2002). At first glance this may seem surprising, as an underdeveloped legal system, combined with limitations on ownership of publicly-owned assets made it nearly impossible to collateralize loans. So how was it possible that lending to TVEs nearly doubled within a decade?

The explanation may lie in a particular form of joint liability lending that emerged in China. Under joint liability lending, members of a group are held mutually responsible for repaying individual loans made to group members. Park and Shen (2002) describe the particular way of sanctioning that allowed Chinese lenders to circumvent the problem of collateralizing loans: "managers of collective firms are appointed by local government leaders who, as insiders, closely monitor firm decision-making. Because most collective enterprise managers are native local residents, they often have well-developed personal relationships with local government officials and depend on officials' support for career advancement. Local government officials thus possess the information and sanctioning ability necessary to make joint liability lending contracts credible. They often explicitly or implicitly guaranteed loans in lieu of collateral, so that enterprises owned by the same local government (or community) became jointly liable for loans to individual enterprises." Park and Shen (2002) also describe how, in the mid-1990s, a number of changes harmed the environment for joint liability lending and how this led to a dramatic change in the lending preferences of banks in favour of private firms.¹⁶⁵

Both the historical European example and the more recent example from China illustrate that institutions tend to function well if they complement the existing environment in terms of other supporting institutions, human capabilities and available technologies.¹⁶⁶ Very different institutions can have similar effects. The examples also illustrate that institutions may need to change or adapt as a result of changes in the external environment. Institutions that are efficient in a certain place at a certain point in time may do a bad job if imposed on a different external environment. Institutional change is a complicated process that typically takes place very

¹⁶⁵ One of these changes was the deterioration of firm performance as the economy slowed and competition increased in product markets. As a result, the advantages of local leader involvement in TVE management declined and the incentive problems of public ownership became more apparent.

¹⁶⁶ See also World Bank (2002).

gradually rather than abruptly. Although formal rules can in principle change overnight as the result of political or judicial decisions (e.g. revolutions), informal rules embodied in customs, traditions and codes of conduct are very difficult to change.¹⁶⁷ Moreover, institutions do not always adapt automatically in an efficient way to changes in the external environment, and as a result societies may be stuck with “bad” institutions. Whether or not efficient institutions arise will depend to a large extent on whether this is in the interests of those having the power to devise new institutions.¹⁶⁸

(b) Measuring the effect of institutions on trade flows

The availability of information and the assessment of risk are particularly important concerns for foreigners trading with a country. Even if a country lowers its trade barriers, outsiders may be reluctant to trade with the country if, for instance, they do not believe contracts can be enforced or are not sure whether payments will be made. Therefore the quality of domestic institutions matters for international trade.¹⁶⁹ This Section takes a closer look at the effects on trade of three indicators of institutional quality included in the World Bank Database for Governance Indicators:

- “Government Effectiveness” refers to the quality of public service provision, the quality of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures, and the credibility of the government’s commitment to policies. It is, therefore, a measure of the quality of government inputs.
- “Rule of Law” is based on several indicators that measure the extent to which agents have confidence in, and abide by, the rules of society. These include perceptions of the incidence of crime, the effectiveness and predictability of the judiciary, and the enforceability of contracts.
- “Control of Corruption” measures perceptions of corruption, conventionally defined as the exercise of public power for private gain.

These indices can take values between -2.5 and 2.5, and the higher the value the better the institution. The reason for focusing on these three variables is that they can be expected to affect significantly the degree of uncertainty involved in trade and, therefore, transactions costs. In many cases, governments have the power to change domestic institutions, and therefore the index of “government effectiveness” is likely to reflect the quality of domestic institutions in general. This index will also determine the likelihood of uncertainties related to policy changes in general and trade policy changes in particular. The “rule of law index” refers, among others factors, to the enforceability of contracts, the importance of which has been discussed in detail in the previous subsection. High levels of corruption increase uncertainty as to the size of gains to be expected from economic activities. Corruption is often a widespread phenomenon with potentially large negative effects on trade.¹⁷⁰ In a ranking of the main obstacles for doing business based on a 1996 World Bank survey of 3,685 firms in 69 countries, corruption ranked as the second obstacle. It was only preceded by complaints about tax regulation or high taxes.¹⁷¹

¹⁶⁷ North (1990, 1994).

¹⁶⁸ North (1990). See also Anderson (2001) on possible conflicts of interest concerning the preference for high quality institutions.

¹⁶⁹ Anderson and Young (2000) present a theoretical framework in which the absence of the rule of law has a negative effect on trade.

¹⁷⁰ Causality can also go in the other direction. Ades and Di Tella (1999) argue that openness increases competition and thus reduces the rents that can be appropriated through corruption. Their data analysis confirms this argument. Wei (2000) shows that “natural openness”, as determined by a country’s geography and size, reduces corruption. He argues that this is the case because natural openness increases a country’s incentive to invest in corruption-fighting public governance infrastructure. Another strand of literature has focused on the negative effects of corruption on foreign direct investment. See for instance Wei (1997).

¹⁷¹ Brunetti et al. (1997) as cited in Anderson and Marcouiller (2002).

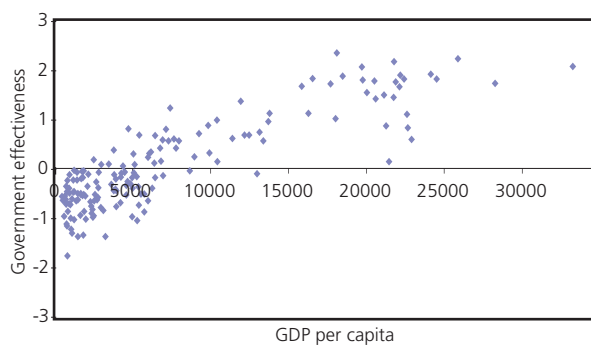
Table IID.1
Highest, lowest and median values in institutional quality

	Government effectiveness	Rule of law	Corruption control
Maximum	Singapore (2.34)	Switzerland (2.21)	Finland (2.39)
Median	Peru (-0.18)	Philippines (-0.22)	Madagascar (-0.28)
Minimum	Somalia (-2.14)	Congo, Democratic Republic of the (-1.83)	Congo (-1.56)

Source: Kaufman et al. (2002).

institutions do not always require significant investments and institutions supporting good governance are also possible in poor countries. Clearly defined and enforceable property rights, at least for physical assets, are possible in poor countries. It is also possible to create and maintain incentives that stimulate productive activities and transactions rather than rent-seeking in rich as well as poor countries. Finally, good institutions refer to the level of trust and the incentives they create, rather than to particular organizational structures or cultural characteristics. Over time and across countries many different institutional structures have been associated with high income levels or high growth rates. China and Ireland are among the five fastest growing countries during the decade from 1991 to 2001, and they are countries with very different institutional structures and income levels. Despite these differences, the two countries have in common that their institutions are of higher quality than those of other countries with similar income levels.¹⁷⁴

Chart IID.1
Average government effectiveness (1996, 1998, 2000) and GDP per capita (1995)



Source: Kaufman et al. (2002) and World Development Indicators.

quality of formal institutions tends to coincide with more trade. They also find that similarity between trading partners in the quality of their institutions promotes trade. Anderson and Marcouiller (2002) use survey data from businessmen gathered by the World Economic Forum on contractual enforcement and corruption as an index of institutional quality. They find that lower institutional quality has a substantially negative effect on trade. Rauch and Trindade (2002) focus on the role of trans-national networks for trade. As discussed before, such networks can play an important role when it comes to contract enforcement in international trade. They can also reduce transaction costs through the reduction of information costs. Rauch and Trindade (2002) find

Table IID.1 shows the countries with the highest and lowest value for the three institutional variables. It also shows the country at the median value. The Table suggests a link between institutional and economic development. Chart IID.1 confirms that these two variables are closely related.¹⁷² The Chart plots the index for government effectiveness against GDP per capita, showing this close relationship graphically. Several studies covering different groups of countries and different time periods have found that the quality of institutions is an important determinant of economic performance.¹⁷³ It should also be noted that the level of institutional quality depends on the level of income as well, since rich countries can afford better institutions. Yet good

Another characteristic shared by China and Ireland is that they experienced a sharp rise in their openness to trade with other countries. Openness as measured by total trade as a share of income is another variable that has been found in the literature to be an important determinant of a country's level of income. The previous discussion suggests that the quality of institutions may also affect a country's level of openness to trade. A number of empirical papers focusing on the determinants of trade flows show that institutional quality is indeed positively related with the size of trade flows. De Groot et al. (2003), for example, study how the measures for institutional quality included in Table IID.1 above affect trade and find that a better

¹⁷² The correlation coefficient between institutional quality and GDP per capita is around 0.9 for all three measures of institutional quality.

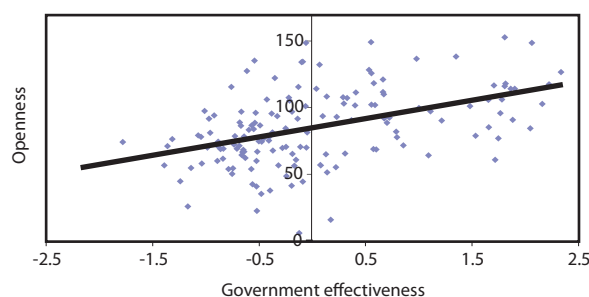
¹⁷³ See for example Acemoglu et al. (2001; 2002).

¹⁷⁴ The point estimate for Ireland's government effectiveness in 2002 is 1.62 compared to a 1.48 average for high income countries. China's point estimate is 0.18, compared to -0.37 for lower middle income countries (World Bank: Governance Research Indicators Dataset, 2002).

that the presence of ethnic Chinese networks has an important positive impact on bilateral trade and that this impact is larger for differentiated than for homogeneous products. The latter result can be explained by the fact that information costs are more important in the case of differentiated goods.

Chart IID.2 shows the result of another study that analyses the relation between institutional quality and openness (Jansen and Nordås, 2004). The study explores whether and to what extent there is a relation between the quality of institutions and how successful trade liberalization is in obtaining a higher degree of integration into world markets. Three findings are worth noting from this study. First, there is a strong positive relation between institutions and openness, as Chart IID.2 shows. Second, the better the institutional quality, the more difference it makes whether it has high or low tariffs. For example, a reduction in average applied tariffs from about 13 per cent to about 5 per cent will increase openness by ten percentage points if the control of corruption index has a value of zero, and by twenty percentage points if the control of corruption index has a value of unity.¹⁷⁵ If the control of corruption index is at the very low end of the spectrum, however, lower tariffs will have no effect on the openness index. Finally, it is found that a country's own tariffs are much more important for its trade performance both in terms of openness and bilateral trade than its trading partners' tariffs.¹⁷⁶

Chart IID.2
Openness and government effectiveness



Source: Kaufman et al. (2002) and World Development Indicators.

2. DOMESTIC INSTITUTIONS AND SOCIAL ACCEPTANCE OF TRADE REFORMS

Concerns about the social acceptance of reform arise at two different stages of the trade liberalization process: during the adjustment process, and once the economy has adapted to the new situation (i.e. when the economy is open). The reasons for resistance against trade reform or pressure for policy reversals are likely to be different at these two stages. Possible policy responses to increase social acceptance of change, therefore, also differ.

(a) Social acceptance during the adjustment process

The process of adjustment to trade liberalization involves costs that are mainly paid by agents operating in the import competing sector. Political resistance against trade reform, or pressure to reverse it, is likely to come from firms and employees in that sector.

There will always be industries in which foreign competitors are more efficient than domestic producers. When import barriers on the products of those industries are lowered, foreign producers will be able to attract domestic consumers with lower prices. Domestic import competing firms in those markets will face downward pressures on sales and profits which, in turn, can lead to pressure for lower wages, job losses and perhaps even company closures. Lower wages and/or job losses, and the prospects of lower returns to capital, will cause workers and capital to search for employment in other parts of the economy. This search is very likely to include the country's export industries, especially if the trade liberalization is the kind of reciprocal liberalization that occurs in a multilateral round such as the recently launched Doha negotiations. Provided the country is pursuing sound economic policies, other parts of the economy are likely to grow, as consumers – who are benefiting from lower prices due to trade liberalization – expand their purchases to a range of other goods and services.

¹⁷⁵ The sample mean tariff level is 13 per cent while the standard deviation is 7.8 percentage points. Recall that the control of corruption index takes values between -2.5 and 2.5.

¹⁷⁶ The regressions in the study control for market size, distance to markets, whether the country is landlocked or an island, and the quality of infrastructure.

The concentration of adjustment costs in particular sectors of economic activity is a particular characteristic of trade liberalization. Other policy reforms cause adjustment costs, but in many cases these tend to be more evenly spread across the population. A reduction of legal minimum wages, for instance, will affect low income earners across the economy. Also, a reduction in government spending will have repercussions in different sectors of the economy. The more concentrated the losers of a reform are within a society, the more likely they are to join forces against the relevant reform. Thus, even if the magnitude of adjustment costs caused by trade reform is not necessarily different from the costs arising from other reforms, the concentration of those costs in very specific sections of the economy raises the prospects of well organized resistance against trade reform.

Many of those losing their jobs in an import competing industry may end up finding better paid jobs in exporting sectors. Others will receive lower wages in the long run. Likewise, there will be companies that manage to adjust to the new competitive situation, while others will have to shrink or even close down. In other words, while most actors in the import competing sector will have to go through an adjustment process, an important number of them may well end up being better off in the long run. It has been argued, however, that even individuals in this latter group may show resistance to trade liberalization if they do not know in advance whether they will be among the losers or the winners of trade reform. Fernandez and Rodrik (1991) show that in this situation some of those who would gain from trade liberalization may *ex ante* judge it wiser to lobby against trade reform rather than run the risk of being among those who lose from the change. It is argued that this status-quo bias explains phenomena like those observed in Chinese Taipei and Rep. of Korea (early 1960s), Chile (1970s), and Turkey (1980s). In all three cases, reform was imposed by authoritarian regimes and against the wishes of business, even though business emerged as the staunchest defender of outward orientation once the policies were in place.

What can be done to reduce the resistance to trade reform from the import-competing sector and thus increase social acceptance of trade reform? Two approaches have been discussed in the literature. One approach focuses on the need to create “winners” from trade reform as quickly as possible in order to counterbalance pressure against trade liberalization.¹⁷⁷ The other approach focuses on keeping the losses of those that will suffer from adjustment to the absolute minimum.

(i) “Create winners” from trade reform

Trade liberalization creates new opportunities for exporters, particularly if trade liberalization is reciprocal and makes new export markets accessible. The better exporters’ information about these opportunities, the faster will be their response to them.¹⁷⁸ Information failures are increasingly recognized as a key constraint in developing countries. They may, for instance, be one of the reasons for the disappointing supply responses to increases in agricultural prices that has been observed in many developing countries. Information spreads slowly within the country and public investment in basic infrastructure, such as roads or in the development of local media, could do a lot to improve information flows.

A particularly relevant type of information is that directly related to exporting activities. Exporting firms need to have information about the foreign markets they serve and potential buyers in foreign markets need to have information about the exporting firm. The costs of obtaining this information are potentially high, in particular for new exporters. Surveys of manufacturing firms carried out in Kenya, Zimbabwe and Ghana in 1992 and 1993 showed that the majority of firms have little involvement in international markets. The vast majority of firms imported none of their raw materials, exported none of their output, and did not have any foreign ownership.¹⁷⁹ For this type of firm, penetrating a foreign market for the first time is likely to involve a very costly process of search and screening. Existing studies have documented the efforts by US retail corporations

¹⁷⁷ See for instance Rodrik (1989), who argues in favour of export promotion, in particular during early stages of trade liberalization, in order to build up support for the policy changes.

¹⁷⁸ Exporters may also have to make important investments in order to expand production or to start new export activities. As such investments need to be financed, the functioning of domestic financial markets is crucial for the supply response to trade liberalization. Financial markets have been discussed in more detail in Section IIB of this Report.

¹⁷⁹ Pack and Paxson (1999).

to source products in Africa.¹⁸⁰ Sourcing from Africa is complicated by the fact that US firms lack reliable contacts on the continent that can assist them in screening out undesirable firms – or even countries. If US retail corporations, with all the resources and finance they can muster, find it hard to source products in Africa, it must be extremely difficult for African firms to investigate and penetrate Western markets, particularly if they have barely been involved in international markets.

A study of African exporters of garments and home products indicates that the transactions costs of linking into international markets in Africa are likely to be quite high.¹⁸¹ One problem is that Africa has no reputation as an exporter of manufactured products. This reputation problem is something all nascent exporting countries have had to overcome. The study suggests that mechanisms need to be found to reduce the high *ex-ante* search costs for buyers, as well as the high direct marketing costs for African suppliers. Collective marketing support services are often missing or are weak in delivering adequate services. The creation or improvement of such services can play an important role in speeding up and improving the supply response to trade reform.

An additional obstacle to entering export markets for African firms is, in many cases, the precarious state of infrastructure and service delivery at ports. In a modern economy where the time taken to reach market and delivery reliability are important competitive factors, it is simply not possible for African entrepreneurs – however innovative and capable – to penetrate export markets if their goods are stranded for weeks at the ports, and roads are impassable during the rainy seasons. These issues are discussed in Section IIB.

(ii) Attenuate individual losses from trade reform

Government efforts to reduce adjustment costs in order to increase the social acceptance of trade reforms should focus on workers in import competing industries, where losses from trade liberalization tend to be most keenly felt. The functioning of labour markets will to some extent determine the size of the adjustment burden to be carried by workers, as this will determine the length of the period of unemployment they are likely to go through.¹⁸² Employment protection policies, for instance, may discourage entrepreneurs from hiring the few workers needed for starting up a new company as it would be costly to fire them if a business turns out to be less profitable than expected. Job creation in export sectors would then remain moderate, reducing the chances of displaced workers from import-competing sectors of finding new jobs.

High minimum wages may lead to excessive lay-offs, particularly in those sectors under competitive pressure from abroad, where minimum wages would most likely become binding. Without the option of lowering wages, companies faced with strong competition may start laying off potentially large numbers of workers. The sudden unemployment of large numbers of workers represents less of a problem for the economy if these workers easily find new jobs. But there may be serious problems if bottlenecks occur in the job search or retraining process, and it may be difficult for the economy to create the necessary new jobs within a short time-frame.

The level of unionization in import-competing sectors may also have an impact on the adjustment burden resulting from trade reform. The higher the level of unionization in those sectors, the more likely it is that workers were able to share in the rents accruing to those sectors prior to reform.¹⁸³ In other words, the higher the level of unionization, the more likely it is that workers were earning wages above the value of their marginal product prior to reform and the higher the wage losses they will face if they become redundant. Affected workers will have stronger reasons to resist trade liberalization. A high level of unionization will also give them more political weight in their struggle against trade liberalization. A vast political economy literature has emphasized resistance by potential losers as one of the main obstacles to adjustment. Resistance by losers could lead to half-hearted adoption of reforms, thus diluting their economic impact. The mere threat of prolonged strikes, or massive street demonstrations, could make a government delay the adoption of economic reforms, dilute their substance or lead to policy reversals, with negative consequences for adjustment.

¹⁸⁰ Biggs, T., G. Moody, J. van Leewen and E. White (1994), as referred to in Fafchamps (2001).

¹⁸¹ Biggs et al. (1996).

¹⁸² See Bacchetta and Jansen (2003) for a broader discussion on the role of labour markets in the adjustment process.

¹⁸³ See Harrison and Hanson (1999) for evidence on how Mexican labour shared in the rents accruing to protected sectors prior to trade reform.

So how do these different characteristics of labour markets interact during an adjustment process? Forteza and Rama (2001) compare the impact of different labour market characteristics on an economy's propensity to adjust.¹⁸⁴ In addition to minimum wages and non-wage costs, the authors include the level of unionization and the size of government employment in their measures for labour market rigidity. These two indicators are intended to capture the ability of potential losers from reform to express their grievances. The results of their empirical analysis show that countries experience recessions immediately before adjustment and slower recovery afterwards, where organized labour is potentially influential. Whereas growth performance is not affected by the level of minimum wages and non-wage costs. These results suggest that labour market characteristics affect adjustment through political mechanisms rather than economic ones.

Although the study by Forteza and Rama (2001) focuses on developing countries there are reasons to believe that labour markets are more likely to create excessive unemployment following trade reform in industrialized countries than in developing countries. Many developing countries, in particular the poorest ones, are characterized by dual labour markets, with a relatively inflexible formal segment but a highly flexible informal segment, where employment protection policies and minimum wages are non-existent.¹⁸⁵ Union membership as a percentage of the total labour force tends to be lower in developing countries than in industrialized countries. When looking at regional averages, union membership turns out to be highest in Eastern Europe and Central Asia, with 67 per cent of the labour force unionized (Forteza and Rama, 2001).¹⁸⁶ The average share of unionized labour in total labour is 37 per cent in industrialized countries, significantly higher than in Latin America and the Caribbean (19 per cent), the Middle East and North Africa (17 per cent), Sub-Saharan Africa (10 per cent) and South Asia (9 per cent). The degree to which a high level of unionization leads to political resistance, however, depends on many other factors such as, for example, the relationship between unions and the political leadership. In 1990, France was one of the European countries with the highest number of strikes and lockouts (1,529), although it has a relatively low level of unionization (14.5 per cent in 1985 and 9.1 per cent in 1995). In contrast, Austria is a country with a significantly higher level of unionization (51 per cent in 1985 and 41.2 per cent in 1995), but a very low number of strikes and lockouts (9 in 1990).¹⁸⁷

In general, it could be argued that the likelihood of long unemployment spells following trade reform is higher for workers in industrialized countries than in developing countries. Yet being unemployed is likely to cause significantly more hardship in developing countries than in industrialized countries. Credit markets typically fail to help the jobless in both industrialized and developing countries. But while many industrialized countries have developed social safety nets to assist individuals concerned, developing countries are typically unable to afford adequate social safety nets.

Most European Union members are, for instance, characterized by large equity-oriented welfare states.¹⁸⁸ The US welfare state is considered to be less generous, but the country utilizes a special programme of "Trade Adjustment Assistance" for displaced workers.¹⁸⁹ This programme offers a variety of benefits and reemployment services to assist trade-displaced and unemployed workers in preparing for and obtaining suitable employment. These benefits include special income support, job search and relocation allowances and paid training schemes. On the other hand, recent macroeconomic crises in Latin America and East Asia have shown that existing safety net mechanisms are too often inadequate.¹⁹⁰ Their coverage is limited and the assistance available is far below demand during a crisis or adjustment period. Moreover, the poor are often unaware of the programmes, or have too little influence to obtain their entitlements. In principle, informal safety nets such as family support systems can replace formal safety nets. A case study of Uganda, however, shows that these informal safety nets tend not to work for the poorest¹⁹¹, whereas informal mutual insurance at the community level works well in Ugandan middle-class families.

¹⁸⁴ The study looks at adjustment to «economic reform programs» financed by World Bank adjustment credits and loans.

¹⁸⁵ Matusz and Tarr (1999).

¹⁸⁶ The figures refer to averages over the period 1970-1999. The ILO (1999) reports declining levels of unionisation in many European countries in the 1990s.

¹⁸⁷ See ILO (1999).

¹⁸⁸ The term "equity oriented" refers to the fact that their welfare systems contain strong elements of income redistribution. See, for instance, the discussion in Sapir (2000).

¹⁸⁹ See Bacchetta and Jansen (2003) for a more detailed discussion.

¹⁹⁰ Ferreira et al. (1999).

¹⁹¹ McDonald et al. (1999).

The introduction of more sophisticated safety nets in developing countries could significantly reduce the adjustment burden carried by the poorest workers, and thus increase social acceptance of trade reform. Where the introduction of wide-ranging and permanent social safety nets goes beyond the means of a government, the installation of temporary arrangements in the period following trade liberalization may be an option.¹⁹² Special attention would need to be paid to the targeting of benefits in order for them to reach the most needy. Such programmes are likely to be more effective in countries characterized by high quality institutional arrangements.

(b) Social acceptance of an open trade regime

Trade liberalization may also have long-term negative effects for some. The literature has focused on two effects – increased exposure to external risk and distributional effects.

Openness increases an economy's exposure to external shocks. At the same time, however, openness can reduce the negative effects of domestic shocks. A drought that destroys a large share of the domestic harvest, for instance, can have disastrous effects on food supply in a closed economy. Effects will be less dramatic in an open economy that can import food in order to cover the domestic shortages. A priori, therefore, it is not clear whether individuals' exposure to risk is higher in an open economy than in a closed economy. Rodrik (1998) argues that the former is the case. He shows that there is a positive and robust partial correlation between openness, as measured by the share of trade in GDP, and the scope of government, as measured by the share of government expenditure in GDP. In order to show that the explanation for this statistical relationship is to be found in the role of external risk, the paper performs regressions in which openness is interacted with two measures of external risk – volatility of the terms of trade and the product concentration of exports. In each case the interaction term is strongly significant, while the coefficient on openness *per se* turns either statistically insignificant or negative when it is significant. Government consumption thus plays a risk-reducing role in economies exposed to a significant amount of external risk.

Trade is also expected to have long-term distributional effects as it increases the demand for some types of labour while it decreases the demand for others. In particular, trade is expected to decrease the demand for unskilled labour in industrialized countries, and to decrease their wages relative to the wages of skilled workers. Countries like the United States have experienced periods of significant increases in wage inequality in recent decades.¹⁹³ Other industrialized countries, in particular some European countries, have not experienced significant increases in inequality, but are characterized by increasing levels of unemployment among unskilled workers. This contrast can be explained by differences in the functioning of labour markets. Minimum wages, for instance, may have the effect of transforming inequality into unemployment. This is the case when decreased demand for certain kinds of domestic products may reduce the demand for certain types of labour in such a way that wages would be below the minimum wage. Since companies cannot lower wages to that point they will, instead, lay off workers. Increased unemployment and increased inequality may be two different effects with the same cause – a reduction in the demand for unskilled labour. In both cases, social insurance systems can help to make the unskilled better off, either in the form of unemployment assistance or in the form of a system of redistribution that ensures that increased inequality in gross wages does not result in increased inequality of net wages.

Even though trade may be one of the factors behind observed increases in inequality in industrialized societies¹⁹⁴, it is almost certainly not the only one. Profound changes in production technologies in recent decades are also likely to have affected the demand for workers of different skill levels. Several empirical studies have measured the relative impact of trade liberalization and technological change on skill inequality in developed countries.

¹⁹² See, for instance, Ferreira et al. (1999) and Gupta et al. (2000) for the role of social safety nets in the protection of the poor from macroeconomic shocks.

¹⁹³ This has occurred alongside increases in the supply of skilled workers during the same period.

¹⁹⁴ See WTO (2003a) on the effect of trade on inequality in developing countries.

The estimated contribution of trade to the rise in skill inequality differs widely across the various studies. At one extreme, the studies of Berman, Bound and Griliches (1994) and Lawrence and Slaughter (1993) attribute a small or non-existent role to trade, but an overwhelming role to technological change. At the other extreme, Wood (1994) attributes 70 per cent of the causation to trade. Cline (1997) provides a comprehensive overview of the existing literature (at that stage) and concludes¹⁹⁵ "a reasonable estimate based solely on the literature reviewed in this chapter would be that international influences contributed to about 20 per cent of rising wage inequality in the 1980s". Cline (1997) himself finds different results: " ... about one-third of the net increase in the skilled/unskilled wage ratio from 1973-93 was attributable to trade and an additional one-ninth was attributable to immigration".¹⁹⁶

Both increased uncertainty and increased inequality, be they in terms of job opportunities or in terms of income, could undermine social acceptance of trade reform in the long run. This can be ameliorated if public institutions intervene more intensively in the provision of insurance (against unemployment, for instance) in those countries where openness significantly increases a country's exposure to risk, and in the redistribution of wealth where openness contributes to increases in inequality.

¹⁹⁵ Another, more recent overview of the literature is Acemoglu (2002).

¹⁹⁶ Bhagwati (2000), in contrast, suggests that the effect of trade with poor countries on wage inequality in industrialized countries has been positive and has moderated the adverse impact from other causes (like technical change) on real wages in the North. He argues that capital accumulation and technical change in the 1980s and early 1990s offset the effects of trade liberalization and resulted in a reduction of the relative supply of labour-intensive goods. The net result of these forces would be an increase in Northern prices for labour-intensive manufactures, a phenomenon that has indeed been observed. The changes emanating from the South thus push goods prices in the wrong direction and cannot be responsible for the decline of the real wages in the North.