Chapter 2

The World Trading System: The Road Ahead

Many aspects of globalization have captured worldwide attention in the 1990s, including capital flows, migration, and environmental issues. But for more than a century, the driving force behind globalization has been the expansion of trade in goods and services. And throughout the early decades of the 21st century, trade will continue to drive global integration, especially among developing countries.

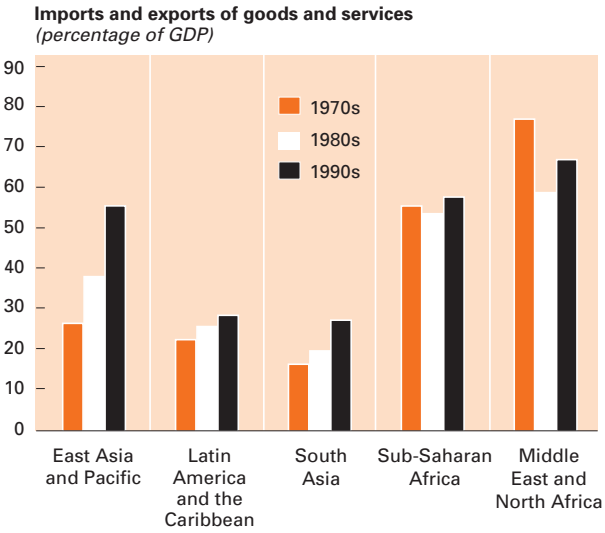
Trade is important to developing countries for four reasons. First, it is frequently the primary means of realizing the benefits of globalization. Countries win when they gain market access for their exports and new technology through international transfers, and when heightened competitive pressure improves the allocation of resources. The rising share of imports and exports in gross domestic product (GDP) for Latin American and Southeast Asian countries in 1980–97 attests to a growing exposure to international trade (figure 2.1). African economies have also felt the effects of international trade for some time. Although the continent's share declined during the 1980s, it fell from a high starting point.[1]

Second, the continuing reallocation of manufacturing activities from industrial to developing countries offers ample opportunity to expand trade not only in goods, but also in services, which are becoming increasingly tradable. In a few decades global trade in services may well exceed that in goods.

Third, trade is intertwined with another element of globalization: the spread of international production networks. These networks break up sequential production processes, which traditionally have been organized in one location, and spread them across national borders. This dynamic will result in further geographic dispersion of production and increased trade among cities, regions, and countries. Increasingly, the fortunes of the new production venues are bound together by trade.

Fourth, the growth of trade is firmly buttressed by international institutions of long standing. The World Trade Organization (WTO), built on the legacy of the General Agreement on Tariffs and Trade (GATT), is the latest step in creating a commercial environment more conducive to the multilateral exchange of goods and services.[2] The GATT and WTO have served as the means of securing past gains through multilateral trade liberalization. But more important, the

Figure 2.1
Foreign trade has increased in most developing regions since 1970



Note: Data are averages over each decade.
Source: World Bank, *World Development Indicators,* 1999.

WTO can function as the point of departure for future rule-making to promote still greater openness to trade. If trade is to continue expanding as rapidly as it has in the past, and if it is to be of greater benefit to developing countries, the international community must engage in further liberalization and institutional reforms.

This chapter starts by outlining how the global trading system benefits developing countries, and reviewing the impressive record of trade liberalization during the last 15 years. However, the lack of attention given to the social consequences of reform has threatened a backlash against trade, which has the potential to stall this momentum toward reform. The chapter then describes how further trade liberalization in two sectors—agriculture and services—can especially benefit developing countries. The rise of global production networks and cities will also have profound implications for the world trading system—broadening participation in the system and fusing its participants closer together. The chapter ends by analyzing how the pace of and support for liberalized trade in developing countries will be affected by these developments.

How the global trading system benefits developing countries

Trade liberalization benefits economies in two important ways. First, when tariffs are lowered and relative prices change, resources are reallocated to production activities that raise national incomes. The tariff reductions implemented after the Uruguay Round raised national incomes by 0.3–0.4 percent.[3] Second, much larger benefits accrue in the long run as economies adjust to technological innovations, new production structures, and new patterns of competition. These gains will continue to be as important in the future as they have been in the past.

Trade liberalization has other powerful effects. First, it strongly influences the way firms perform. The evidence of its effects on domestic enterprises highlights the benefits developing economies gain from access to world markets.

- Increased imports have been found to discipline domestic firms in Côte d'Ivoire, India, and Turkey by forcing incumbent firms to bring prices closer to marginal costs, thereby reducing the distortions created by monopoly power.[4]
- Trade liberalization can permanently raise the productivity of firms by providing access to up-to-date capital equipment and high-quality intermediate inputs at relatively low prices. Some firms in the Republic of Korea and Taiwan (China), for instance, raised productivity by diversifying their use of intermediate inputs.[5]
- Firms' productivity levels also rise when businesses are exposed to demanding international clients and the "best practices" of overseas competitors. Domestic firms may also benefit from the opportunity to reengineer foreign firms' products. Indeed, the differences in the productivity levels of exporting and nonexporting firms often diminish once previously nonexporting firms begin selling products abroad, as studies from Colombia, Mexico, Morocco, and Taiwan (China) show.[6]

Second, trade liberalization can set off a chain of events that concentrates economic activity in a city or region.[7] When costs fall as output rises, businesses have an incentive to locate production activities in a few locations, laying the groundwork for "agglomerations" of economic activity. As demand from overseas purchasers boosts output in these locations, average costs fall and profits rise. The rising profits attract new firms that produce similar goods and thus provide a new source of agglomeration. The increase in final goods producers then encourages the entry of new intermediate input producers with products (such as nontradable services) tailored specifically to the needs of the final goods producers. The

new inputs make the production of final goods yet more efficient, lowering costs and raising quality (and possibly revenues). Final goods production becomes still more profitable, attracting more producers. The cycle continues until it is curtailed by congestion—that is, when output grows faster than the capacity of local infrastructure. These cumulative processes lead to the higher productivity that characterizes urban areas (see chapter 6).[8]

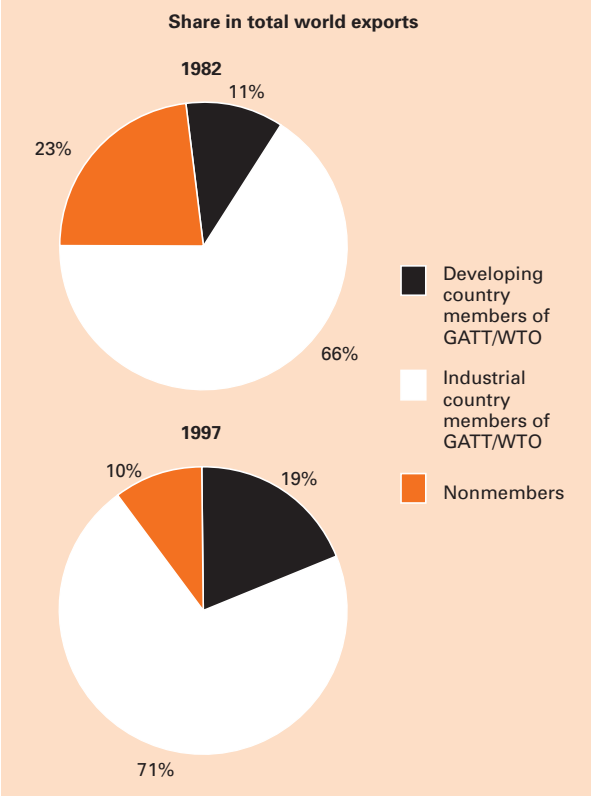
WTO mechanisms for promoting and maintaining liberal trade regimes

The international trading system owes its robust development to successful institutions that straddle international and national levels—for many decades the GATT and now its successor, the WTO. An effective WTO serves the interests of developing countries in four ways:

- It facilitates trade reform.
- It provides a mechanism for settling disputes.
- It strengthens the credibility of trade reforms.
- It promotes transparent trade regimes that lower transactions costs.

These benefits explain the willingness of developing countries to join the WTO in increasing numbers. In 1987, 65 developing countries were GATT members.[9] In 1999, 110 non-OECD countries were members of the WTO, accounting for approximately 20 percent of world exports (figure 2.2).[10]

Figure 2.2
More of the world's exports are covered by WTO disciplines, especially exports from developing countries



Source: WTO, *Annual Report,* 1997.

Facilitating trade reform

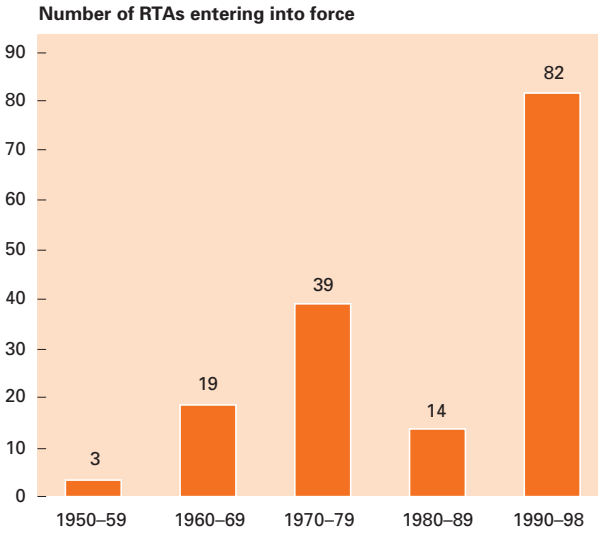
Countries benefit from unilateral reductions in their own barriers to imports. But in a classic dilemma for policy reform, the costs of unilateral trade liberalization are concentrated among a few import-competing interests, while the benefits are distributed thinly across many consumers. The would-be beneficiaries of trade liberalization have little incentive to lobby against the opponents. The WTO exists to overcome this problem—that is, to facilitate trade reform by changing the political equation to generate support for multilateral trade agreements. These agreements create a set of concentrated "winners" in member states—the exporting firms, which benefit from lower tariffs in potential export markets, and which therefore have an incentive to oppose import-competing firms. To maximize the number of winners, multilateral trade negotiations tend to cover many sectors and countries.

Multilateral trade negotiations are not the only means of tilting the political balance to favor trade liberalization. Growing numbers of industrial and developing countries are signing regional trading arrangements (RTAs), often, but not always, with neighboring countries. Regional agreements have proliferated since 1990, covering not only trade in goods but also trade in services, investment regimes, and regulatory practices (figure 2.3). This regionally based liberalization has increased intraregional trade and investment flows.[11] In some cases the regional concentration of trade has become pronounced. In 1992 trade among the members of the Andean Community—Bolivia, Colombia, Ecuador, Peru, and Venezuela—was 2.7 times higher than their economies' national incomes and geographic separation would typically generate (box 2.1).[12]

Encouraging countries to resolve their disputes through negotiation

The dispute settlement mechanism of the WTO benefits developing economies.[13] Initially, members of the

Figure 2.3
More regional trading arrangements (RTAs) came into force in the 1990s than ever before



Source: World Bank 1999g.

WTO undertake to settle disputes bilaterally. But if this process fails, a dispute can be referred to an international panel for adjudication. If the panel votes to uphold the complaint, it can recommend that the offending measure be removed.[14] If the country against which the complaint has been lodged does not comply with the panel's ruling, the complainant can apply for permission to retaliate by withdrawing trade concessions.

In principle, the dispute settlement mechanism makes it easier to enforce the numerous trade agreements that fall under the WTO umbrella. But due to the costs and expertise required to mount a case, and the limited leverage gained by shutting a trade partner out of a small market, more often than not the dispute settlement mechanism is of greatest benefit either to large developing countries or to several small countries acting in concert. Still, in certain areas the mechanism particularly benefits developing economies. For instance, many of the liberalizing measures affecting the textile trade that were agreed to during the Uruguay Round will be implemented in the first decade of the

Box 2.1
Regional trading arrangements and the global trading system: complements or substitutes?

The growing popularity of regional trading arrangements (RTAs) has ignited concerns that these agreements may undermine the global trading system by discriminating against imports and investments from nonmembers. Critics of regional arrangements argue that this practice would violate a core principle of the World Trade Organization (WTO): that all imports from member states should face the same barriers to trade. Furthermore, eliminating tariffs on imported goods from some countries but not others can be counterproductive. If imports from high-cost producers inside the agreement replace goods from low-cost producers outside the agreement, the importing country will not only lose tariff revenue but will wind up with imports that cost nearly as much as before.

Supporters of RTAs maintain that these agreements have enabled countries to liberalize trade and investment barriers to a far greater degree than multilateral trade negotiations allow. Proponents also argue that regional agreements have gone beyond trade liberalization, taking important steps toward harmonizing regulations, adopting minimum standards for regulations, and recognizing other countries' standards and practices—trends that enhance market access. Some empirical evidence supports each view. Thus, a recent survey concluded that regional arrangements "seem to have generated welfare gains for participants, with small, possibly negative spillovers onto the rest of the world."[15]

Should future research suggest that RTAs are having adverse effects on the world trading system, the arrangements will have to be aligned with the nondiscrimination principle of the global trading system. One response is to pursue further multilateral trade liberalization to limit the margin of preference regional agreements create. Policymakers who believe that their country is suffering because of the rise of RTAs elsewhere thus have a further incentive to support multilateral trade liberalization.

A second response is to alter the WTO's agreement on regional trading arrangements to commit members to phase out any preferential market access within a certain time frame. Such a provision ensures that preferential market access is only a temporary feature of any regional initiative. To make this approach more attractive to members of a regional initiative, they could be offered credit for the reduction in trade barriers, which could be used in future multilateral trade negotiations.

A third response is to negotiate a "model accession clause" for the principal types of RTAs. Such clauses contain a set of conditions nonmembers must meet in order to become members. Meeting the conditions automatically triggers a negotiation for accession to the regional agreement. These clauses could also ensure that the trade barriers nonmembers face do not rise when an RTA is established or when new members are admitted.

Source: Baldwin and Venables 1995; Bhagwati 1991; Fernandez and Portes 1998; Frankel 1997; Panagariya 1999; Panagariya and Srinivasan 1997; Primo Braga, Safadi, and Yeats 1994; Schiff and Winters 1998; Serra and others 1998; Wei and Frankel 1996; World Bank 1999g; Yeats 1996.

21st century.[16] In this case the dispute resolution mechanism can play a significant role in ensuring that developing countries are still able to expand their textile exports. The dispute settlement mechanism can also be used to protect developing countries from the imposition of banned market-closing measures, such as pressure to agree to "voluntary" restraints on their exports, or the improper use of permitted market-closing measures, such as the use of sanitary standards as a barrier to trade rather than a protection for public health.[17]

Reinforcing the credibility of trade liberalization

Countries that have a history of import substitution policies—that is, of imposing barriers to imports with the intention of producing the same goods domestically—may want to signal that they have switched to a more liberal trade policy. In this case the WTO's tariff-binding option may prove particularly useful.[18] A WTO member can unilaterally reduce its trade barriers to some new level and then promise that future trade barriers to imports from all other WTO members will be no higher than this new, lower level. This promise, known as a "binding," is incorporated into the country's obligations at the WTO. Binding reinforces the political will to maintain a more liberal trade policy, even in the face of attempts by import-competing firms to reverse the reforms. If a country reneges on its obligations, WTO rules require that it offer compensation to trading partners whose interests have been adversely affected.[19]

In the past 15 years, largely because of the environment created by the GATT and WTO, many developing economies have unilaterally reduced their trade barriers. The trend toward outward-oriented trade policies is not confined to any one continent or region, and it predates the completion of the Uruguay Round (figure 2.4). For example, between 1988 and 1992 Kenya reduced its average tariff rate from 41.7 to 33.6 percent. The credibility of such unilateral trade reforms plays a crucial role in their success. The private sector and international investors react less favorably to an announced trade liberalization if they believe that the reforms are likely to be reversed at the first sign of import surges, current account difficulties, or recession.

Only a few countries have bound their unilateral trade reforms, typically during a subsequent multilateral trade round.[20] An additional incentive for binding unilateral reforms might be to give explicit credit in subsequent multilateral trade negotiations to developing countries that "bind" their unilateral reforms before those negotiations begin. The advantage of these inducements was apparent in the Uruguay Round negotiations, when credit was given informally for such bindings. Developing economies that bound substantial unilateral reforms received $1.50 of tariff concessions for every $1 they offered, significantly more than the $1.10 received by countries that had not undertaken unilateral reforms.[21] Codifying this informal system would reduce uncertainty about the benefits of using this commitment mechanism.

Promoting transparent trade policy regimes

The WTO's Trade Policy Review Mechanism, created in 1989, is designed to enhance the transparency of trade policy regimes worldwide. Depending on a country's share of world trade, its trade policy regime is reviewed every two, four, or six years. Representatives from member states discuss the results of these reviews in a forum that provides a nonconfrontational atmosphere for discussing trade practices.[22] This process reduces the incentive for governments to adopt and retain trade policy measures that contravene international rules, especially those countries with the largest shares of world trade. Such mechanisms not only nudge governments to comply with WTO commitments but also lower tensions among members.

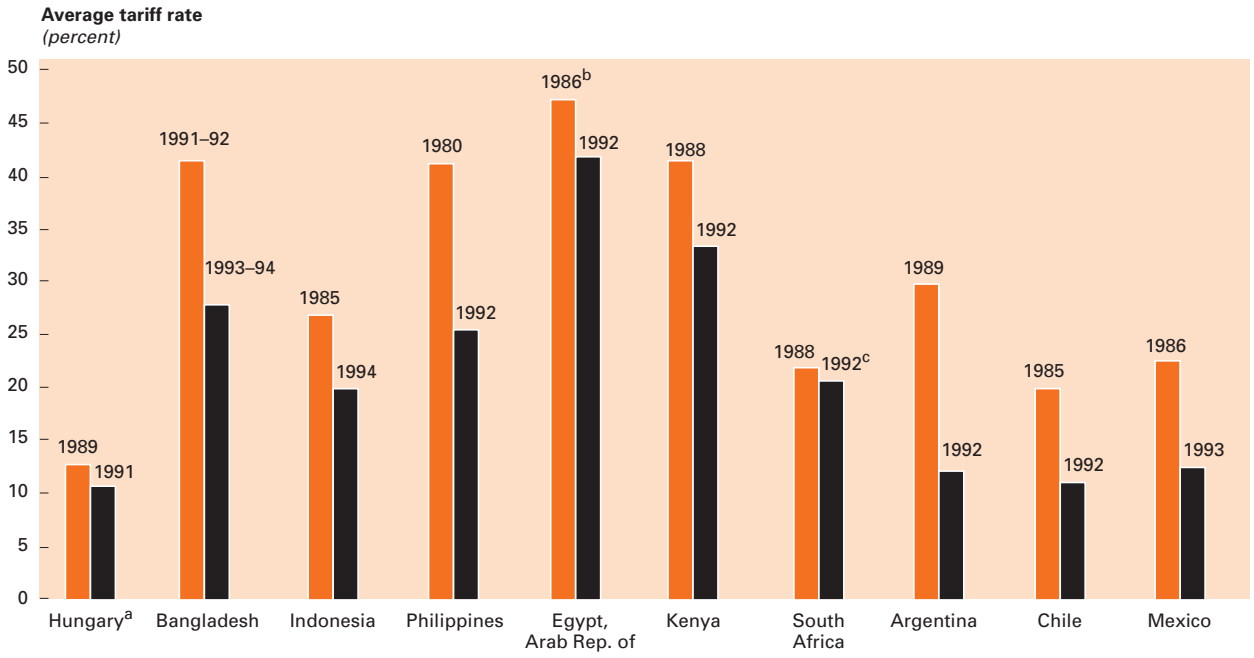
Building technical capacity in trade matters in least-developed countries

The growing number and complexity of the issues negotiated at the WTO have prompted questions about the adequacy of the technical expertise available to developing countries in their national capitals and at their missions in Geneva.[23] In 1997 industrial countries deployed an average of 6.8 officials to follow WTO activities in Geneva. Developing countries sent an average of 3.5 (figure 2.5). Because they are not as well represented, developing countries may have difficulty negotiating the most favorable trade agreements and using the dispute settlement mechanism effectively. To tackle this problem, the World Bank, in conjunction with other multilateral institutions, has developed the Integrated Framework for Trade and Development in the Least-Developed Countries. The aim of the framework is to prepare developing countries to participate effectively in the WTO (box 2.2).

Sustaining the momentum for trade reform

The successful completion of the Uruguay Round of multilateral trade negotiations and the growing popu-

Figure 2.4
Many developing countries started liberalizing before the end of the Uruguay Round



Note: This figure focuses on pre-1994 tariff rates because reductions in the average tariff rate after 1994 could be due to the implementation of the Uruguay Round.
a. Data are from the European Commission's Market Access database.
b. Trade-weighted average.
c. Manufacturing-sector average.
Source: Drabek and Laird 1998.

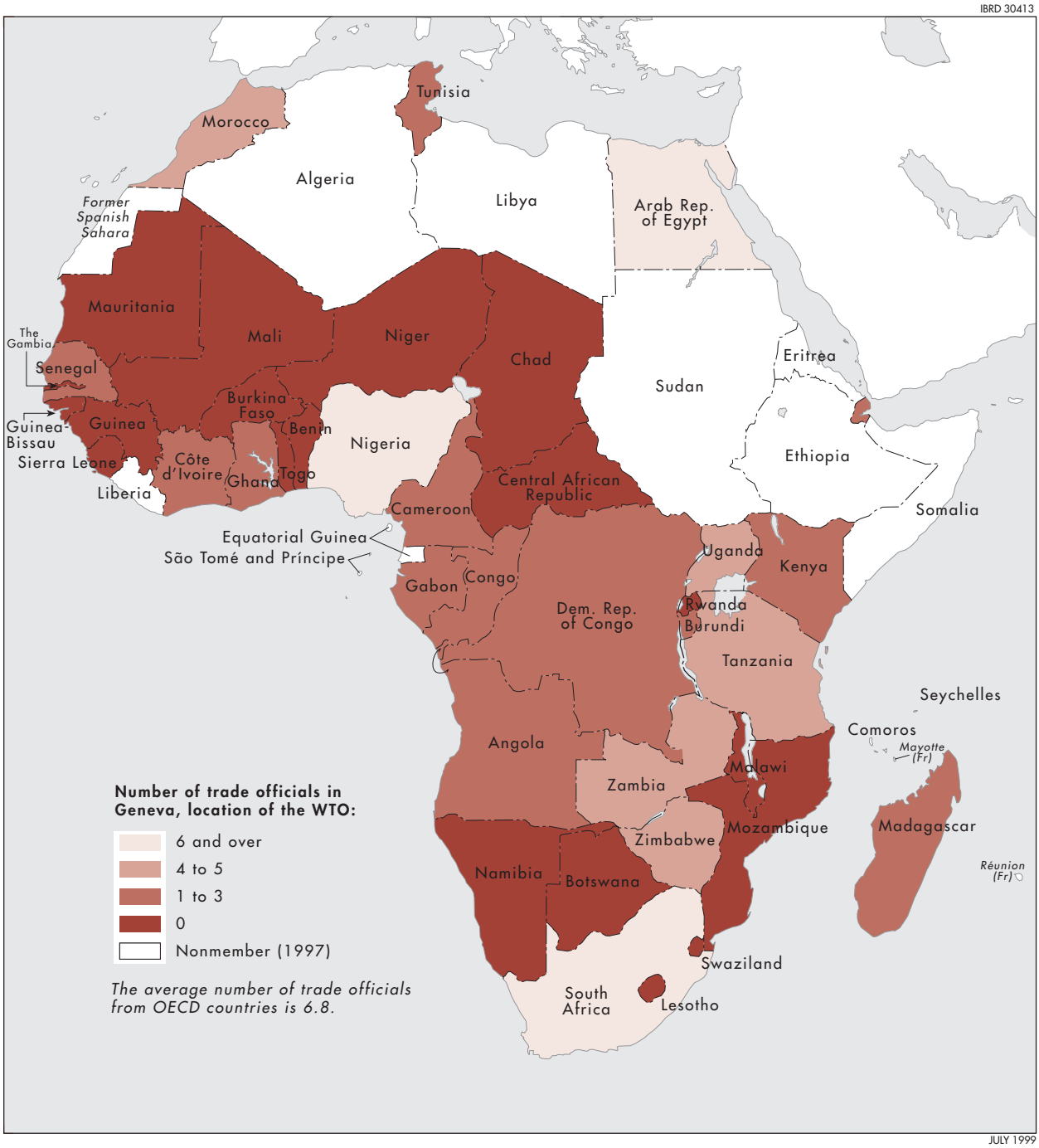
larity of RTAs have created considerable momentum for integrating countries further into the global trading system. Policymakers in developing and industrial countries now confront the task of maintaining this momentum. Concerns about the effects of trade have received much attention in recent years, including worries over inequality, poverty, the environment, and the financing of social safety nets.[24] Even though the empirical evidence almost always fails to validate these concerns, policymakers have become increasingly sensitive to them.

Recent concerns about the pace of trade reform

Developing countries are indeed exporting more to their industrial counterparts. As early as 1990, many industrial countries had seen substantial increases in the ratio of their merchandise imports to merchandise output, leading to even greater competition for sales in their markets.[25] The composition of developing countries' exports has changed, too, creating increased competition in manufactured products, especially in medium- and high-technology goods. For example, the share of high-technology products exported by East Asian economies increased substantially between 1985 and 1996. Meanwhile, Latin American countries and India have shifted their exports from resource-based manufactures to low- and medium-technology exports (figure 2.6). The quality of exports from the Czech Republic, Hungary, Poland, and the former Yugoslavia in engineering, clothing, textiles, and footwear products has also improved in the 1990s.[26]

These heightened competitive pressures enhance overall national welfare, but they are not well received by import-competing firms. These firms are already leading a reaction against trade liberalization in both developing and industrial countries. In addition to lobbying policymakers, import-competing firms use antidumping laws—which are still permitted by WTO

Figure 2.5
Equal players? African representatives at the WTO



Note: Data are for 1997. Mauritius, which is not pictured, had four officials in Geneva.

Box 2.2

Building technical expertise on trade policy: the Integrated Framework for Trade and Development in the Least-Developed Countries

The Integrated Framework for Trade and Development in the Least-Developed Countries, a partnership among multilateral agencies and least-developed countries, provides assistance in integrating these countries into the global economy. The framework was initiated by the 1996 World Trade Organization (WTO) Ministerial Declaration, which asked WTO member countries to provide enhanced market access for the least-developed countries. The declaration also requested that the multilateral institutions involved—the WTO, the World Bank, the International Monetary Fund, the United Nations Development Programme, the United Nations Conference on Trade and Development, and the International Trade Center—provide an integrated framework for trade-related assistance.

The framework includes initiatives to build infrastructure, streamline the business environment, ensure the efficiency and transparency of customs administration, increase governments' capacity to develop effective trade policies, and enhance the private sector's ability to identify and operate in export markets. The framework also aims to enhance least-developed countries' participation in the WTO so that they can take a more active role in the day-to-day workings of the organization and help set the agenda for the next round of multilateral negotiations.

In establishing the framework, the WTO invited each least-developed country to submit a needs assessment for trade-related assistance, including for physical infrastructure, human resource development, and institutional capacity building. In their assessments of the major obstacles to trade expansion, most countries identified supply-side constraints and a lack of technical capacity. The countries will update and rank their needs to produce multiyear programs of trade-related assistance that will be presented at donor consultations on trade matters. For each participating country, this consultation will produce concrete pledges constituting a firm program of trade-related assistance.

Of the 48 least-developed countries, 40 have already presented their needs assessments. Uganda has already implemented its program of trade-related assistance, and 16 other countries have been preparing similar programs for a 1999 donor consultation on trade matters. The discussion of the multiyear program at the Consultative Group meeting in Kampala in December 1998 raised the profile of the Integrated Framework. Several donors are prepared to support aspects of the program, including the U.S. Agency for International Development and the U.K.'s Department for International Development. Country teams from multilateral agencies assist the least-developed countries whenever requested.

Uganda's experience demonstrates just how much this framework can contribute to a developing country. Uganda presented its multiyear program of trade-related assistance at the Consultative Group in 1998. The World Bank's resident mission in Uganda created the operational process for the program, using existing sector investment projects in education, health, and roads. A steering committee led by the trade ministry reviewed the needs assessment, ranking items according to the country's general priorities. The presence of donors and private sector representatives on the steering committee facilitated a consensus and ensured full financing of the priorities the program had identified.

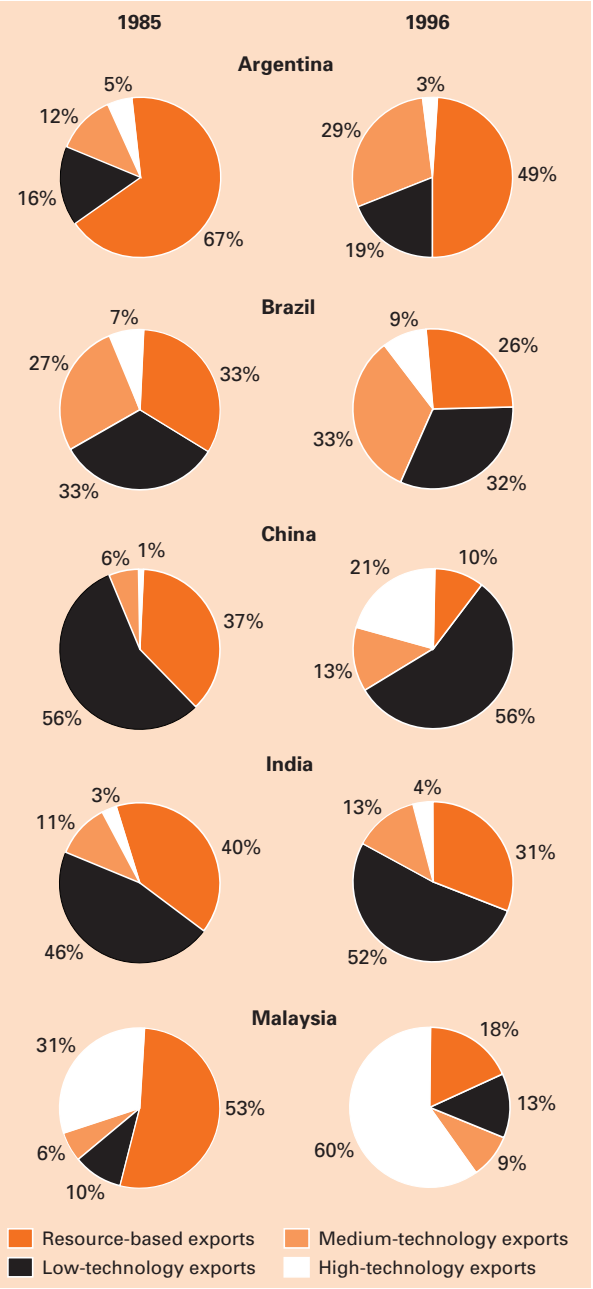
rules—to allege unfair trade practices by foreign competitors. A good is said to be dumped if its export price is less than either the price in its home market or the average cost of production. Antidumping laws enable countries to impose offsetting duties on the products of foreign firms found to be both dumping products on the domestic market and causing "material injury" to a domestic industry.[27]

Until the early 1990s the main users of these laws were Australia, Canada, the European Community (as it was then), New Zealand, and the United States. However, these countries have been joined by a number of new users, primarily developing economies such as Argentina, Brazil, India, Korea, Mexico, and South Africa (table 2.1). In the late 1980s developing countries initiated less than 20 percent of all antidumping actions. By the late 1990s they accounted for around 50 percent (figure 2.7). Developing countries have also become the targets of antidumping actions at close to the rate of industrial countries (figure 2.8). Antidumping actions are becoming a widespread phenomenon, diluting market access and the gains from trade liberalization.[28]

The reaction against increased competition from imports is not limited to antidumping suits. Concerns have been raised that rising import competition is adversely affecting labor market outcomes and, in particular, causing the widening income inequality observed in some industrial economies.[29] These concerns have led to calls to slow, halt, or even reverse trade liberalization in industrial economies—actions that would directly affect the number and size of export markets open to developing countries.

The link between increases in imports and rising income inequality is highly controversial. With a few exceptions, empirical research has found that imports from developing countries have relatively limited effects on wages and employment in industrial countries.[30] This research does not deny that income inequality is

Figure 2.6
The composition of many developing countries' exports was transformed in just over 10 years



Note: Export groups are based on the use of scientists and engineers in production and on the amount of research and development activity required. *Resource-based exports* are unfinished raw products. *Low-technology exports* are typically labor-intensive manufactures with low worker-skill requirements, such as textiles, garments, and footwear. *Medium-technology exports* are products that entail fast-moving production technologies and some design effort, such as automobiles, chemicals, industrial machinery, and consumer electronics. *High-technology exports* are products that combine intensive use of highly skilled employees with substantial research and development; examples include fine chemicals and pharmaceuticals, aircraft, and precision instruments.
Source: Lall 1998.

increasing, but it does suggest that, because increased trade is not a primary cause, erecting new trade barriers is unlikely to solve this pressing problem.[31]

Sustaining reform by treating import competition on a par with domestic competition

The widening use of antidumping actions against foreign firms threatens to undermine one of the key benefits of global trade rules: stable and predictable access to foreign markets.[32] Even though there is no economic rationale for doing so, antidumping laws treat the effects of competition from foreign firms differently from those of competition from domestic firms. The parity between foreign and domestic firms could be restored by an international agreement to eliminate antidumping laws and to apply national competition policy laws to import competition. That is, if an antitrust issue exists—such as predation—deal with it, but otherwise leave pricing decisions to individual firms.

Sustaining reform by easing the adjustment to trade liberalization

Supporters of trade liberalization should give greater attention to developing social safety nets and to education and retraining policies that facilitate labor market adjustment to internal and external shocks.[33] Augmenting trade liberalization policies with complementary labor market policies that ease adjustment will reinforce social cohesion and help offset pressures to close domestic markets to foreign goods.[34]

Research into innovative public policies that reduce the costs of economic adjustment continues. "Income insurance," for instance, would compensate workers in the short term for part of any income they lose because of economic adjustment to liberalization. Such a program reduces the pain of job loss while preserving the incentive to look for employment. [35] However, there is little economic justification for treating workers affected by trade competition differently from workers affected by domestic competition, macroeconomic shocks, the adoption of new technology, or any other form of economic adjustment. Economic adjustment policies should aim to reduce the adverse impact of all shocks, irrespective of their source.

Sustaining reform by directly tackling labor conditions in developing countries

Labor practices in developing countries have received much publicity recently, thanks largely to the efforts of nongovernmental organizations (NGOs). Multinational

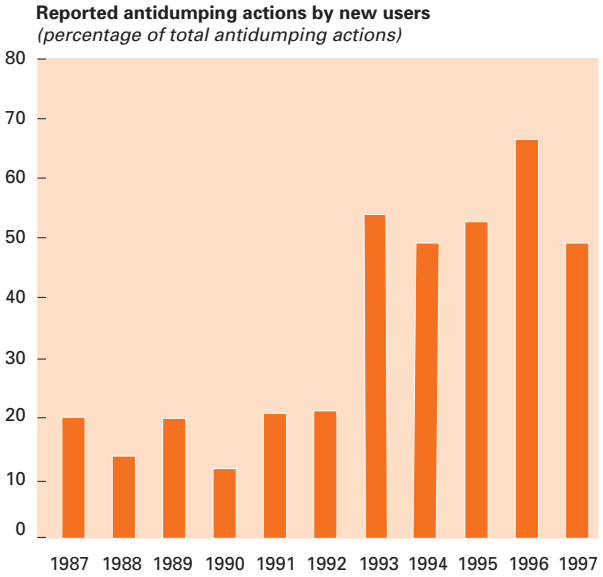
Table 2.1
Reported antidumping actions by members of the GATT and WTO, 1987–97

	1987	1988	1989	1990	1991	1992	1993	1994	1995	1996	1997
New users	24	17	19	20	48	70	162	114	83	148	115
Traditional users	96	107	77	145	180	256	137	114	73	73	118

Note: Traditional users of antidumping laws are Australia, Canada, the European Community (and its successor, the European Union), New Zealand, and the United States. This classification is taken from the source. New users are Argentina, Brazil, India, the Republic of Korea, Mexico, and South Africa.
Source: Miranda, Torres, and Ruiz 1998.

corporations are particularly in the spotlight. Damaging reports have emerged of workers laboring for a fraction of the minimum wage in industrial countries in facilities that fall far short of the safety standards of high-income countries. This publicity has generated strong demands for incorporating international labor standards into the WTO, with trade sanctions to enforce them.[36] The debate on the merits of this proposal is intense, but the evidence that lower labor standards boost export performance is weak.[37] Moreover, imposing trade sanctions on imports from developing countries—especially in labor-intensive industries—will lower wages and worsen working conditions in those countries, not improve them. Better alternatives to imposing trade sanctions exist, including aid programs to improve labor conditions. In addition, developing economies can take steps themselves to improve the conditions of working people, including children (box 2.3).

Figure 2.7
New users initiated an increasing number of antidumping suits during 1987–97



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Source: Miranda, Torres, and Ruiz 1998.

Sustaining reform by preserving the legitimacy of global trade rules

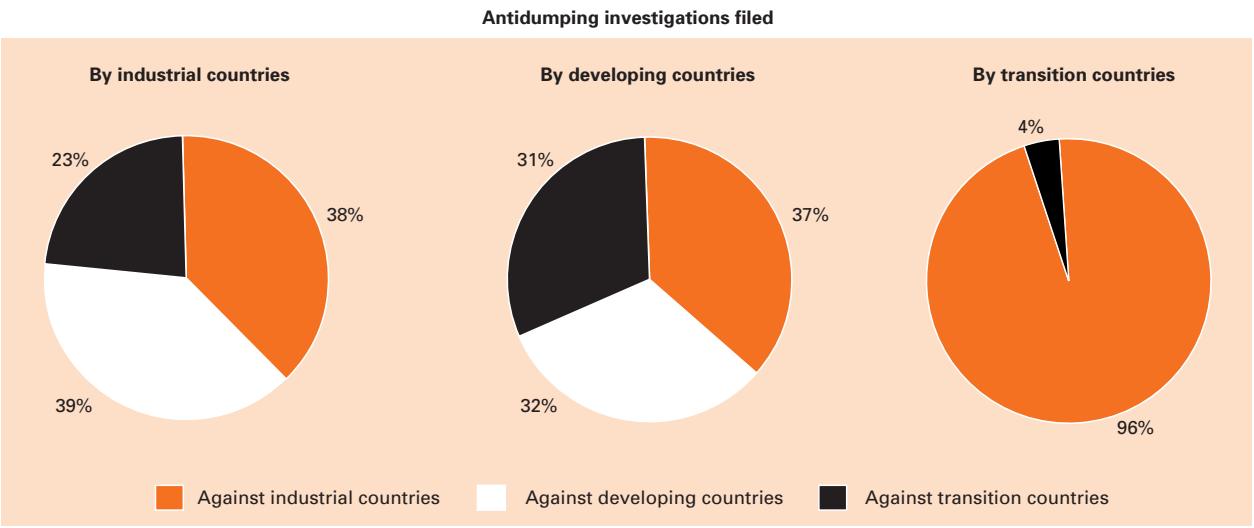
The number of disputes among WTO members is likely to increase in the future, thanks to growing competition in the services and goods markets and the wider scope of multilateral trade rules. NGOs, subnational governments, and even private sector firms will want to be included as participants in the dispute settlement mechanism.[38] If this pressure is not handled well, the legitimacy of global trade rules will be called into question.

A first step in maintaining the legitimacy of global trade rules is to make more resources available for the WTO to implement its dispute resolution mechanism. Several other reforms are also worth considering.[39] Dispute panels could be allowed to take evidence from groups other than governments so that all interested parties can be heard. In addition, regular WTO ministerial meetings can review the ongoing case law that will result from the dispute resolution mechanism, resolving the inconsistencies that disputes might reveal in the provisions of WTO agreements.

International trade and development policy: the next 25 years

International trade institutions and liberal trade policies are a means to an end. They boost trade in existing and new products, enhancing competition in markets, stim-

Figure 2.8
When filing antidumping investigations, industrial and developing countries target each other almost equally



Source: Miranda, Torres, and Ruiz 1998.

ulating productivity, and fostering technology transfer. All these developments in turn increase social welfare. The experience of the last 50 years demonstrates that global trade rules enhance the benefits of unilateral trade liberalization by reinforcing incentives to lower trade barriers and avoid policies that constrain trade.

The global trade regime does face challenges (as discussed above) that must be tackled in order to make further gains. Should these challenges be overcome, what are some of the growth-inducing possibilities? Four such possibilities are likely to be uppermost in the early decades of the 21st century: agricultural trade, foreign investment and trade in services, international production networks, and commerce arising from urban development.[40] Other possibilities have been discussed elsewhere. For example, devising the appropriate intellectual property rights regime for developing countries was discussed in *World Development Report 1998/99: Knowledge for Development*.[41] The World Bank is not alone in analyzing these issues, as the OECD's 1998 study *Open Markets Matter* shows.

Stimulating trade in agricultural products

In developing countries, agriculture offers opportunities not only for expanding export trade but also for improving the livelihoods of many rural populations, as the case study on Tanzania in chapter 8 makes clear. The Uruguay Round of trade talks realized only a small part of the feasible gains from liberalized trade in agriculture because countries were reluctant to scale down barriers.[42] Likely opportunities will arise from a variety of sources: changes in consumer habits, reductions in air transportation costs, advances in biotechnology, and the liberalization of global trade rules.

Rising consumer incomes and declining demand for frozen, canned, and other processed food are creating a need for high-value-added products rather than homogeneous bulk goods. Falling surface and air transportation costs enable firms to supply new markets with fresh products. By increasing the variety of available agricultural products, advances in biotechnology may become particularly relevant for developing countries whose climates sustain only a narrow range of basic agricultural crops. These developments expand the range of potential exports as well as the markets to which products can be sold. But exports can be constrained if a country's domestic infrastructure and trade regulations do not permit speedy delivery. Fears about product safety that lead to calls for banning imports of certain foods can also constrain export growth. The long-standing dispute between the European Union and the United States over hormones used in cattle feed is but one example of this

Box 2.3

Child labor: how much? how damaging? and what can be done?

In developing countries about 250 million children between the ages of 5 and 14 work, at least 120 million of them full time. In Asia 61 percent of all children work full time; in Africa, 32 percent; and in Latin America, 7 percent. Around 70 percent of all child laborers are unpaid family workers. Fewer than 5 percent are employed in export-related production. The vast majority of children working in rural areas are engaged in agricultural activities, while urban children tend to work in services and manufacturing.

Though official statistics suggest that more boys work than girls, the main difference is that boys tend to work in more visible types of employment (in factories, for instance), while girls perform unpaid household tasks or work as domestics. When this difference is taken into account, boys and girls work in similar proportions. The intensity of work boys and girls perform may differ, however, with girls working longer hours. This fact is consistent with the common observation that girls in developing countries generally have lower school enrollment rates than boys.

Not all child labor is harmful. Working children who live in a stable environment with their parents or under the protection of a guardian can benefit from informal education and job training. Many working children are also studying, and their wages help their siblings attend school. However, some forms of employment, in particular prostitution and forced or bonded labor, involve working conditions that are hazardous to the children's health, both physical and mental.

The rate of children's participation in the labor force declines as a country's per capita GDP rises. While as many as half of all children in the poorest countries work, the numbers begin falling rapidly as per capita GDP reaches around $1,200. The incidence of child labor also tends to decline as educational enrollment rises and school quality improves, although the cross-country variations in these relationships are large.

Policies that reduce child labor have strong support on purely economic grounds. When children are sent to work at very young ages for extended periods, they do not develop the skills necessary to earn higher wages later in life, and society loses needed human capital. As adults these individuals have low productivity levels that become a drag on economic growth.

Several approaches to reducing child labor have been suggested. They are not mutually exclusive and probably work best in combination.

- *Reducing poverty.* Poverty is a major cause of harmful child labor. In poor households, children's wages may be essential to the family's survival. Even though poverty reduction is a long-term process, programs that improve the earnings of the poor, address capital market constraints, and provide safety nets can help reduce child labor in the short term.
- *Educating children.* Increasing primary school enrollments tends to decrease child labor. Making it easier for children to attend school and work simultaneously may be the best approach in rural areas. The school year must be carefully scheduled in these areas in order not to conflict with the peak agricultural season, however. Reducing the cost of education through subsidies, direct payments, and school feeding schemes also gives households an incentive to send children to school rather than to work.
- *Providing support services to working children.* These services can include meals, basic literacy classes, and night shelters. Since these programs usually concentrate on children working visibly on the street, their scope is somewhat limited.
- *Raising public awareness.* This approach covers a wide spectrum: improving the general awareness of hazards to working children, raising parental awareness of the loss of human capital associated with child labor, and involving employers, unions, and civil society in efforts to reduce child labor.
- *Enforcing legislation and regulations.* Most countries have laws and regulations governing child labor, but enforcement is weak. In fact stricter, across-the-board enforcement may end up hurting those it intends to protect by reducing the income of poor families and forcing children into more dangerous and hidden forms of employment. The alternative is to focus legislation on the most intolerable forms of child labor. A new International Labour Organization (ILO) convention targeting the worst forms of child labor—including slavery, prostitution, forced labor, bonded labor, and illegal and hazardous work—was adopted in June 1999.

Many other proposals for reducing child labor—including trade sanctions, consumer boycotts, social clauses and certification, and labeling schemes—are fraught with problems. For example, exports produced in the formal sector are the products hit hardest by trade measures, and one effect can be to force workers (including child laborers) into the informal sector, where working conditions are typically worse. Trade sanctions, which may be little more than a cover for the introduction of protectionist measures, may be implemented in ways that have little to do with child labor. Finally, labeling schemes and social clauses are often impossible to monitor.

The World Bank has taken steps to reduce harmful child labor through its ongoing poverty reduction efforts and the child labor program established in May 1998. The program is the focal point for Bankwide child labor activities and supports initiatives such as child labor reduction evaluations. It draws upon the international experience of labor experts from academia, nongovernmental organizations, and other multilateral and bilateral organizations such as the United Nations Children's Fund (UNICEF) and the ILO.

Source: Fallon and Tzannatos 1998; Grootaert and Kanbur 1995; ILO 1993; World Bank 1999f.

problem. The debate over agricultural trade policy, then, is likely to encompass not just market access but methods of production as well.[43]

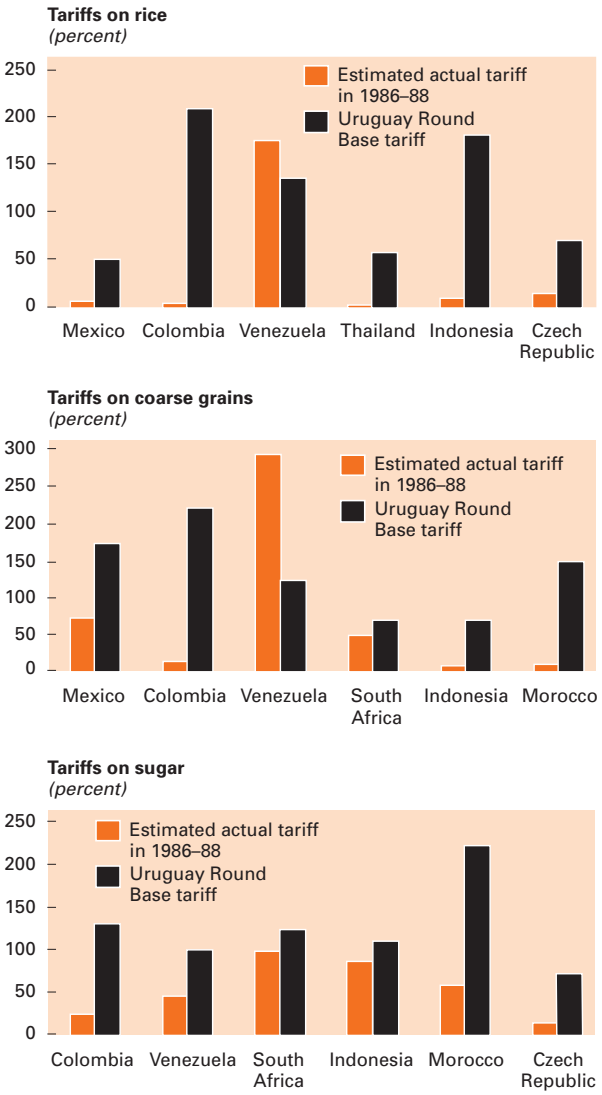
The Uruguay Round agreement on trade in agricultural products laid the foundation for future liberalization. Countries agreed to convert nontariff agricultural barriers into tariff barriers and to set their tariffs at or below a certain level (the "bound" tariff rate). Similar maximums were agreed to for export subsidies and domestic subsidies. The advantage of this approach is that it converts a wide range of trade distortions into three observable trade policies, with maximum levels that can be negotiated down over time.[44] Unfortunately, many countries took advantage of this opportunity to convert their nontariff barriers into extremely high maximum tariffs. For three widely traded commodities—rice, coarse grains, and sugar—many governments chose to set their maximum permitted tariff in the Uruguay Round well above the actual tariff collected in 1986–88 (figure 2.9).

There are several reasons why these tariffs are highly damaging. First, by raising domestic prices above world prices, they raise the cost of food to consumers. Second, they increase costs for domestic food processing firms, harming their export competitiveness. Third, the artificial expansion of the domestic agricultural sector increases the demand for resources, making them more expensive for the rest of the economy.[45] These economic costs must be added to those created by export subsidies for agriculture and the taxes that finance these subsidies. Thus, the next round of trade negotiations should seek to negotiate substantial reductions both in agricultural trade barriers and in those market barriers created by state-owned monopolies that trade in agricultural products.[46]

Since agricultural trade barriers distort the allocation of national resources, their removal will induce adjustments that may include migration from rural to urban areas. Moreover, reform may lead to fears about dependence on foreign sources for food. Recognizing the dislocation induced by trade reform reinforces the case for enhanced flexibility of domestic labor markets and for a robust social safety net. Furthermore, during 1996–97 the World Bank provided loans to over 20 countries to smooth the adjustments created by reform. In addition, assistance was offered to countries facing food shortages and other agricultural emergencies.[47]

Advances in biotechnology have introduced a new factor into agricultural trade policy—sanitary and phytosanitary regulations. Sometimes these regulations are particularly blunt instruments, imposing restrictions on imports that go well beyond what is needed to protect human health.[48] However, governments often have legitimate concerns about protecting the well-being of their citizens. The Agreement on Sanitary and Phytosanitary Measures that resulted from the Uruguay Round seeks to strike a balance between these concerns and unnecessary restrictions by ensuring that sanitary

Figure 2.9
Many countries bound their tariffs on agricultural products in the Uruguay Round at levels well above estimated actual tariffs in 1986–88



Note: Figure shows selected commodities to which tariffication was applied and that are subject to safeguards.
Source: Hathaway and Ingco 1996.

and phytosanitary regulations do not deliberately discriminate against foreign suppliers. A core requirement is that domestic standards be based on scientific evidence, and nothing prevents those standards from being above international norms.[49] But even seemingly unobjectionable regulations based on scientific evidence can be disputed, and the implementation of the agreement will place further burdens on the WTO's dispute settlement mechanism. Those hearing the cases may well have to assess each protagonist's scientific case as well as the implications for international trade.[50]

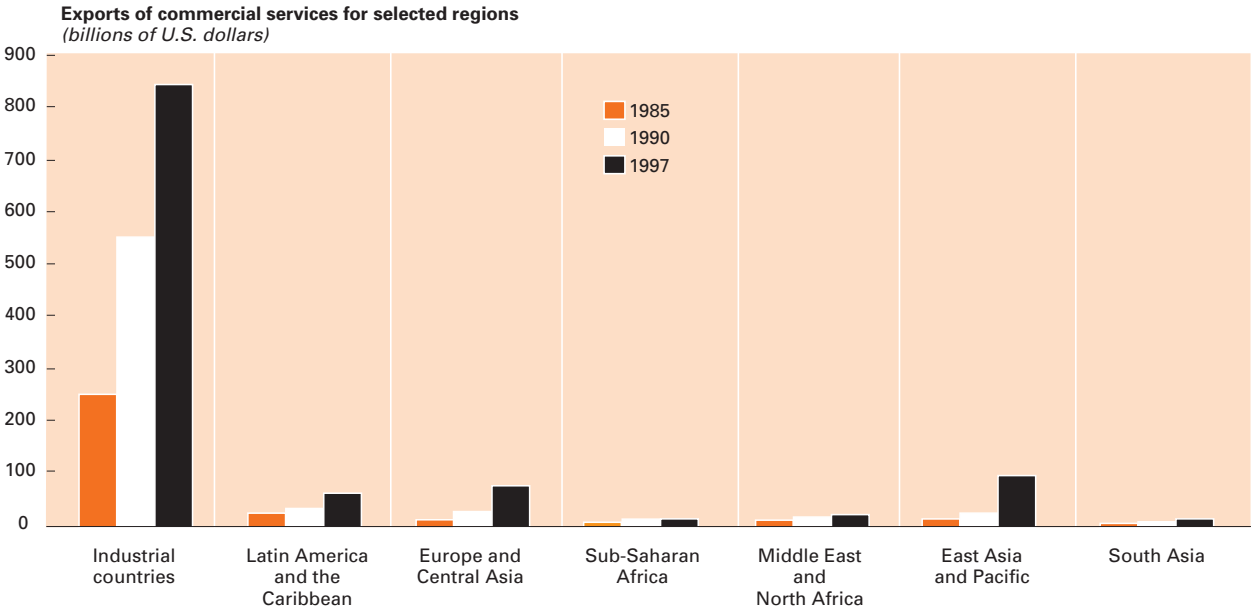
Liberalizing trade and foreign investment in services

Changes in technology, demand, and economic structure will make the exchange of services an increasingly important form of trade in the 21st century (figure 2.10). Falling communication costs and the use of common international standards for some professional services contributed to the large jump in service trade that took place in the mid-1990s. Developing countries stand to gain considerably from the liberalization of trade in services, especially in labor-intensive sectors such as construction and maritime activities.[51] The liberalization of services will also promote competitiveness in sectors that use services as inputs to production.

During 1994–97, world exports of services grew by more than 25 percent. Forecasts of the growth in U.S. trade in services suggest that this pace will resume in the early part of the 21st century, after the macroeconomic effects of the East Asian crisis have abated. Much of this growth will come from developing countries in Asia and from Brazil, challenging the dominance of North American and European firms.[52] In addition, the rise of electronic commerce has created new possibilities for trade in services. For example, a leading Ukrainian manufacturer of wind turbines now contracts out all of its administrative and financial reporting to an accounting firm in southern England.[53]

The stakes in service liberalization are high because most industries use services as inputs to production. Manufacturing industries need cheap and reliable access to global communication and transportation networks to maintain export performance. With products becoming increasingly time-sensitive—the result of shorter product lives and the use of "just-in-time" production—foreign buyers must be assured that a supplier can deliver needed goods on time. Inefficient transportation systems (see the case study on the Arab Republic of Egypt in chapter 8) can prevent domestic industries from joining global production networks.

Figure 2.10
Exports of commercial services increased in every region from 1985 to 1997



Source: WTO, *Annual Report*, 1996, 1998.

When service firms receive trade protection from foreign competition, they can raise the prices they charge to purchasers, which increases the purchasers' costs. In this case protecting service sectors effectively reduces any protection received by their purchasers—as happened in Egypt in 1994, undermining industrial performance in chemicals, crude petroleum and natural gas (where the services purchased accounted for 89 percent of input costs), and iron and steel.[54]

The same core principle underlies trade policy reforms in both services and goods. Measures that give foreign firms increased access to domestic markets will enhance competition, lower prices, raise quality, and improve social welfare. But trade policy for services must take into account an important issue that does not affect trade in goods. Trade in services generally involves the movement of people or capital across national boundaries, often in the form of new subsidiaries. As a result, opening services to international competition may require changes in policies on border measures (as with tariffs), foreign direct investment (see chapter 3), or migration, both temporary and permanent. Future trade negotiators, like those in the Uruguay Round, face the challenge of refining global trade rules for services that take into account the interactions among these policies.

The Uruguay Round produced an agreement on reducing barriers to trade in services, the General Agreement on Trade in Services (GATS). The principal contribution of the agreement lies in the framework it defines, which mandates the application of certain trade rules across service sectors. These include rules governing most favored nation (MFN) treatment and prohibitions against certain restrictions on suppliers.[55] The framework also defines four supply modes for services: cross-border, which does not require the physical movement of producer or consumer; movement of consumer to producer; permanent movement of the producer (including establishing subsidiaries); and temporary movement of people.

But the agreement leaves a substantial amount of room for future liberalization. The coverage of service sectors and supply modes is limited. The agreement covers only 47 percent of sectors (including the key telecommunications and financial sectors) in industrial countries and 16 percent in developing countries, with numerous exceptions. A revealing measure of the limits of liberalization under this agreement is the percentage of service sectors that will experience full international competition: 25 percent in industrial countries and a paltry 7 percent in developing countries.[56]

Industrial countries tend to have more restrictions on services that require the temporary entry of people or the temporary establishment of businesses—for example, construction services, which is one sector where developing countries have a comparative advantage.[57] Looking forward, there is substantial room for the further liberalization of numerous service sectors in both developing and industrial economies. Since the competitiveness of these sectors differs across countries, negotiations that encompass a wide range of sectors, rather than a few sectors in which one country (or group of countries) has a competitive advantage, offer the most room for trade-offs and mutually beneficial agreements.[58]

Fusing domestic firms into global production networks

The fragmentation of production processes across international borders is an important new trend, particularly for developing economies. This "slicing up the value chain" involves separate stages of production being conducted in different countries.[59] Declining communication costs and improved transportation systems permit just-in-time delivery and the coordination of production across borders.[60] Developing economies can expedite their integration into the new production systems by liberalizing and improving their telecommunications and transportation sectors. Global trade rules have fostered global production networks, and an associated rise in intrafirm trade, by progressively lowering trade barriers and reducing the likelihood of unpredictable increases.[61]

International trade data are useful indicators of the rise in global production networks.[62] More than half the exports of foreign affiliates of Japanese and U.S. firms go to other members of the firms' production networks, and close to 40 percent of the parent firms' exports go to their foreign affiliates. In total, about one-third of world trade in the mid-1990s took place within global production networks. In certain industries the trend is even more impressive. In 1995 components accounted for more than one-third of all transportation and machinery imports to Honduras, Indonesia, Mexico, the Philippines, and Thailand.[63] Similarly, parts and components accounted for more than one-third of total transportation and machinery exports from Barbados, Brazil, the Czech Republic, Hong Kong (China), Nicaragua, and Taiwan (China) (table 2.2).

Table 2.2
Share of parts and components in exports, 1995

Economy	Percentage of parts and components in: Total exports	Exports of manufactures	Exports of transportation and machinery
Singapore	18.2	21.7	27.8
Taiwan (China)	17.4	18.8	36.3
Malaysia	14.3	19.1	25.9
Hong Kong (China)	13.6	14.5	46.2
Mexico	13.0	16.8	24.9
Thailand	10.9	15.0	32.5
Barbados	10.9	18.5	61.6
Czech Rep.	10.6	13.0	36.2
Korea, Rep. of	10.0	11.0	19.1
Slovenia	7.7	8.6	24.5
Philippines	6.6	16.0	29.7
Brazil	6.4	12.1	33.9
China	6.0	7.2	28.8
Croatia	5.4	7.3	32.1
Nicaragua	5.0	24.6	81.6

Source: Yeats 1998.

The creation of these global production networks, either as formal corporations or as part of ethnic diasporas (see chapter 1), helps foster an open trading system. Their supporters can be expected to push for continued liberalization on three main fronts. First, they will argue for the removal of tariffs on parts and semifinished goods because when these goods cross national borders several times, even small tariffs can accumulate and undermine profitability. Second, proponents will push for improvements in domestic and international transportation systems because substandard communication and transportation act as a tax on profitability.[64] Third, the new production networks thrive on—indeed, they expect—stable, predictable trade and investment policies. For this reason alone, multinational corporations will support effective enforcement provisions in regional and multinational trade agreements.[65]

Developing countries can benefit substantially from their firms' participation in global production networks. However, they must also beware of possible adverse fiscal implications. A large portion of the trade these networks generate happens within firms that are able to realize profits in countries with low tax rates. Countries with high corporate tax rates may attract foreign direct investment but will realize lower profits than they expected.[66] The benefits of these networks to the economy are then partly offset by a smaller national corporate tax base, resulting in increased pressure to raise taxes on incomes that are less internationally mobile, such as labor. Such pressure could in turn undermine political support for open markets. Multinational corporations may appear to be the primary beneficiaries of liberalization, while contributing little to the infrastructure that encourages production networks in the first place.

In response to these concerns and others about the environmental consequences of some types of production and the competitive consequences of mergers by some of the largest corporations, multinationals may face more constraints on their activities. A farsighted approach would be for leading multinational corporations to develop a code of practices on tax and environmental measures that includes enforcement mechanisms similar to those in international trade agreements. Alternatively, a long-term goal could be a unitary tax system that distributes corporate tax revenues among countries according to a prearranged formula.[67]

Urban development, trade flows, and the world trading system

The expected growth of cities is emphasized throughout this report (especially in chapters 6 and 7) as a key factor shaping the future of developing economies. Urban growth, geographic and economic, will affect both trade flows and the international system governing them. One challenge that has already been mentioned requires

accommodating more views in international trade forums—including those of urban policymakers—while retaining the rights of national governments to initiate, participate in, and conclude trade negotiations. But many other issues will arise as well.

First, the economic strength of cities is built on agglomeration economies, which enable producers to function more efficiently in proximity to a dense network of information, employees, suppliers, and customers. These agglomeration economies can generate more specialized urban production structures. As a result, urban policymakers also have an interest in preserving market access abroad and at home—abroad for their cities' exports, and at home for intermediate inputs that improve productivity and for consumption goods that may be cheaper elsewhere. The rise of cities as economic and political powers, then, is likely to reinforce support for an open world trading system.

Second, to exploit agglomeration economies, cities will increasingly recognize the need to make progress in several policy areas, not just trade liberalization. For example, the effectiveness and cost of transportation and communications services clearly affect cities' capacity to import and export goods and services.[68] Cities may become a force advocating the simultaneous negotiation of liberalization in many sectors, counteracting the interests of producers who support a sector-by-sector approach to negotiation. Because the number of potential trade-offs across sectors in international trade negotiations is greater than those within sectors, cities may offer increased support for broad-based trade liberalization in the WTO.

Third, while integration into the world trading system offers numerous opportunities for urban producers and consumers, cities will have to bolster their capacity to absorb external trade shocks, such as a collapse in export prices. The range of employment opportunities in cities is wider than in rural areas (where production is often concentrated in a few goods and services) and thus helps absorb some of the effects of shocks on the labor market. However, ensuring that urban labor markets are not overburdened with regulations that prevent them from performing this function is essential to avoiding permanent increases in unemployment. The speed at which information about profitable urban economic opportunities reaches investors can increase cities' capacity to absorb shocks. Again, capitalizing on this advantage requires urban policies that ease the exit and entry of firms, including foreign firms. Ultimately, the rise of cities—especially cities that take measures to minimize the damage wrought by external shocks—may quicken the pace of trade liberalization and the integration of developing economies into the world trading system.

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The impressive trade reforms developing countries have undertaken in recent years have yielded substantial economic benefits. But sustaining the momentum of trade reform will be a key challenge for the next 25 years. The continued liberalization of the agricultural and service sectors, in particular, will deliver considerable benefits to developing economies.

The social consequences of the new openness to trade have been associated with a series of economic adjustments, such as regional and sectoral disparities and internal migration to cities. Labor market institutions, including schemes to enhance labor mobility and raise skills, need to be strengthened in order to smooth the adjustment to trade reform. Policymakers must work to ensure that the considerable gains from trade reform are widely shared among the population, reassuring those who initially suffer from reform that their long-term welfare is secure.

Maximizing the opportunities for development offered by expanding international trade will require a stable and predictable framework of institutions. Codifying the rights, responsibilities, and policies of all parties in broad-based institutions will smooth the path of trade liberalization and development reform over the next 25 years. The upcoming Millennium Round of trade negotiations provides an excellent opportunity to pursue such a wide-ranging approach to trade policy reform.