

To move implementation of the Aid for Trade initiative to the next level, a series of national and sub-regional Aid for Trade reviews in Africa, Latin America and the Caribbean, and Asia and the Pacific would be held in 2008. These reviews are intended to advance the implementation of national and sub-regional plans. As noted earlier, there is already an existing mechanism – the Integrated Framework (IF) – through which LDCs benefit from Aid for Trade. Finally, everything is being done to encourage developing countries to take a more active and direct role in the initiative. There is a growing list of countries that are in the process of holding Aid for Trade events as a way to mobilize both domestic and international support.

3. DEALING WITH THE SOCIAL CONSEQUENCES OF LIBERALIZATION

Some of the gains from trade liberalization come about from the reallocation of resources to those sectors of the economy where a country has comparative advantage. While such reallocations are necessary to reap the benefits of trade reform, they also often imply losses for some individual workers. They may, for instance, result in some workers losing their jobs. The consequences of temporary job losses can be harsh and in many countries policies are in place to assist those temporarily out of work. Those policies are often general in nature, in the sense that they target any individual affected by job loss independent of its cause. But examples also exist of policies that target explicitly those who have lost their jobs for trade-related reasons or specific regions or sectors affected by trade.

The discussion in previous sections has shown that for some the negative effects of trade reform may be permanent as they may face lower revenues in absolute or relative terms after trade liberalization. Given that the overall gains from trade are positive, it is in principle possible to redistribute those gains to make everybody better off. Whether such redistribution policies are introduced or not are decisions that have to be taken at the domestic level. Again the question arises as to whether equity concerns related to trade liberalization should be addressed by specific trade-related policies or whether they can be addressed by more general economy-wide redistribution policies.

(a) General policies to assist those negatively affected by trade

i) Facilitating transition

Two types of labour market policies regarding job loss can be distinguished: (passive) income support during periods of unemployment and so-called active labour market policies that attempt to facilitate re-employment.

Social protection systems

Modern economies need to constantly reallocate resources, including labour, from old to new products, from bad to good firms (Blanchard, 2005). At the same time, workers value security and insurance against job loss. In response to this, economies have used different tools to provide a buffer against the most negative consequences of job loss. These tools include job-security regulation that makes it harder for employers to lay off workers and unemployment benefits that provide workers with a certain level of income during periods of unemployment. However, both types of policies may negatively affect the reallocation process, i.e. the process of job loss inherent in the growth process and also the adjustment process following trade liberalization. The question therefore arises whether a trade-off between efficiency and insurance exists and how far this should go.

In this context, Blanchard (2005) argues that it is important to provide generous unemployment insurance, but that it ought to be conditional on the willingness of the unemployed to train for and accept jobs if available.⁹ He argues in favour of protecting workers, rather than jobs, thus indicating a preference for unemployment insurance (potentially co-financed by companies) rather than job-security regulation. Sapir (2006) illustrates that Nordic European countries (Denmark, Finland, the Netherlands plus Sweden) combine generous and comprehensive unemployment benefits with relatively “loose” job-security regulation. He argues that such a system provides insurance to workers and is at the same time “efficient” as these countries are characterized by high employment rates when compared to the OECD average.

Blanchard (2005) also suggests that the cost of low-skilled labour could be reduced through lower social contributions paid by firms at the low wage

end and that work could be made more attractive to low-skill workers through a negative income tax rather than a minimum wage.

Numerous industrialized countries, in particular in the European Union, are characterized by generous social protection systems that differ significantly when it comes to the detail (Sapir, 2006). An important challenge for these countries is to design systems whereby the unemployed continue to have incentives to look for jobs, ensuring that generous social protection systems do not introduce significant inefficiencies. Social protection in low-income countries is typically confined to the minority of workers who are part of the formal economy. This is because it is difficult to introduce systems of social insurance for workers in the informal economy and agricultural sector who are outside the fiscal system; levels of poverty are also high in these sectors.

A major challenge faced by low-income countries is therefore to devise and extend alternative means of providing social protection to workers in the informal economy (Jansen and Lee, 2007). In middle-income countries, where formal employment is more significant, there is often more scope for providing social protection to workers who are adversely affected by trade and related economic reforms. However, very few of these countries have systems of unemployment insurance even though such schemes are financially and organizationally feasible.

Active labour market policies

Active labour market policies are intended to facilitate the re-integration of the unemployed into the labour market as well as the reallocation of labour necessitated by structural change or geographical, occupational and skill mismatches. They include measures such as retraining schemes for the unemployed, job-search assistance, direct employment-creation programmes such as public works schemes, credit and training programmes to promote self-employment, and employment subsidies to promote the hiring of vulnerable groups such as low-skilled workers and new entrants to the labour force.

Active labour market policies are widely used in industrialized countries where they are increasingly being seen as a preferable alternative to passive income support to the unemployed.¹⁰ Coupled with measures to increase the incentive (and obligation) to seek work, such measures appear to have the potential to raise the employment rate (Sapir,

2006). Hybrid systems of income support and active labour policies have also been suggested. Heitger and Stehn (2003), for instance, propose the re-interpretation of the unemployment insurance system as an employability insurance system. Under such a system, an individual who is laid off could take his insurance entitlement and use it to finance the training needed to find another job.

While many developing countries implement elements of active labour market policies, such as public employment services, skill-development programmes and various direct employment creation schemes, the scale of these activities and the resources devoted to them are typically limited (Jansen and Lee, 2007).

ii) Redistribution policies

As in the case of social protection and labour market policies, redistributive policies fall in the domain of domestic policy making. Most industrialized countries have redistributive policies in place, but they differ significantly. Redistributive policies are, for instance, more extensive in Europe than in the United States even though pre-tax inequality is higher in the United States (Alesina and Angeletos, 2005). Alesina and Angeletos (2005) show that different beliefs about the fairness of social competition and what determines income inequality influence the redistributive policy chosen in a society.

A large body of economic literature has analyzed different redistribution policy options. The discussion in this Report focuses on the analysis of redistribution policies in the context of trade reform. In particular, two questions have been reviewed: are the efficiency losses introduced through redistribution policies smaller than the efficiency gains from trade and is it possible to redistribute from capital to labour if capital is more mobile at the global level than labour?

Traditional trade models have predicted that trade would lead to a rise in the wage premium in countries that are relatively well endowed with skilled labour and a rise of the capital-wage ratio in countries that are relatively well endowed with capital. It comes therefore as no surprise that economists have attempted to analyse the effect of redistribution policies within these models. Such policies tend to introduce two distortions into the economy.

The first distortion comes from the policy itself since it distorts incentives. The need to pay for the compensation scheme creates the second distortion. Using a traditional, full employment model of trade, Dixit and Norman (1980; 1986) have argued that it is possible to use commodity taxes to compensate the losers from trade liberalization without exhausting the benefits from freer trade. Brecher and Choudhri (1994) have raised concerns about this result by showing that in the presence of unemployment this scheme may not work. Instead, they show that in such a setting and under reasonable conditions, fully compensating the losers may eliminate all of the gains from trade. Feenstra and Lewis (1994) have also shown that when factors of production are imperfectly mobile, a compensation scheme on the basis of commodity taxes may neutralize the benefits from trade. Davidson and Matusz (2006) estimate that the total cost of compensation remains quite modest and never rises above 5 per cent of the net benefit from liberalization.

Another question that has received significant attention in the public finance literature in recent years concerns the incidence and optimality of taxes when factor markets become more integrated. One standard model is built on the assumption that capital becomes more and more mobile across countries or regions while labour is rather less mobile or even assumed to be immobile (Janeba, 2000).

Increasing mobility of capital has important consequences for tax policy because a higher elasticity of capital relative to labour would call for lower tax rates on capital on efficiency grounds. This has at least partly undesirable distributional consequences. In particular, it significantly restricts the possibilities for governments to redistribute from capital to labour, which may be a matter of concern if the inequality between capital and labour earnings increases, for instance, as a result of increased globalization. Several contributions to the literature have recommended international tax coordination or even tax harmonization in order to reduce the strong downward pressures on the taxation of capital income (Rodrik and van Ypersele, 2001; Razin and Sadka, 2004). International tax coordination would allow countries to reap the benefits of capital mobility, while compensating the losers of increased openness.

(b) Specific trade adjustment programmes for workers

i) Can specific trade adjustment programmes be justified?

Providing specific assistance to workers displaced by trade liberalization can be justified if these workers face worse job prospects than other unemployed individuals. Evidence on whether this is the case is scarce and is mainly based on US data on recipients of Trade Adjustment Assistance (TAA). The US TAA is one of the few programs explicitly targeting trade adjustment. As it has been around for several decades – it was introduced in 1962 – sufficient data are available to analyse differences between TAA recipients and recipients of “ordinary” unemployment benefits in the United States.¹¹

Decker and Corson (1995) find that during the 1980s, recipients of TAA in the United States were more likely than other unemployed individuals to have been laid off due to plant closures, to have experienced longer jobless spells, to have suffered a larger decline in wages and were less likely to be recalled to their old job.¹² They also find that TAA recipients were more highly paid before lay-off than other unemployed workers.¹³ In a more recent study, Kletzer (2001) does not find significant differences between those who lose their jobs because of trade liberalization and other unemployed workers in terms of levels of work experience before job loss, educational attainments, re-employment rates, re-employment wages and sectors in which they find re-employment.¹⁴

The latter may explain why, according to Aho and Bayard (1984), the political argument for government intervention is the best argument for specific programmes to supplement a more general, and less generous, job loss programme where such programmes are in place. The political argument is that certain interest groups have sufficient political power to block or delay socially beneficial changes unless they are generously compensated and otherwise assisted. According to Aho and Bayard (1984), the case for a special programme such as TAA for trade-displaced workers is that the alternative to TAA is increased trade barriers or greater difficulty in reducing existing trade restrictions because of the political power of the potential “losers”.

Numerous references in the economic literature suggest that political concerns may, indeed, have played a fundamental role in introducing and revising trade-adjustment assistance programmes in the United States. According to Feenstra and Lewis (1994), for instance, the introduction of TAA in 1962 was used to “compensate workers for tariff cuts under the Kennedy Round of multilateral negotiations”. Baicker and Rehavi (2004) point out that in 1993 Congress created the NAFTA Transitional Adjustment Assistance as part of the push to secure the passage of the Agreement. This programme explicitly targeted workers who lost their jobs as a result of trade with Canada or Mexico or through plant relocations to these countries. The same authors link the recent revision of US TAA, in the context of the so-called Trade Adjustment Reform Act 2002, to the US administration’s desire to obtain congressional renewal of the “trade promotion authority”.

Nevertheless, in countries that lack wide-ranging social protection systems, the introduction of adjustment programmes of limited duration, targeting those negatively affected by trade reform can be justified on the grounds of the above-mentioned equity concerns or on grounds of efficiency concerns. Efficiency concerns may, for instance, be related to problems of labour-market congestion that can occur if the local labour market is relatively small and workers are relatively immobile (Aho and Bayard, 1984).¹⁵ Efficiency concerns have also been invoked by Levy and van Wijnbergen (1995) in their analysis of agriculture liberalization in the context of NAFTA in Mexico. The authors argued in favour of gradual trade liberalization together with a well-targeted adjustment programme of investments in land improvements in order to transform a loser from trade reform (rain-fed land) into a winner from trade reform (irrigated land). They argued that gradual trade liberalization would make it possible to reap the combined benefits of transformation and trade without having to experience a period of losses.¹⁶ Such an adjustment programme would also have had the potential to reduce the level of migration from rural to urban areas that took place in certain parts of Mexico in the aftermath of NAFTA liberalization (Nadal, 2000).

ii) Designing specific trade-adjustment programmes: the example of retraining programmes

Training programmes often form part of the “active labour market policies” discussed above and have in

many cases had a positive impact on employment.¹⁷ In the context of targeted (trade) adjustment programmes for workers, however, the effects of retraining schemes have sometimes been considered disappointing. The following discussion illustrates that outcomes are likely to depend significantly on the design of such programmes.

With respect to the US TAA training component, Decker and Corson (1995) find that the training provided through trade-adjustment assistance does not seem to increase re-employment wages. While Marcal (2001) also fails to find evidence that training increased re-employment wages, she finds some evidence that trainees had higher employment rates relative to recipients not in training and to those who had exhausted unemployment insurance benefits. Matusz and Tarr (1999) cite similar evidence based on government-sponsored retraining programmes in Hungary and Mexico in the context of public sector downsizing. Evidence for Hungary suggests that workers who participated in the programme had a slightly higher chance of getting re-employed compared with those who did not. Furthermore, the wages of participants upon re-employment were slightly higher compared with those of non-participants in the programme who later became re-employed. The trainees also subsequently obtained jobs that had longer durations. In Mexico, the retraining programme seemed only to be effective in increasing the chance of finding a job or getting a higher wage for trainees who had previous work experience and for adult male participants, respectively.

Rama (1999) gives some hints as to the reasons for disappointing outcomes of retraining programmes. He analyzes a case of public-sector downsizing by Spain in the 1980s that had only limited success in relocating workers to alternative industries, in spite of extremely large retraining programmes. Rama (1999) argues that failure was partly due to retraining being focused on updating previous skills rather than on acquiring new ones.

In order to be successful, training courses may need to target specific skills demanded in expanding sectors. In the context of the privatization of Brazil’s Federal Railway, for instance, an attempt was made to adapt training courses to the particular needs of laid-off workers.¹⁸ For this purpose, regional labour markets were studied in detail by labour market specialists in an attempt to determine the nature and composition of the market, relative to supply and demand. This information was used

to help organize training and to determine what was necessary to achieve optimal results from the company's efforts to help participants of the incentive programme to re-enter the job market.¹⁹

iii) Targeting adjustment assistance

According to traditional trade theory, adjustment is expected to take place across sectors as production factors move from import-competing sectors to exporting sectors. Adjustment assistance, therefore, was often targeted at particular sectors or was conditional on the sectors being affected by import surges. Traditionally, eligibility for assistance under the US TAA was based on increases of imports of articles of the same nature or directly competitive with articles produced by sectors that subsequently experienced layoffs (Magee, 2001).

The 2002 reform of TAA broadened the definition of the eligible set of workers significantly (Baicker and Rehavi, 2004). It now includes workers laid off in plant relocations, reflecting the concern of off-shoring. The new definition also reflects awareness of the fact that workers may be affected by trade even though their employer is not directly active in trade. Under the new definition, secondary workers employed by upstream suppliers or downstream customers of firms affected by trade liberalization may also be eligible for trade adjustment.

Recent trade literature, however, suggests that even such a broadened definition may fail to capture all workers affected by trade and that, more generally, it may prove to be impossible to identify all workers affected by trade liberalization. As discussed in previous sections, recent studies indicate that adjustment processes may not only be observed between sectors but that significant job reallocation may also take place within sectors. In particular, the traditional approach has been challenged by the so-called "new-new trade models". These studies predict that trade reform will trigger job creation and job loss across sectors as both net-exporting and net-importing sectors will have expanding high-productivity firms and low-productivity firms that shrink or close down (Bernard et al., 2007b). For policy-makers, this implies significant reshuffling of jobs within sectors.²⁰ This also implies that a wider range of jobs are at risk in all sectors.

While traditional trade models would suggest that policy-makers who wish to assist workers focus on

so-called comparative disadvantages sectors, i.e. those that can be identified as import-competing sectors, more recent research suggests that such targeted intervention is not justified. Instead, this research may explain why surveys in industrialized countries have revealed that workers in very different types of industries feel greater job insecurity as countries liberalize (Scheve and Slaughter, 2004). Baldwin (2006a) argues that it will be increasingly difficult for policy-makers to predict the direction and nature of employment changes.

(c) Helping workers to adjust: a role for international cooperation?

The possible role for international initiatives in helping to deal with the social consequences of trade reform have mostly been discussed in the context of adjustment problems. In particular, it has been argued that trade reform should be designed in such a way that adjustment is as painless as possible for workers, in particular the less privileged. Gradual liberalization would, for instance, give labour markets time to adjust and avoid temporary unemployment surges due to labour market congestion (Aho and Bayard, 1984). It has also been argued that it could be helpful for developing countries to receive international funding to deal with negative social aspects of the adjustment process following trade reform.

i) Multilateral trade agreements and adjustment

Multilateral trade liberalization is by its very nature a gradual process and in this respect leaves room for adjustment processes to take place smoothly. Many WTO agreements contain more or less explicit provisions that aim to facilitate their adoption. In particular, they often specify phased-in implementation periods, with developing and least-developed countries usually being granted longer implementation periods than industrialized countries.²¹

Multilaterally agreed trade rules also offer countries several safety valves that can be used to address adjustment problems.²² In particular, the so-called "safeguard" provisions in WTO agreements offer members the possibility to react subsequently to problems caused by unforeseen import surges. Bacchetta and Jansen (2003), however, argue that the safeguard provisions target adjustment problems

faced by firms rather than those faced by workers. In particular, the WTO Agreement on Safeguards seemingly wants to facilitate the restructuring of industries hurt by import competition rather than the reallocation of workers who consequently lost their jobs.

ii) Financing temporary trade-adjustment assistance in developing countries

The discussion above illustrates that most industrialized countries have more or less generous social protection systems in place, sometimes combined with trade-specific adjustment programmes. In many developing countries, in particular least-developed countries, both types of schemes are missing. In the absence of any social protection, unemployment – even for a short period – may cause considerable hardship in developing countries. Or, as Winters (2000) puts it, for the poorest “even switching from one unskilled informal sector job to another could cause severe hardship”.

To the extent that the introduction of wide-ranging social protection systems in middle- and low-income countries takes time, the introduction of targeted trade-adjustment assistance could be justified in countries lacking more general systems. The challenge is to design them in such a way that they are effective. The analysis of existing trade-adjustment assistance schemes in industrialized countries can provide some guidance on this. The question also arises as to whether there could be a role for the international community in contributing to the funding of such schemes.

4. DO ALL COUNTRIES GAIN FROM TRADE? THE ROLE OF TECHNOLOGY

From the discussion of major trade theories and associated empirical evidence in Section C, it seems reasonable to conclude that the gains from trade are universal – that is, shared among all countries participating in international trade. However, several studies have highlighted the possibility that, under certain circumstances, one country may gain less than its trading partner or even lose when trade is liberalized (although global gains always remain positive).²³ This may be of obvious concern to policy-makers trying to emphasize the benefits of trade opening. Two key aspects in the

distribution of gains from trade across countries appear to be countries’ relative size and level of technological development, and the relationship of these issues with other relevant factors. For instance, as described in Section C.1.b, differences in the availability of resources may influence the choice of technology. The latter may change rapidly in open economies and, therefore, alter the initial situation of gains from trade. Since the economic size of a country cannot easily be changed, at least in the short-term, technology appears to be an important factor shaping a country’s expectations of trade benefits. In Section C.3.d, it was noted that technological leadership can even make up for size disadvantages.

The theoretical literature examined in Section C.4.a emphasizes that while the general presumption is that trade liberalization enhances innovation and world growth, several counteracting effects may be at work. This implies that, at least in theory, it is possible to have varying effects on growth, whereby some countries benefit while others are negatively affected by a reduction in trade barriers. The evidence that is extensively reviewed in Section C.4.b points to the limited relevance of these counteracting effects. In particular, the evidence at the firm-level in both developed and developing countries for several trade liberalization episodes attests that trade reforms improve the growth of plant productivity and, hence, the overall growth of the economy (see also Sections C.3.a and C.3.c).

Nonetheless, policy-makers still believe that trade may lead to “incorrect” specialization. The notion of “incorrect” specialization is based on the assumption that the spread of technology across borders is limited while (as discussed in Section C.4.b) empirical literature finds that knowledge developed in one country has positive effects on other countries through trade. However, a possible counter-argument could be that while this form of technology transfer is present in general, not all countries may benefit from it.

From a policy perspective, the question remains as to whether a country should welcome the possibility to trade with technologically advanced partners or shun it, and what it can do to reduce technological differences. By the same token, it must be asked how trade itself can act as a mechanism for technology transfer and what policies may encourage such exchanges. These issues are discussed in turn.