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# TRADE POLICY AND ECONOMIC TRANSFORMATION

BRIEF

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# TABLE OF CONTENTS

List of acronyms	iv
Key messages	v
1. Introduction	1
2. Economic transformation	2
3. Trade and economic transformation links in an historical context	3
4. Transmission channels from trade to economic transformation	4
greater allocative efficiency	4
increased competition	4
increased market size	5
better access to inputs and improved backward linkages	5
better forward linkages	5
increased skills and technology	6
political economy effects	6
5. Trade policy and economic transformation	7
shallow trade liberalisation	8
export promotion	9
trade facilitation	10
liberalisation of mode 2 trade in services	10
liberalisation of mode 3 trade in services / foreign direct investment	10
liberalisation of mode 4 services	11
regional trade agreements and preferential trade agreements	12
export processing zones and special economic zones	13
other trade policies	14
6. Concluding remarks	15
References	16

## LIST OF ACRONYMS

DFID	Department for International Development
EPZ	Export Processing Zone
ESCAP	Economic and Social Commission for Asia and the Pacific
ET	Economic transformation
FDI	Foreign direct investment
IMF	International Monetary Fund
ISI	Import substitution industrialisation
LAFTA	Latin American Free Trade Association
NAFTA	North American Free Trade Agreement
ODI	Overseas Development Institute
OECD	Organisation for Economic Co-operation and Development
RTA	Regional trade agreements
SET	Supporting Economic Transformation
SEZ	Special Economic Zone

## KEY MESSAGES

- Trade has historically played a crucial role in the debate on economic transformation (ET), but the transmission mechanisms of different types of trade policies have not always been clearly articulated and empirical evidence is lacking in specific areas.
- ET involves moving resources between sectors (for example, from agriculture to manufacturing); and improving productivity within sectors (for example, from subsistence agriculture to high-value crops), including through firm entry and exit, as well as within firms.
- ET and trade are intimately linked through, for example: diversification of production and trade; discovery and development of new productive capabilities through trade; and creation higher domestic value added in trade.
- Whilst there has been a firm belief in a strong link between trade and transforming productive structures, it remains too ambitious to identify a unique and unambiguous link between trade policy, trade, and economic structures. Import substitution strategies were used during the 1960s and 1970s to move resources from, typically, natural-resource-based sectors to manufactures. In the late 1980s and early 1990s, trade liberalisation was one of the most important policy tools under the so-called Washington Consensus.
- This briefing discusses the effects of the following trade (related) policies:
  - Shallow integration policies such as tariff reduction or quota removal
  - Export promotion
  - Trade facilitation
  - Liberalisation of mode 2 trade in services
  - Liberalisation of mode 3 trade in services
  - Liberalisation of mode 4 trade in services
  - Regional trade agreements
  - Free trade zone / export processing zones
  - Other (e.g. regulation on intellectual property, standards or competition)
- Trade policy affects ET through multiple channels (see Table 1):
  - Allocative efficiency – increased specialisation through trade can lead to a one-off shift in economic structures
  - Market size – trade allows benefiting from economies of scale, which raises productivity, and hence promotes ET
  - Competition – competition can lead to dynamic effects on firms and within-sector productivity and ET
  - Access to inputs and backward linkages – cheaper and better-quality inputs can raise productivity and within-sector productivity
  - Forward linkages – engaging with value chains with high productivity clients
  - Skills and technology – increasing technological capabilities through trade
  - Political economy – trade could be managed by or break through interests of existing elites.
- The briefing identifies several areas that require empirical work: (i) empirical evidence on the way in which trade affects the within and between components of productivity change and ET; (ii) building up more evidence on what drives exports of services, incl. the role of trade policy played in this; and (iii) the effects of different forms of global and regional value chains on ET.

# 1. INTRODUCTION

This briefing discusses the pathways between trade and economic transformation (ET) and identifies issues for further research. There is a long-standing debate on how to promote ET in both academic and policy circles (see McMillan et al., 2015).

This briefing highlights various channels through which trade can influence ET and discusses the links between various types of trade agreements and economic transformation. The relationship between trade and economic transformation is complex and multidimensional. There are many ways in which trade, the type and method of trading, and initial endowments and policies and institutions in a country affect ET. This briefing first discusses the pathways of impact which will support a better understanding of the role of trade policies.

The structure is as follows. We define the process of ET in section 2. Section 3 reviews very briefly the historical evolution of the theories and approaches of how trade and trade policies were used to support ET. Section 4 discusses the range of transmission mechanisms between trade and economic transformation. Section 5 discusses how trade policy might affect economic transformation. Section 6 concludes.

## 2. ECONOMIC TRANSFORMATION

Economic growth is necessary for development.<sup>1</sup> The increase in the quantity of resources available to produce and/or distribute is essential in the development process. However, economic growth alone does not guarantee all development objectives. The quality of economic growth matters, and it is essential for sustained development that growth involves some form of ET. ET leads to growth that

- generates income broadly across all households or population groups;
- is resilient to price shocks and cycles as well as other non-economic events such as climate; and
- increases the opportunities for future economic growth (self-sustained).

Analysing the drivers of ET involves an understanding of the determinants of growth and productivity at the micro, sectoral and macro levels. This includes understanding how resources move to higher-value uses and the role played by diversification in production and trade.

Economic transformation can be defined as moving factors of production (labour, capital and land) from lower to higher-productive activities. It includes:

- moving resources between sectors (for example, from agriculture to manufacturing); and
- improving productivity within sectors (for example, from subsistence agriculture to high-value crops), including through firm entry and exit, as well as within firms.

ET and trade are intimately linked through, for example:

- diversification of production and trade
- discovery and development of new productive capabilities through trade; and
- creation of higher domestic value added in trade.

Diversifying production and/or increasing the domestic value added are often the results of ET. If ET has been successful, we should observe a more diversified production and export structure as well as an increase in the domestic value added in output and trade. Participation in value chains and other ways of trade is also a means towards transformation, but not the objective.

<sup>1</sup> Further discussion in McMillan, Page and te Velde (2015)

### 3. TRADE AND ECONOMIC TRANSFORMATION LINKS IN AN HISTORICAL CONTEXT

Trade policy has received much attention amongst the range of policies used to enhance ET. Clearly, the use of trade policy to promote changes in the economic structure is not new. In the 1960s and early 1970s, under the premise that the evolution of the terms of trade was against the development prospects of natural-resource-based exporters (Prebisch, 1959), the import substitution industrialisation (ISI) strategy and trade protection tried to change the export structure towards an industrial basis. Moreover, trade agreements implemented at that time, such as the Latin American Free Trade Association (LAFTA), intended to achieve transformation by diverting trade away from efficient import sources into the domestic market or into the agreement member's market.

ISI was used during the 1960s and 1970s to move resources from, typically, natural-resource-based sectors to manufactures. Although the process helped to diversify the export structure, it was unsustainable because the search for efficiency in production was not a guiding principle (unlike for example the experience of exporting in Korea which disciplined domestic industry). Moreover, the replacement of foreign production with domestic production prevented the gain in productivity within sectors. This implied that, although there was some structural change, seen in the expansion of industrial sectors, this was biased towards inefficient and low-productivity sectors.

In the late 1980s and early 1990s, trade liberalisation was one of the most important policy tools under the so-called Washington Consensus (Williamson, 1990 and Rodrik, 2006). According to this approach, the inefficient production structures created during ISI were crowding out efficient sectors from investment and resources. This approach considered that fundamental reforms (trade liberalisation being one of paramount importance) were necessary to allow the private sector to make the investments that would increase productivity in the economy. Whilst the public sector had an important role in steering policy in favour of developing certain key sectors in the ISI period, the Washington Consensus argued it was better that the market decide which sectors to invest and expand.

Thus, although trade policy was used differently, and the approaches explored different development channels, there was a firm belief in a strong link between trade and transforming productive structures. However, a historical overview suggests it remains too ambitious to identify a unique and unambiguous link between trade policy, trade, and economic structure, for various reasons.

First, there is no such thing as a unique trade policy. Trade policy is a heterogeneous set of policies. Trade policy has been (and frequently still is) associated to typical trade barriers such as tariffs or quotas. In addition, there are many other policies that directly affect goods and services (and production factors) when they cross international borders. Trade policy can also be unilaterally, regionally or multilaterally.

Second, the institutional context within which trade policy develops matters. Trade policy has different effects depending on whether complementary policies and institutions are weak or strong.

Third, ET is a multidimensional process with many channels operating jointly. Each of these channels will affect different dimensions of ET. Therefore, the same trade policy may affect ET differently depending on the channel under consideration.

Fourth, the emergence of the value chain analysis provides another perspective to the analysis. Whilst the standard trade analysis focuses more on goods and services traded, value chain analysis puts the emphasis on processes and tasks traded and how domestic value added is embodied in domestic and foreign production. This leads to considering domestic activities as part of global value chains rather than as domestically and internationally independent.

## 4. TRANSMISSION CHANNELS FROM TRADE TO ECONOMIC TRANSFORMATION

Trade policy affects ET through multiple channels. This section describes the main mechanisms through which trade can generate productivity chains, promote structural change, and encourage domestic firms to participate in value chains.

We identify the following transmission channels from trade to ET:

- Allocative efficiency – increased specialisation through trade can lead to a one-off shift in economic structures
- Market size – trade allows benefiting from economies of scale, which raises productivity, and hence promotes ET
- Competition – competition can lead to dynamic effects on firms and within-sector productivity and ET
- Access to inputs and backward linkages – cheaper and better-quality inputs can raise productivity and within-sector productivity
- Forward linkages – engaging with value chains with high productivity clients
- Skills and technology – increasing technological capabilities through trade
- Political economy – trade could be managed by or break through interests of existing elites.

### GREATER ALLOCATIVE EFFICIENCY

The traditional view on trade suggests that opening up to trade or investment under perfect competition leads to a reallocation of labour (and other factors of production) towards sectors with a comparative advantage. This leads to a one-off increase in allocative efficiency and factor prices (i.e. increased wages), but trade does not have any implications for overall employment levels. Whilst the effects on ET are modest by being one-off, the effects might be important in shaping economic structures and securing the basis of future ET. For example, the Indian trade liberalisation in the early 1990s has helped the export-oriented services sector by releasing resources used inefficiently elsewhere and making them available to other, more productive sectors. If there is no supply response in the sectors in which there is a comparative advantage, trade could simply lead to the reduction in productive capacity in inefficient sectors.

### INCREASED COMPETITION

Trade can support ET by increasing competition. In markets characterised by monopoly or oligopoly, (the threat of) increased imports constitute a useful way to introduce additional competition and remove the rents generated by high prices. Moreover, even in domestic competitive markets but not opened to international trade, openness helps to eliminate existing trade diversion favouring domestic firms, particularly in sectors where no comparative advantages can be identified.

Additional competition forces incumbent firms to invest, in order to increase productivity and remain competitive in relation to potential entrants. Moreover, those firms that cannot compete or improve productivity exit the market. This generates important effects within sectors by increasing productivity in incumbent firms and excluding low-productivity firms from the market. As high-productivity firms increase their output because of the reduction in firms, they gain economies of scale, increasing productivity even further.

If firms operating in a particular sector in the domestic market cannot afford the investments or changes necessary to compete with the foreign competitors, it is expected that the whole output of the sector will be reduced. However, more importantly, the reduction in the output would release resources in the form of capital and labour that can be used in the rest of the economy in more productive activities. This could be in incumbent sectors that become productive or in new sectors and products. However, the movement of resources into new productive sectors may be complicated, and in the short run, production and export

diversification may be harmed. For example, liberalisation policies in Chile in the early 1980s led to the disappearance of many sectors in the short run; however, after that adjustment period, Chile added to its copper-based export supply products such as wine, salmon, and wood products, among others.

## INCREASED MARKET SIZE

Increased productivity could put firms into better positions to compete in other markets. This would lead such firms to move from supplying the domestic market to becoming exporters. Firms that are more productive would be in a better position to export (Krugman, 1980 and Melitz, 2003). However, it is also claimed (Wagner, 2007 and Girma et al., 2004) that firms are productive because they export. This implies a circularity in the link between exports and productivity.

More competition will concentrate output into the most efficient and productive firms, increasing their output. The increase in the market size through exports will lead to even higher output. The two effects are expected to generate economies of scale associated with the reduction in the production and trade costs and the most efficient use of non-scalable and non-divisible resources such as management.

If exports make firms more productive, trade policy can help to reduce production costs; make products more competitive; and increase exports and, consequently, productivity. On the other hand, if only productive firms manage to export, trade policy can help to increase productivity (via the channels described before) and increase exports. This implies that no matter what the causal relationship between exports and productivity may be, trade policy can help deliver the ET objectives.

## BETTER ACCESS TO INPUTS AND IMPROVED BACKWARD LINKAGES

Trade is also associated with increased competition in inputs markets, which can lead to lower prices. This reinforces the productivity and competitiveness effects in the remaining firms, described above, as trade allows them to access an increased supply of cheaper and better-quality inputs, with lower costs and higher productivity. Imported inputs might include better and state-of-the-art technology that increases productivity even further. More, better and cheaper inputs would increase productivity within sectors.

As domestic firms become more productive and competitive in the domestic and world markets, they will require reliable, cheap and good-quality sources of inputs. This may lead them to engage in long-term relationships with suppliers (abroad and domestic) that would take the form of value chains. This implies that the more productive domestic firms would engage with input providers that are more productive, which leads to a general increase in the productivity of the chain. Although this may reduce the share of domestic value added embodied in production and trade, it will expand total domestic value added by increasing output via cost reductions and productivity gains. This suggests a complementarity between foreign and domestic value added in achieving higher productivity in each of the stages of the value chain.

The changes in productivity described, as well as the increased productivity in the inputs employed, could lead to a reconfiguration of the role of domestic firms in the chain. For example, they could move up into higher-value-added-capturing activities. However, this would depend on other factors that would be outside the standard trade transmission channel, such as education and innovation policies among others. For example, some stages of the value chain were outsourced to Mexican firms partly because of the North American Free Trade Agreement (NAFTA). However, these involved mostly low-value-added activities such as assembling and packaging, whilst American firms retained and expanded the high-value-added activities

## BETTER FORWARD LINKAGES

Highly productive domestic firms could also engage in value chains with firms operating downstream. As firms become more productive because of the increased competition and lower prices for inputs, they will be cheaper and reliable sources of inputs for firms operating in other countries. This implies the creation and the strengthening of the existing forward linkages in value chains.

Domestic firms could move into more value-added-capturing and complex activities within the chain. This might imply movement to upstream activities within the chain that will intensify forward linkages. However, as we mentioned, these movements might depend on the synergies between trade and other development aspects. For example, increasing trade might require using the distribution and retail capabilities in the destination country. This will lead to efforts being focused on the production-related part of the chain, and leave the other activities to be performed by firms with superior related skills, increasing forward linkages.

## INCREASED SKILLS AND TECHNOLOGY

Imported inputs frequently include higher-quality products that embody technology and skills. This might be a cost-effective way to diffuse technology in the economy, which is necessary for ET. Increased imports of high-skill, labour-intensive inputs reflects the lack of workers with these capabilities in the domestic market.

Greater access to state-of-the-art technologies enhances the skill set and affects the relationship between labour and capital. Depending on the technology adopted, it is possible that productivity of one factor will increase more than the other factors; this may lead to additional changes in the pattern of specialisation, towards those products most intensive in the use of the factor with the increased productivity.

Trade in services and openness to foreign direct investment (FDI) could contribute to the availability of skills. Temporary movement of high-skill workers (mode 4) linked with trade in services under mode 3 (Commercial presence) and FDI could generate spillovers into the economy that would increase productivity within sectors. Moreover, in the specific cases of value chains, monitoring and controlling activities are facilitated when trade in services in modes 3 and 4 are liberalised. For example, supermarkets and stores require control of the production quality and procedures of the firms that provide them. As certification bodies in the sourcing countries are often ineffective or lacking, buyers rely on sending specialists to perform these duties.

## POLITICAL ECONOMY EFFECTS

Firms that begin to export would realise the importance of having competitive markets at home for the provision of goods and services. This might create additional support for implementing reforms in the domestic market that might lead to increased productivity and participation in value chains (e.g. manufacturing exporters in East Africa would like to see better railways to break through the dominance of truckers). Therefore, exports would create an additional set of actors or increase the importance of those that promote domestic market reforms. Increased imports may weaken established interests by providing more options to consumers, but trade can also be manipulated by elites (e.g. in West Africa much corridor trade faced little competition, and as a result trade costs were high).

## 5. TRADE POLICY AND ECONOMIC TRANSFORMATION

Trade policies affect the exchange of goods and services between a country and the rest of the world. Therefore, they are the core of the analysis as they can directly influence the economic structure.

Shallow integration policies involve typical border measures such as tariffs, preferences, quotas, licenses and customs procedures. Regulations on cross-border services provision (mode 1) would also fit in this category. They are typical border measures, as they operate in the precise instant that a good or service crosses the frontier. The effect of a tariff on the price of the imported product (and consequently on that of its domestic competitor) is seen almost immediately after the product has crossed the border. However, this is not the only type of policy affecting the prices and the quantities traded.

Deep integration policies, on the other hand, are 'behind the border', aiming to affect the interactions among domestic markets (including factors markets), a country's policy, and international rules and regulations, once a good or service has crossed the border. They are measures that regulate the business environment in a more general sense. They include measures associated with regulation that affect competition between imported and domestic products, foreign investment, government procurement, and efforts towards the removal of non-tariffs barriers such as harmonisation of standards.

At this stage, domestic policies begin to play a decisive role because deep integration policies are generally defined within the context of other more general policies. The harmonisation of food standards, for example, may be framed within the context of health policies and their outcomes. On the other hand, exclusion of foreign investment from certain sectors may be associated with national security and defence policies.

Some policies have an incidental effect on the economic structure, others are defined with the intention of modifying it. Some address a series of behind-the-border matters, which affect the operation and efficiency of markets for goods, services and factors in the domestic economy and consequently firms' productivity and capability to trade. They include policies affecting goods and services irrespective of their origin, such as taxes, subsidies and other non-discriminatory regulations; and policies that affect production factors such as education and skill development, infrastructure, innovation, technology transfer, etc.; as well as any other more general country- and sector-wide policies.

We discuss the effects of the following trade policies

- Shallow integration policies such as tariff reduction or quota removal
- Export promotion
- Trade facilitation
- Liberalisation of mode 2 trade in services
- Liberalisation of mode 3 trade in services
- Liberalisation of mode 4 trade in services
- Regional trade agreements
- Free trade zone / export processing zones
- Other (e.g. regulation on intellectual property, standards or competition)

Table 1 presents a summary of how the effects of trade policy are channelled through ET. In some cases, unidirectional effects have been identified, whilst in others, opposite forces may be in operation. Each of the policies are discussed further in this section and their effects described in more detail. We use the three facets of ET from section 2: within sector, between sector productivity changes and value chain engagement.

Table 1. Trade Policy and Economic Transformation

Policy	Economic transformation effects		
	Within sector	Between sectors	Value chain engagement
<b>Shallow integration (e.g. tariff liberalisation, quota removal)</b>	<b>Yes</b> (allocative efficiency, increased market size, increased competition, lower price of inputs)	<b>No</b> (increased competition) <b>Yes</b> (lower price of inputs)	<b>Yes</b> (increased backward linkages)
<b>Export promotion</b>	<b>Yes</b> (increased market size)	<b>Yes</b> (but sectors need to be identified beforehand)	<b>Yes</b> (by connecting suppliers and buyers)
<b>Trade facilitation</b>	<b>Yes</b> (trade cost reduction. Lower price of inputs, increased competition, increase market size)	<b>No</b> (increased competition) <b>Yes</b> (reduce costs of trade)	<b>Yes</b> (increased backwards and forward linkages)
<b>Liberalise trade in services in mode 2</b>	Not clear	Maybe	Not clear
<b>Liberalise trade in services in mode 3 (and investment policy)</b>	<b>Yes</b> (increased competition in services, allocative efficiency)	<b>Yes</b> (potential exports in services)	<b>Yes</b> (potential increase of domestic value added in exports)
<b>Liberalise trade in services in mode 4</b>	<b>Yes</b> (increased availability of skills)	<b>Yes</b> (new skills necessary in new exports)	<b>Yes</b> (facilitates monitoring and control)
<b>Aggressive preference seeking/Trade agreements</b>	<b>Yes</b> (increased competition, cheaper inputs, allocative efficiency, risk of trade diversion)	<b>Yes</b> (in exporting products with no comparative advantage, but risky if efficient scales are not reached)	<b>Maybe</b> (if value chain in new countries can be integrated)
<b>FTAs (import side)</b>	<b>No</b> (risk of trade diversion of inputs)	<b>No</b> (increased competition)	<b>Maybe</b> (if enough scale is reached)
<b>Free trade zones / export processing zones</b>	<b>Maybe</b> (increased productivity, but may disconnect it from the rest of the economy). It may crowd out domestic investment.	<b>Yes</b> (opportunities in new sectors)	<b>Yes</b> (forward linkages in low-value-added stages. It may need to reach large scale)
<b>IPR enforcement</b>		<b>No</b> (in the short run may harm output in certain sectors) <b>Yes</b> (in the long run creates incentives)	<b>Yes</b> (secures control and monitoring)
<b>Standards harmonisation</b>	<b>Yes</b> (reduced costs of compliance. Increase market size)	<b>Yes</b> (reduced costs of compliance)	<b>Yes</b> (facilitates monitoring and control)
<b>Competition policy</b>	<b>Yes</b> (increased competition and cheaper inputs)	<b>No</b> (increased competition) <b>Yes</b> (cheaper inputs)	<b>Yes</b> (increased backward linkages)

## SHALLOW TRADE LIBERALISATION

Shallow integration policies will affect ET through the three channels described in Table 1. First, they will increase the productivity of firms within each sector. An immediate effect of tariff reductions on firms and producers, for example, is to increase competition. Additional competition will reduce domestic prices and force incumbent producers to take action. Some firms may need to make adjustments in their production processes and make investments in order to continue being profitable. Other firms, typically the less efficient ones, may find it impossible to cope with the additional competition and will leave the market. Evidence from India (Krishna and Mitra, 1998) indicates that this effectively happened after its 1991 liberalisation programme. This implies that trade policy affects ET via its effects on firm productivity and sectoral productivity (Melitz, 2003). This process is reinforced by the economies achieved by the increase in the production scale of each firm. This implies that the high-productivity firms that manage to stay in the market become even more productive because of the increase in scale associated to the exit of the low-productivity firms.

Second, shallow integration policies will promote ET through structural change by contracting and expanding sectors. It is possible that the exit of inefficient firms may dominate and, consequently, the output and trade of the sector decrease and eventually disappear. As we mentioned, ET involves the movement of resources from inefficient to efficient sectors, implying the contraction of the first and the

expansion of the second, as Pavcnik (2002) found in Chile. This is an additional channel of operation on the ET generating *inter-sectoral* effects. As firms exit sectors where minimum efficiency levels cannot be achieved, they will release resources to be employed by other, more efficient sectors. For example, land used for pasturage may find a more efficient use in cereals production.

Third, shallow integration policies are a necessary condition for value chain participation. This type of trade policy affects integration into value chains and, consequently, into productivity. In fact, the surge of global value chains increases the cost of protection (Organisation for Economic Co-operation and Development (OECD) et al., 2014), given their cumulative effect, as intermediates are traded multiple times across borders. Trade liberalisation implies more competition for the domestic firm inputs. This implies lower prices for inputs but also the construction of links with more efficient firms abroad. Thus, part of the increase in productivity is associated to the engagement in value chains with more productive providers of inputs, suggesting that trade liberalisation may increase *backward linkages* with foreign firms.

In addition to having the effects of increasing participation in value chains, relocating resources between sectors, and increasing productivity within sectors, trade policy through tariff reduction may also help to diversify export supply. Lower tariffs and barriers can reduce the output (and exports) in certain sectors and reduce the diversification in exports. This specialisation effect leads to a decrease in output of inefficient sectors and an increase in output of efficient sectors. This would mean that, in the short run, tariff liberalisation – although promoting structural change – might generate a less diversified export structure. However, tariff liberalisation can help to diversify exports by decreasing the costs of inputs and making the exports in new products profitable. Melitz (2003) suggests that as export activities carry a fixed cost, under a protectionist regime only a limited number of firms can afford them, leading to export concentration. The removal of barriers had important diversification effects in Vietnam, Rwanda and Tanzania (International Monetary Fund (IMF), 2014).

## EXPORT PROMOTION

Exporting involves certain fixed and frequently sunk costs necessary to enter new markets (either countries or new products). Typically these include advertising activities to introduce the product to consumers. As these activities might present public good characteristics, the private provision might not be optimal. Moreover, even when their benefits can be private, firms might not be in a position to afford the costs associated with them. Therefore, public spending on export promotion – financing advertising, participation in events, etc. – can help to overcome some of these costs. These activities include the efforts made through the presence of embassies and consulates. For example, Rose (2007) finds that each additional consulate is associated with between 6 and 10% higher exports between 2002 and 2003 in large exporters. No evidence is found for small countries.

Export promotion can have important effects on within-sector productivity, particularly by expanding exports into new countries. In this way, economies of scale because of additional customers would lead to productivity gains within sectors. On the other hand, promotion of new products can increase diversification of the export supply and promote structural change. However, it is necessary to know beforehand which products might have a ‘non-revealed’ or latent comparative advantage. In addition, Dixit and Grossman (1987) suggest that export promotion may not only affect the promoted sectors. They suggest that in a context of oligopolistic markets, export promoted industries may disadvantage the non-promoted ones in their respective markets.

The effects on value chain engagement are not clear. As export promotion activities tend to be more effective for the final stages of the chain, only those firms involved in retailing and wholesaling take advantage of it. However, even in this case, it depends whether these firms are also the firms that controls and monitor the whole value chain.

## TRADE FACILITATION

Trade facilitation includes all those policies associated with the simplification of import and export procedures. These include activities and formalities related to collecting, presenting, communicating and processing information required to move goods between borders. Excessive documentation will bring additional costs associated with its preparation that might involve paying intermediaries and other agents. As well, differences in procedures between countries (even when not excessive) may generate additional costs. Therefore, customs procedures harmonisation is also part of the trade facilitation effort.

Trade facilitation can increase productivity within sectors. Trade facilitation, similarly to tariff reduction, reduces the costs of imports. In the case of imported inputs, their lower price will influence the competitiveness of the products already exported. Similarly, it will reduce the price of the competing foreign products. Therefore, it will enhance productivity within sectors in the same way as shallow integration policies described above. Trade facilitation measures in Indonesia, on the other hand, have benefited firms, particularly those that are informed about them (Tambunan, 2013). As with shallow integration, trade facilitation may reduce the export supply in some sectors (via its effects in the cost of imports), and it may increase exports in new sectors via its effects on the cost to export. This suggests that trade facilitation can also promote structural change.

In terms of integration into value chains, reduced trade costs are crucial and trade facilitation would have a strong effect. In a context of global value chains, high trade costs (or tariffs) would act like barriers impeding the movement of intermediate products within a factory. The effect of trade costs in the price of the incoming and outgoing intermediates should be kept to a minimum. Therefore, trade facilitation efforts increase the engagement in value chains by increasing backward linkages and by engaging into forward stages of the value chain by providing cheap intermediates. For example, trade facilitation measures increased the linkages of Bangladeshi farmers with international entrepreneurs in global trading of vegetables (Hasan, 2013).

## LIBERALISATION OF MODE 2 TRADE IN SERVICES

The elimination of restrictions in the consumption of services abroad can enhance productivity and help to diversify the export structure. Barriers in this type of service provision mode tend to be low. However, firms that gain access to cheaper and better-quality services abroad will have positive productivity effects. An example is the maintenance services provided abroad for vessels and aircraft. Additionally, low barriers provide a diversification opportunity in the providing country. This indicates that mode 2 services liberalisation can increase productivity within sectors via the cost reduction effects and also contribute to structural change through the promotion of exports of services. The provision of aircraft maintenance services in Ethiopia in the region is an interesting example. Elimination of restrictions on non-residents receiving certain services provided locally may boost certain services activities. These activities are not limited to standard tourism services and include specialised types of tourism such as medical. These types of services are particularly important in cross-border trade.

## LIBERALISATION OF MODE 3 TRADE IN SERVICES / FOREIGN DIRECT INVESTMENT

This type of service provision is strongly related to FDI, as providers of these services require a commercial presence in the country of consumption. Therefore, investment policies will have an important effect on both service provision and investments.

In the first place, liberalisation of trade in services in mode 3 would affect ET by increasing productivity within sectors by providing cheaper services. Particular features of trade in services in this mode are that imports of services must be produced locally and that its liberalisation enhances competition both foreign and domestic (Mattoo et al., 2006). As firms use services as inputs, enhanced competition in their provision affects productivity via cheaper and better-quality services. In fact, even if the new providers completely replace the domestic ones without increasing output, there will be positive effects, as they are likely to

bring with them better technology. Although it is unclear whether this effect will be stronger in some particular firms, a generalised boost is expected in productivity in each sector.

At the same time, liberalisation will also promote structural change by creating opportunities in other sectors. Although foreign competition in services might reduce production costs and make new products competitive in the world market, increasing export diversification, a further important effect may result from new opportunities created in the exports of these services. This means that the same foreign firms that provide services in the domestic market might also export these services. This is particularly important in tourism. A foreign firm operating a hotel provides services under mode 3 to the residents but services in mode 2 for non-residents. Therefore, liberalisation of trade in services in mode 3 can help to diversify the export structure and contribute to structural change.

Services are particularly important in value chains, as a large share of value added embodied in manufacturing exports comes from them (Lodefalk, 2014). It accounted for almost 50% of the value added exported in 2011 (Mendez-Parra, 2015). This implies that any policy that makes services more competitive would enhance value chain participation. Firms may gain productivity in the stages at which they are currently operating and/or move to others of higher value added capture. In addition, it is possible that trade in services liberalisation may lead to domestic backward linkages, as firms would develop stronger links with their domestic services providers.

Investment policies are expected to have an important effect on within-sector productivity. Investment policies that provide equal treatment to foreign and domestic investors and that do not reserve sectors to domestic investors can have important sector effects. More FDI would bring additional competition in the output and input markets. In addition, these new firms may bring better business practices that might transpire to the rest of the sector (Saggi, 2002).

FDI may unlock the potential in the exports of new sectors without the need of disengaging resources in others. However, if FDI brings factors, such as capital, it may help to expand the output in those products that use these factors more intensively. This may lead to a structural change through diversification as we explained before. For example, FDI in the production of flowers in Ethiopia has allowed expansion of their export structure without taking resources out of their traditional exported products.

Together with the rest of the policies identified, FDI might help increase participation in value chains. Moreover, as FDI may bring better business practices that can be extended to their local partners and affiliates (Javorcik and Spatareanu, 2008), it may help local firms to gain productivity in the chain and increase the value added. For example, this is frequently seen in the case of electronics or car manufacturing, where the quality requirements tend to be extended to the local suppliers, helping them to achieve productivity and competitiveness.

## LIBERALISATION OF MODE 4 SERVICES

The liberalisation of trade in services provided by the temporary movement of natural persons may have important effects on ET. It is important to make the distinction between the effects coming through mode 4 exports and the imports. Particularly when the economy lacks skilled workers, import of services under this mode may constitute the only source of qualified workers. Although temporary, the movement of natural persons can have important effects on economic transformation as the skilled workers bring innovative and high productive practices that can be transpired to the local staff.

Import of services under this mode might help to increase productivity within sectors, as firms would have access to foreign providers in activities where the local providers are insufficient. In addition, as FDI can help to unlock productive potential in some products, mode 4 provision can have a similar effect by allowing the use of foreign skilled labour. This type of service provision may be essential in securing the minimum quality of the good or service provided (i.e. a hotel using a trained chef). Therefore, liberalisation in this type of provision may be essential to generate structural change and diversify production.

On the other hand, exports of services under Mode 4 can help to diversify the overall export structure. The provision of business (accountants, lawyers, engineers, etc.), personal services (hairdressers, trainers, etc.) and entertainment services (performers, artists, etc.) constitutes an export opportunity, particularly for self-employed and freelance workers. Although some of these services may be provided under the other modes, competitiveness on the provision of services is notably enhanced when restrictions to the temporary movement of workers are minimal.

Evidence indicates (Jansen and Piermartini, 2004) that this type of provision has a positive effect on trade in goods as well as migrants by providing business connections between local and foreign suppliers and consumers. This means that liberalisation of services in this mode may affect productivity in each sector. Also, migrants may take acquired tastes to their home market and generate a new export opportunity. For example, South American exports of yerba mate to Syria and Lebanon are the result of migrants from those countries acquiring the habit of drinking mate while working in the region.

## REGIONAL TRADE AGREEMENTS AND PREFERENTIAL TRADE AGREEMENTS

The transmission channels described operate under the assumption that no distortions discriminate against trade partners. This may not be the case if regional trade agreements (RTAs) or preferences are in place. Given their nature, these can generate some additional positive and negative effects that need to be considered.

RTAs are expected to increase imports and exports from and to the partner countries. If a partner country is an efficient supplier (or it has a comparative advantage in the provision of that good or service), domestic consumers and producers alike will benefit by having access to cheaper products and inputs. This effect is known as *trade creation*. In contrast, if the partner country is an inefficient producer, no reduction in prices will occur. Imports will be diverted to inefficient suppliers or *trade diversion* will occur.<sup>2</sup> On the other hand, Chang and Winters (2002) indicate that regional agreements can exert price effects on the exports of excluded members. As intra-regional trade is exempt from tariffs, the resulting competitive pressures force excluded countries to reduce their prices in order to remain competitive.

On the export side, the situation is slightly different, as both efficient and inefficient firms will increase their exports to the domestic partner. Efficient firms are likely to do it by expanding their output without reducing supply in the domestic or in third markets.<sup>3</sup> In contrast, inefficient firms might increase exports by reducing supply, particularly in the domestic market, as it is unlikely that they were exporting to any market before the agreement.<sup>4</sup> This implies that this increase in exports is expected to happen with minimum investments that would not increase productivity.

On the other hand, the exports possible by an inefficient domestic firm would depend exclusively on the continuation of the distortion. If the partner country reduces its protection via Most Favoured Nation tariffs, or signs an agreement with a third country that has efficient firms in that sector, the low-productivity and inefficient domestic firm would find it hard to compete in the market. Therefore, this export-enhancing effect is unlikely to generate long-lasting transformation effects.

However, in the short run it could generate some export-diversification effects via the generation of rents on the exporting side. The sustainability of these effects and the transformation into a long-term transformation change depends on the achievement of minimum efficient scales and productivity levels. This is unlikely to occur if trade diversion dominates. For example, EU preferences have allowed the

<sup>2</sup> Trade diversion is claimed to be the major reason for the growth of intra-agreement trade in the case of Mercosur. Road vehicles explain half of the effect (Yeats, 1998).

<sup>3</sup> For example, the fact that Argentine wine is exported to markets with and without FTA such as Brazil and Europe indicates the Mercosur trade creation effect in this product.

<sup>4</sup> Products being exported exclusively to those markets under FTA or preferences may indicate the presence of a diversion effect.

exports of Kenyan kidney beans and flowers. Although they are almost exclusively being exported to the EU, they have helped to diversify the export structure.

In general, unilateral or generalised trade policy reform would generate more important effects. However, given the explicit reciprocity of commitments in RTAs, they tend to be easier to present to the public and to implement than unilateral liberalisation. As the free trade agreement (FTA) partner is also liberalising its trade, there is a perception of a balanced effort amongst partners. Therefore, FTAs tend to have more public support than unilateral efforts. The reciprocity in measures, from the political point of view, helps in the implementation of the necessary domestic reforms (Baccini and Urpelainen, 2014). As the FTA partner is also liberalising its trade, there is a perception of a balanced effort amongst partners. Therefore, FTAs tend to have more public support than unilateral efforts.

RTAs might help to enhance value chain participation by promoting specialisation of production between partners and more cross-border production sharing (Blyde et al., 2014). However, they would only deliver productivity gains to the chain if the specialisation results in achieving minimum efficient scales that lead the chain to integrate with others worldwide. For example, firms producing similar products in partner countries can specialise in certain stages, achieve economies of scale, and integrate into a regional value chain because of the agreement.

In the case of unilateral preferences, the effects are primarily on the export side. Preferences can help productivity via increases in the production and export scales of firms in the sectors already exporting. However, Collier and Venables (2007) argue that preferences could enhance exports and employment as long as they are consistent to the trade fragmentation given by value chains. This means that they would enhance productivity if they do not alter the implicit rate of protection along the chain. Nevertheless, although preferences apply within sectors, only the most productive firms might afford the compliance costs associated to preferences (rules of origin certification).

On the other hand, preferences granted could help to increase exports in new sectors, leading to a diversification effect and structural change. For example, EU preferences granted to African countries constitute the main explanation for the exports of certain products such as the Kenyan case described before. However, the evidence found is mixed and depends strongly on the preference margins (Persson and Wilhelmsson, 2013; Gamberoni, 2007). If diversification tends to favour sectors with no comparative advantage, there is a risk associated with the removal or reduction of the preference.

Preferences may be important in the integration into value chains, particularly with respect to the formation of forward linkages. Retailers and manufactures located in the preference-granting country may source their inputs and intermediates from countries with preferential access. This implies that preferences may be essential in this aspect. Integration of South African producers of fresh fruit into value chains led by European supermarkets are facilitated either by the preferences granted to these countries under the (Africa, Caribbean and Pacific) Preferences or currently under the Trade, Development and Cooperation Agreement.

## EXPORT PROCESSING ZONES AND SPECIAL ECONOMIC ZONES

Export processing zones (EPZs) or special economic zones (SEZs) are another tool available to promote production and trade and generate ET. They are fenced off areas with special incentives (subsidies, tax rebates, loans, subsidised services, etc.) designed to encourage the location of firms with the objective of generate agglomeration economies (by clustering related firms together) and consequently reduce production and trade costs and hence increase productivity and competitiveness.

EPZs and SEZs could crowd out domestic investment if domestic firms relocate into the zones without generating additional investment. However, evidence from China indicates that free zones increase FDI (Wang, 2013). On the other hand, Karunaratne and Abayasekara (2013) indicate that EPZs have important effects in the formation of backward and forward linkages in Sri Lanka.

The effect on ET is ambiguous. They might increase FDI and increase productivity, but they could just relocate existing investments to take advantage of the incentives provided. If this is the case, no changes in productivity within and between sectors should be expected. However, even in the case of low-value-added activities such as assembling and packaging, they could generate some transformation effects through the creation of export opportunities that contribute to the diversification of exports and the structural change (see Kingombe and te Velde, 2015).

In addition, these types of special zones may help to integrate firms into value chains. Clustering amongst related firms is behind the establishment of these forms. In fact, complete value chains could be located in a given zone with suppliers and assemblers clustering together (the approach taken by Singapore in Jurong for example). However, in order for this to be efficient, the whole chain needs to be at the frontier of productivity. This may require very high scales that might not be achievable with available resources. Moreover, it implies a movement against the specialisation force in tasks seen in value chains.

## OTHER TRADE POLICIES

The list of trade policies that might promote ET through productivity effects within sectors, through structural change and through value chain engagement is important. In addition to the policies described, the effects associated with technical standards harmonisation, for example, may increase productivity within sectors by reducing costs of compliance with multiple standards (Shepherd, 2007) and by increasing scales in processing. Its effects on value chains are also important. Harmonisation of standards facilitates the construction of stronger forward and backward linkages. It also generates important benefits in the monitoring and control of value chains by the firms that lead them. Free zones may encourage engagement in value chains, particularly in the early stages and in low-value-added stages.

## 6. CONCLUDING REMARKS

There are strong but complex links between trade and economic structure. Trade policy can be used to change export and production structures. ET requires moving resources used inefficiently into high-productivity activities. Trade policy can help to trigger or enhance such transformation processes.

Trade policies affects ET through a variety of channels. While this brief suggested a set of transmission channels between trade, trade policies and ET, further evidence is necessary to assess the empirical importance of these channels in supporting ET in various economic and policy contexts. The identification of pathways of impacts between trade and ET suggests that first and foremost that the effect of trade on economic transformation is the result of trade openness and access to cheaper and higher quality inputs, in other words through imports, as well as economies of scale.

Also, in the longer run, trade openness and the resulting increase in competition will increase the efficiency of domestic producers through the exiting of less efficient producers. Whilst securing access to other markets is also important, the effects on the domestic economy of eliminating trade protection and reducing rents could be strong with long-lasting effects. Non-protectionist trade policy can generate conditions for transformation of the economy that will create the basis for economic and social development. However, such transformation takes time and policies to support losers and enhance winners will be necessary in the short run.

There are several areas that require empirical work: (i) empirical evidence on the way in which trade affects the within and between components of productivity change and ET; (ii) building up more evidence on what drives exports of services, incl. the role of trade policy played in this; and (iii) the effects of different forms of global and regional value chains on ET.

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