Beware of NAMA’s slippery slope to de-industrialisation

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Following the failure of the WTO to finalise modalities for agriculture and non-agriculture market access (NAMA) at the scheduled deadline of the end of April, the WTO’s Director-General Mr. Pascal Lamy warned that the price of “failure” would be high. A new deadline of the end of June has now been set, for a mini-Ministerial meeting to finalise the modalities.

I entirely agree with him the “price of the failure would be high”, but my concept of “failure” is different from that of Mr. Lamy.

The Director-General was referring to the “failure” to conclude an agreement. What concerns me is the risk of the “failure” by developing countries to fully appreciate that accepting the proposals made by developed countries on NAMA will put the majority of them on the slippery-slope road to de-industrialization.

In fact, their industrial development will be blocked, and they will be locked into production of primary commodities and simple resource-based and labour intensive products. Then the price of the failure will be extremely high for generations to come.

An agreement should not be adopted simply for the sake of having an agreement; hence a deal should not be concluded if it does not serve the objective of industrialization and development. The failure to reach a bad or damaging agreement will in fact be a success for development.

Let me elaborate. The proposals for NAMA, based on low coefficients in a non-linear tariff-reduction "Swiss formula" will tie the hands of developing countries, preventing them from having the flexibility they need in their trade and industrial policy. This is a recipe for “backwardness”, not progress. It facilitates the operations of transnational companies, not development.

Since the beginning of the Doha Round, developed countries have been pushing for liberalization in trade of manufactured goods which has three main characteristics:

* Reduction of tariff rates across the board, leading to very low and eventually to zero tariff rates.

* Reduction in tariff dispersion, leading to uniformity of tariff rates.

* Near-universal application, with the same principle and tariff reduction formula to almost all countries, with only some special treatment for LDCs for a temporary period.

Accordingly, it is proposed that the affected countries cut their tariffs, reduce their dispersion and bind at least 95 per cent of their individual tariff lines at about the same low rates.

For example, the USA originally proposed cutting the tariffs to a maximum of 8 per cent by 2010 and reducing them to zero by 2015. Certain sectors were proposed to be subject to zero tariffs immediately upon the conclusion of the Doha Round. The EU has suggested non-linear cuts in tariffs according to the Swiss formula, and a low and uniform coefficient of 10 for both developed and developing countries.

The latest coefficient numbers being floated by the developed countries are 10 for developed countries and 15 for developing countries. This is self-serving, for the developed countries (which now have relatively low industrial tariffs) would only have to reduce a little, while developing countries (which have higher tariffs) would have to undertake steep cuts.
The Swiss formula proposed by EU, and approved in Hong Kong, despite the opposition of the majority of developing countries, is: $T = \frac{(a \cdot t)}{a+t}$, and $R = \frac{t}{a+t}$, where $T$ and $t$ and $a$ are the new and initial tariff rates and constant coefficient, respectively, and $R$ is the rate of tariff reduction.

This formula has the following main characteristics. First of all, the coefficient - $a$ determines the maximum tariff rate possible under the formula. Therefore, a coefficient of 10 implies that the highest new tariff rate a country can have will be 10%, irrespective of its present tariff rate.

Secondly, the higher the initial tariff rate, the higher the rate of reduction in tariff. Thirdly, the lower the coefficient, the higher will be the rate of reduction in tariff. Fourthly, for high tariff rates the rate of reduction in tariffs is higher than when a simple linear formula is applied (in which case the same percentage reduction is applied to all tariff lines). Finally, the formula will lead to lower rates of percentage reduction than those generated by a tariff-independent linear reduction in a certain range of low tariff rates.

From the above, it can be seen that the Swiss formula fits the interests of the developed countries, while it goes against the developing countries' interests. Initial tariffs for developing countries are much higher than that of developed countries. Therefore, the former would be subject to significantly greater reduction in their tariff rates in terms of percentage as well as percentage points.

For example, if the EU proposal of a single coefficient of 10 is approved, a tariff rate of 5% for developed countries will be reduced to 3.33% (a reduction of 33 per cent or 1.67 percentage points). By contrast, a tariff rate of 60 per cent for developing countries will be reduced to 8.8 (or a deduction of 85 per cent, or 51.2 percentage points). (See SUNS #5906, November 1, 2005).

The application of the proposed Swiss formula with the coefficients proposed by developed countries will have a significant detrimental long-term effect on industrialization of developing countries, besides significant loss in government revenues. But it has no negative effects on developed countries.

Developed countries are already industrialized; they have the supply capacity to produce capital-intensive, skill-intensive and technology-intensive goods. By giving up trade barriers on imports in exchange for market access in developing countries, they do not sacrifice their long-run industrial development. Of course their upgrading of the industrial sector depends on the development of new technology. But they have firmly secured protection of their new technologies through the WTO’s TRIPS agreement.

By contrast, the use of tariffs is almost the only remaining trade policy instrument for developing countries as non-tariff barriers have been removed almost entirely, and they are effectively denied the use of subsidies geared to export performance.

Yet the industrial sector of most developing countries is, unlike that of developed countries, underdeveloped. Thus they need to apply higher tariffs to some of their industries, particularly new ones. The low and bound tariffs rates being proposed will disarm them of an important policy tool for establishing new industries and upgrading the existing ones.

Of course, by obtaining further market access in developed countries, they will improve the prospects for expanding exports for their existing efficient industries, i.e. industries in which they have static comparative advantages. But binding tariffs at low levels deprives them of the tool of expansion of supply capacity in new industries in which they may wish to develop dynamic comparative advantage.

Therefore, even when market access is provided for such potential products, the prospects for their supply expansion will be absent due to the lack of policy space. In other words, for the sake of better access to markets for their current export products, they sacrifice the ability to establish new industries or upgrade into new products.

Such a trade off will result in deepening of their static comparative advantage; while long-run industrialization and development is sacrificed even if there is an efficiency gain through reallocation of resources in the short run. The experience of successful industrializers and premature liberalization in colonies and in developing countries provide us with lessons from history.

The experience of successful early and late industrializers indicates first of all that with the exception of Hong Kong, no country has managed to industrialize without going through the infant industry protection phase, although across-the-board import substitution and prolonged protection have also led to inefficiency and failure.
Secondly, government intervention, both functional and selective, in the flow of trade and in the economy in general has played a crucial role in the process of industrialization. In all cases, including Great Britain, industrialization began on a selective basis, although to a different degree, and continued in the same manner until the industrial sector was consolidated.

Thirdly, when their industries matured, they began to liberalize selectively and gradually. Therefore, trade liberalization is beneficial after an industry reaches a certain level of maturity provided it is done gradually and selectively. In contrast, premature trade liberalization, whether during the colonial era or in more recent decades, has had disappointing results. For example, when the USA tried to liberalize pre-maturely in 1847-61, the industrial sector suffered and the country had to revert to protectionism against imports from Great Britain.

Fourthly, government intervention was not confined to trade, and the state intervened through other means, directly and indirectly, in particular to promote investment and to develop the necessary institutions and infrastructure. Industrialization was also supported by attention to and growth in agricultural production.

Fifthly, while different countries did not follow exactly the same path, all learned from the experience of others; the USA learned from Great Britain, Germany from the USA, Japan from Germany and the Republic of Korea from Japan, etc.

Sixthly, all main early industrializers tried to open the markets in other countries when their industrial sector matured. In the 19th century, free trade policy was forced on the colonies and the 5 per cent rule (according to which 5 per cent was the maximum tariff rate allowed on any import item) was imposed on semi-colonies and independent countries through "unequal" bilateral treaties and/or through force (for example, in China, after the opium war of 1839-42).

Further, the policy space of the colonies, in the 19th century, was further limited by England by outlawing high value-added manufacturing activities in the colonies and banning the export of competing items from colonies to England. Instead, production of primary products was instituted and promoted. The outcome of the imposition of pre-mature trade liberalization on the colonies was devastation and de-industrialization.

During recent decades, developing countries have been pushed through multilateral organizations and bilateral trade agreements to open their markets. In addition, tariff peaks and escalation and arbitrary anti-dumping measures have been among the means of restricting imports of high-value added products from developing countries.

The results of a study, by the author, of about 50 developing countries which have undertaken trade liberalization during the 1990s indicates that with the exception of East Asia, their trade liberalization has had three main characteristics which are common with the proposals of developed countries in NAMA negotiations: Uniformity: i.e. a tendency toward uniform of tariff rates for various industries in each country; Universality, i.e. application of the same recipe to all countries irrespective of their level of industrialization and development; and premature and rapid liberalization.

The results of this liberalization have been disappointing for most of the countries other than those in East Asia. Firstly, only in 20 countries, or 40% of the sample, have exports of manufactured goods showed high growth rates (more than 10% a year).

And of these, only in about 10 countries (mostly in East Asia) were high growth rates of exports accompanied with increasing or high growth rates of Manufacturing Value Added (MVA). MVA is the more important indicator, as it measures the net output or income accruing to the country, whereas a rise in exports could also be accompanied by a corresponding or even higher rise in imports (including of inputs that produce the exports).

In fact, in half of the sample countries de-industrialization took place over 1980-2000; the MVA/GDP ratio declined without recovering to the initial level; and in many countries industrial employment also suffered severely.

Secondly, when exports expanded, this growth was mainly in resource-based industry and some assembly operation without much upgrading, except for industries which were dynamic during the import-substitution era and were near the stage of maturity, or which continued to benefit from some sort of support from the government.
Thirdly, even though the relative incentives changed in favour of exports, the manufacturing industry suffered from low investment despite a significant increase in foreign direct investment in some cases (for example, Brazil). Investment in manufacturing suffered because the balance of risk and return turned against the manufacturing sector.

The above survey results add to the conclusion that low and uniform bound tariff rates, particularly if it tends to zero in the next round, would imply the end of industrialization of many developing countries.

What is needed is a dynamic flexible tariff structure where only average tariffs (which may be even higher than the current average rate) are bound with significant dispersion.

In developing countries, different industries require different rates of protection and different lengths of time for their development. This is because there are differences in risks and scales of production, as well as in time and experience needed for technological upgrading.

Another problem is that uniform tariff rates provide different effective rates of protection for various industries, depending on their import intensity. For given uniform rates for output and inputs, the higher the import intensity, the lower the effective rate of protection. As a result uniform rates involve biases against new industries as new industries usually have high import intensity. This explains why assembly operation does not easily lead to increases in value added.

Since the conclusion of the Uruguay Round developing countries have stepped into a slippery-slope situation. The solution is to change the road as the change of slope only postpones their slipping into the depth of backwardness. The change of the road is achieved only by the change in the philosophy behind GATT/WTO rules which is the static version of the international trade theory.

What is needed is a dynamic trade policy with dimensions of space and time which would allow:

- Rules that accommodate different levels of industrialization and development at each point in time, as a rule not as an exception;
- A change of trade policy in each country as the country develops;
- Developing countries to use export performance requirements;
- Easier transfer of technology to developing countries by changing TRIPS rules.

Most important of all, however, is that developing countries should have a clear concept of their policy on their industrial development when they conduct negotiations. There is no need to put first priority on concluding the negotiations simply to avoid blame for “failure”, if the results of the negotiations are a recipe for their countries’ de-industrialization.