

Asia Development Forum

3-5 November 2002

Seoul, Korea

by Kanokpan Lao-Araya*

Comments on Ramkishan Rajan's Paper:

Assuring Benefits for the Poor in Liberalizing Developing Economies

1. Thank you, Professor Rajan, for your efforts put into preparing this very informative paper for this seminar session on how a government of a liberalizing developing economy can assure benefits of trade to its poor citizens. I find that the content of the paper is very broad. This paper would have been an excellent read if your goal were to be getting the reader familiarized with a general overview for the effect of globalization on poverty reduction and the nexus between trade liberalization and poverty reduction in general. What I expected to find, however, is more specific, that is the answer to the question: how can a government of a liberalizing developing economy assure benefits of trade to its poor citizens.

2. "Liberalizing" economy refers to an on-going process of trade liberalization. Generally, the comparison is made between two regimes: *before* and *after* trade liberalization. The main focus therefore should be on the short-term adjustment during the transitional period of trade liberalization. There is only one sub-section of the paper discusses the adjustment programs that a government of a liberalizing developing country can adopt.

3. Note that trade liberalization is voluntary so that it implies no surprise for the government. At most, the government may underestimate the extent to which the impact of liberalization process has on the economy. Liberalization is not the same as the financial crisis case that the government has no prior knowledge of the shock.

4. Despite of the insufficient discussion on the short-run adjustment programs in the paper, the Power Point presentation provides a constructive framework for analyzing and identifying the determinants of successful adjustment programs that mitigate the short-run adverse effects of trade liberalization on the poor.

5. Figure 1 and Table 1 use a simple model of 2 factors (Labor and Capital) and 2 industries (Export and Imports) to identify the "winner" and "loser" of trade liberalization. In a short run where both factors are immobile, the losers are both workers and capitalists in the import industry. This industry was protected under the old regime (before liberalization). Before trade liberalization, tariff or non-tariff barriers kept the domestic price of the import-substitution good artificially lower than its imported counterparts.

6. It is reasonable to assume that capitalists in developing countries are not poor. Therefore, the focus of adjustment program should be targeted at the workers in the import industry. The question is: what kind of adjustment programs does the

* Economist, Development Indicators and Policy Research Division, Asian Development Bank. The views expressed herein are the views of the author and do not necessarily reflect the views or policies of the Asian Development Bank (ADB) or its Board of Directors or the governments they represent. ADB makes no representation concerning and does not guarantee the source originality, accuracy, completeness, or reliability of any statement, information, data, finding, advice, opinion, or views presented.

government need to effectively mitigate the adverse effect on these poor workers who in the new regime lost their jobs? To minimize the risk of having increased poverty incidence, section 4.2 in the paper suggested two sets of government policies to cope with this issue. First, the government's policies must be focused on continued basic training and re-tooling of individuals to adapt to the export industry. This ability to adapt to the new industry must be smooth in a dynamic environment. Second, the government must establish adequate social safety nets to protect the poor and mechanism to compensate "losers."

7. The policies regarding retraining must be coupled with improvement of labor market information and counseling. More importantly, these short-term social policies such as training program must target the right people, i.e. the poor in the sunset industries. Prior to the liberalization, the government should be well prepared in identifying prospective the poor who will be affected by the change. To minimize the adverse effect to the losing poor, the government needs to do an exercise to identify the sunrise and sunset industries. To do so, the government needs to know the industries that it will have comparative advantage over its trade partners. Once that is identified, the government must design re-training program for the workers to learn new skills needed for the sunrise industries. Of course, in the real world, it is not easy to identifying what will be sunrise industries under the new liberalized regime.

8. Comparative advantage in terms of price efficiency requires a big assumption on homogeneity of the traded good. In reality, even two units of the same product classified under the HS 9-digit code are not the same. They are not completely substitutable in some consumers' opinions. Do you think a Beer Lao is substitutable for a Budweiser? Just because Beer Lao is cheaper does not necessarily lead to a conclusion of a higher comparative advantage. Nonetheless, the governments of liberalizing economies should try to postulate on different scenarios of what will happen and prepare corresponding responsive adjustment policies.

9. To identify competitiveness, it is not easy but not impossible. There is a simple way to identify what will be the sunrise and sunset industries under the new liberalizing economy. Let's just take a look at a simple case of liberalizing trade barriers. Before liberalization, tariff rates are high. After liberalization, tariff rates are low. For simplicity, we have to assume homogeneity of products. The shopping list for this simple analysis include the following items: (1) import and export values (2) before-liberalization and after-liberalization tariff rates of each product in the detailed custom line items. This data on both import and export are normally recorded in detailed line items by the customs department. Using this data, the government can identify sunrise and sunset industries. For sunset industries: what are the import goods that were subject to high tariff rate prior to trade liberalization but are about to be imported much higher volume in the liberalization regime. For sunrise industries: what are the new exportable goods under the new regime (given that in the new regime these sun-rising industries emerge from lower tariffs on downstream industries.

10. Finally, the second set of policy that the paper suggests the government of a liberalizing economy should adopt is social safety net. Though mentioned that social safety net is important, I was disappointed that the paper and presentation did not discuss social safety net in detail. It is a relatively new terminology in the field of public finance. The term "social safety net" became increasing trendy since the Asian financial crisis. The paper did not clearly answer an important question: what is the well-designed social safety net that would mitigate the possible harmful effects on the

poor? Professor Rajan only cited Baldacci et al (2002) in section 4.2 that governments should aim to have safety nets as permanent institutions to be deployed as needed. This is a very wishful thought. But making social safety net permanent institutions, the government needs to create another specific-interest agency with earmarked revenue.

11. Social safety net refers to government expenditure programs designed to provide targeted income support and access to basic social services to the poor after events that pose major risks to these vulnerable group. The design of social safety net programs needs to take a very careful consideration. Criteria for designing social safety net programs include (i) adequate protection, (ii) efficient targeting, (iii) limited size and duration of benefits so that they avoid creating a culture of dependency among recipients, (iv) consistent with overall targets of fiscal and macroeconomic policy, and (v) transparent and accountable in both preparation and implementation stages.

12. The presentation states the reason for moving from fiscal centralization to decentralization is explained by efficiency gain. But the most decentralization literature proposed that the main benefit of decentralization is about local governments understand the needs of local people better than the central government. The danger of decentralization has been discussed widely. In practice, successful decentralization requires a well-designed mechanism that makes local governments accountable via a balanced their authorities with responsibilities.

13. The last but not least important point to be discussed is about budgetary impact of liberalization in terms of tariff reduction. The three outcomes of lower trade tax revenue that were mentioned should be (a) borrow to finance budget deficit (not "worsening of budget deficit"), (b) compensate revenue loss via tax structure and administration reform (not "raising of other taxes with consequent distortionary effects"), and (c) reductions in government expenditure. The presentation ended the discussion on "budgetary impact of liberalization in terms of tariff reductions" with the bullet point that I disagree. It said in that bullet point:

- It has been argued that the fiscal costs of deeper integration may not be worthwhile in view of the development alternatives that exist (education for girls, improvements in basic infrastructure, investments in health and nutrition)

This comes down to the point about raising other taxes to replace international trade taxes was considered by Professor Rajan as distortionary. Well, taxes distort decisions. But they are necessary for financing public provisions. As mentioned, public services such as education, basic infrastructure, public health and nutrition are important for development. Governments need revenue to finance these public provisions. Reducing trade taxes definitely reduce distortion, at least the distortion of resource allocation. Instead of producing products with low comparative advantage, resources can be devoted to producing other products with high comparative advantage. Normally, the revenue loss caused by lower trade tax revenue will be compensated by consumption taxes. As a country adopts liberalization, the government normally replaces traditional turnover taxes with the value added tax (VAT). VAT is compatible to liberalization regime as it normally uses destination principle where taxes are paid by the consumers at the end destination. In the sense, VAT is actually less distortion than turnover taxes where there generally is double taxation. Finally, point (b) should cover not only tax structural reforms but also tax administration reforms. Efficient, effective, and transparent tax administration can lead to higher revenue without having distortionary effects.

14. In summary, I think this paper is quite comprehensive on the general nexus between globalization and poverty reduction. However, it needs to further examine international experience in order to draw convincing suggestions on how a government in a liberalizing developing economy can assure benefits to the poor in short-to-medium run.