Open Markets Matter: The Benefits of Trade and Investment Liberalisation

Summary

Never before have so many countries at such different levels of development been involved in so much activity aimed at progressively rolling back obstacles to freer trade and investment. Yet, paradoxically, at no time during the post-war period has the prospect of further liberalisation generated so much public anxiety, not least within those countries that built much of their prosperity on a liberal trade and investment order.

The debate over open markets has changed markedly in tone and substance. Support for liberalisation has eroded in some segments of civil society in recent years because of concerns about jobs, wages, the environment and national sovereignty. Waning support points to a deficit in communications and in policy. The communications deficit can be remedied if the proponents of open markets explain clearly what trade and investment can and cannot do and what liberalisation is and is not responsible for. But it is not sufficient to point to incontrovertible evidence that liberalisation creates wealth or to the social and economic costs of failure to adjust to changing conditions. It is also necessary to confront the worries of citizens who are adversely affected by change. The challenge for policy-makers is thus to design policies to help citizens and communities take advantage of the ongoing, unprecedented, technology-driven structural transformation of national economies, a transformation in which trade and investment play a part, but only a part.

This Policy Brief summarises a new OECD study of the benefits of open markets. The study's chief purpose is to help governments better explain the clear net benefits of keeping markets open to international trade and investment and of staying the course of market-led reforms. In doing so, it stresses that market liberalisation is not a self-contained, abstract end in itself. Rather, it is one important component of what must be a coherent set of policies aimed at achieving a durable improvement in living standards.
What are the benefits of open markets?

Trade and foreign direct investment are major engines of growth in developed and developing countries alike. Trade has consistently outperformed domestic output. The volume of world merchandise trade is 16 times greater today than it was in 1950, as compared to a six-fold increase in the volume of world production. That reflects the dismantling of import and export barriers. Outflows of foreign direct investment (FDI) have grown even faster, rising twenty-five fold during the last quarter century, from $14 billion to $350 billion a year. Trade-and investment-induced market integration has led to deeper forms of economic interdependence among nations, as a growing number of developing and former centrally-planned economies have become more closely linked to the global economy.

The case for open markets rests on solid foundations. One of these is the fact that when individuals and companies engage in specialisation and exchange, a country will exploit its comparative advantage. It will devote its natural, human, industrial and financial resources to their highest and best uses. This will provide gains to firms and consumers alike. Another is the strong preference of people the world over for more, rather than less, freedom of choice.

A more open domestic market is not a handicap; it is a source of competitive strength. Exposure to international trade is a powerful stimulus to efficiency. Efficiency, in turn, contributes to economic growth and rising incomes.

Results speak for themselves. In the last decade, countries that have been more open have achieved double the annual average growth of others. Liberalisation from the Uruguay Round alone has delivered a global tax cut estimated to be worth more than $200 billion per annum: the equivalent of adding a new Korea or Switzerland to the world economy over the next ten years. Liberalisation benefits citizens in tangible ways: in the case of Australia, for example, its recent unilateral trade liberalisation has, in effect, put A$1,000 in the hands of the average Australian family.
The rewards of openness:
Trade orientation and living standards in developing countries

Source: Greenaway et al (1989) and IMF, World Economic Outlook (selected years)
Why is foreign investment beneficial?

The case for opening markets to foreign direct investment is as compelling as it is for trade. More open economies enjoy higher rates of private investment, which is a major determinant of economic growth and job creation. FDI is actively courted by countries, not least because it generates spillovers such as improved management and better technology.

The benefits are tangible. As is true with firms that trade, firms and sectors where FDI is intense have higher average labour productivity and pay higher wages. Outward investment enables firms to remain competitive and thus supports employment at home. Investment abroad stimulates exports of machinery and other capital goods, and increases demand for intermediary products, know-how and specialised services. A study of OECD countries found that each $1.00 of outward foreign direct investment was associated with $2.00 of additional exports, and a trade surplus of $1.70. Without FDI those exports would be smaller, sustaining fewer of the more productive, better paying jobs that go with them.

Liberalisation can benefit developed and developing countries alike. As is the case for OECD countries, foreign investment brings higher wages, and is a major source of technology transfer and managerial skills in host developing countries. This contributes to rising prosperity in the developing countries concerned, as well as enhancing demand for higher value-added exports from OECD economies. In this way, developing countries are becoming major stakeholders in the trading system today, as is evidenced by estimates that close to one half of Uruguay Round welfare gains may accrue to them.

The payoff from foreign direct investment: Wages

Wages per employee of foreign affiliates in manufacturing
National firms = 100

Source: OECD (1996)
How does market openness affect employment and earnings?

Despite these gains, concerns are voiced about the impact of openness on labour markets. This is seen to stem from the fact that, since the 1970s, there has been an increasing differential between labour market outcomes – employment and earnings – of skilled and unskilled workers in OECD countries. This has led some to see competition, particularly from low wage, low-labour-standard developing countries as the fundamental cause of this situation. This study recalls that while increased imports from developing countries do place downward pressure on wages of unskilled labour relative to skilled workers, such impacts are modest. The fact is that these and other changes, such as those arising from domestic competition, labour-saving technological change, shifts in patterns of demand and movement in the business cycle, occur continuously in modern economies. Thus, the effects of trade and investment need to be kept in perspective. This is why, in the case of the United States, trade has been found to be responsible for less than 6 per cent of the drop in US manufacturing employment between 1978-90. The following factors should be borne in mind:

![Chart: OECD imports from low, middle and high-income countries, 1960-95](Source: OECD Foreign Trade database)

While imports of manufactured goods from emerging economies have grown over the past three decades, their value amounts to a mere 1.6 per cent of OECD countries’ combined output. What’s more, the fact that total trade of manufactures between OECD countries and emerging economies is broadly in balance, a situation that has changed little since the late 1960s, draws attention to the mutual benefits of this exchange.

Increased foreign direct investment and the outsourcing of production exert similarly modest effects on OECD labour markets. As with trade, FDI is still largely an intra-OECD affair. Some 85 per cent of outflows originate in, and 65 per cent of inflows are directed at, other high-wage, high value-added OECD countries. Developed economies
today derive around 70 per cent of their output and employment from the service sector. Most of these services remain non-tradable and, to the extent that there is competitive pressure associated with greater trade and investment in services, this comes, once more, predominantly from other high wage OECD countries.

More than 60 per cent of world FDI flows are directed to, and sustain employment in, services activities where OECD countries and workers are by far the most competitive suppliers. In addition, the FDI that flows outside OECD tends to go to the largest or richest markets rather than those that could be considered «low wage platforms».

While it is recognised that trade, investment and technological change have interacted in ways that depress demand for unskilled workers, liberalisation leading to competition from low wage countries has not been a major contributing factor. Fully 80 to 90 per cent of changes in wages and income distribution in OECD countries are the result of factors other than trade with developing countries. The aggregate contribution of trade to employment has to be taken into account, too. Since 1993, exports have accounted for one-third of US economic growth and one in ten civilian jobs are supported by exports of goods and services. The ratio in manufacturing is one in five. In Ireland, one in four jobs depend on exports; in Canada, it is one in three. In France close to 30 per cent of jobs depend directly or indirectly on foreign direct investment.

Despite the fact that open trade and investment produces overall gains, some citizens and communities (often-concentrated in particular sectors) experience adjustment pains and income losses as a result of liberalisation. This presents a genuine challenge to our societies. The real question is what is the appropriate response? This question is addressed below.

**What is the cost of protection?**

One approach has been – and remains – to protect industry and workers against imports by raising trade barriers. Societies typically pay a high price when they resort to protection. Protection raises the price of both imports and domestic products, and restricts consumer choice. It defers change and raises its cost, inflicts damage on exporting firms by making them less competitive and almost invariably translates into greater long-term hardship.

The cost to consumers of protection in OECD countries has been estimated to be as much as US$ 300 billion. In the United States it has been estimated that if liberalisation were stopped right now, the wages of skilled workers would decline 2 - 5 per cent and unskilled wages would remain flat. Imposing a 30 per cent tariff on developing country exports would inflict even greater damage; it would cut the wages of unskilled workers by 1 per cent and those of skilled workers by 5 per cent. Protection does not deliver what it promises. The average cost to consumers of a job protected exceeds the wages of employees whose jobs are saved. In one extreme case the consumer cost of saving a single job in one OECD country was estimated to be US$ 600 000 per annum. Even when the cost is lower, the fact remains that protection consumes resources that could more fruitfully be used to retrain or provide transitional income support to displaced workers, or to help firms develop new products or new businesses.

**How should adjustment be approached?**

The fact that resort to protection is not the answer is a vital message in its own right. But it is not the whole story. Policies are still needed to ease the plight of those in the front line of adjustment. It is just as important to stress, therefore, that there is, in fact, a better way.

Properly designed labour market and social policies that provide adequate income security while facilitating the redeployment of displaced workers into expanding firms and sectors, produce important equity and efficiency gains. The effectiveness of these policies will, of course, depend on the degree of flexibility in product and labour markets, and they cannot play this role in isolation from a range of other policies. In fact, a much broader strategy is called for, one capable of increasing
the flexibility of markets, upgrading the skills of workers and raising workforce mobility. Areas such as regulatory reform, education, training, taxation, pension reform and the portability of health benefits (where that is an issue) need to be dealt with in a comprehensive way. This will ensure that citizens and communities are able to take advantage of and adjust to the foremost challenge they face, technology-driven structural change.

In sum, a balanced mix of policies is needed to reinforce adaptive capacity in the face of all structural changes, including those stemming from trade and investment liberalisation.

Social protection policies also need to be reoriented to ensure that those who lose their jobs – including as a result of trade or investment liberalisation – are insured against excessive income loss during the period of search for a new job. There is no inevitable connection between increased openness and less social protection. In fact, increased international trade and investment is an additional reason to improve the efficiency of public systems of social protection, rather than a rationale for reducing them.

What about rules on foreign direct investment?

For the reasons discussed above, the contribution of foreign investment to economic growth and development is now widely recognised. This is certainly the case for OECD countries and increasingly so for non-member economies as well. Although reaping the full benefits of foreign investment depends on many factors, including the policy environment of host countries, foreign investment brings capital and know-how, creates higher quality jobs and increases domestic productivity. Foreign direct investment (FDI) can raise social and environmental standards when accompanied by appropriate government policies and responsible behaviour by enterprises. The stability of FDI has shown its value in recent financial crises.

Despite the benefits and importance of foreign investment, which has been growing faster than trade and is central to countries integration into the global economy, adequate multilateral investment rules are still lacking. International rules have much to contribute to the stability of the multilateral system by helping avoid distortions to production and trade and in promoting more stable investment flows, higher quality investments and a better distribution of their benefits. Adherence to rules may be especially valuable to countries whose share of international investment falls short of their needs, as well as to small and medium-sized enterprises that might otherwise hesitate to invest outside familiar territory. Rules offer transparency and predictability for investors, and a vehicle for international co-operation and dispute resolution. These benefits flow to all countries, regardless of size and regardless of whether they are capital exporting or importing countries.

OECD member countries believe in the desirability and merit of international rules for investment as a vehicle for encouraging investment flows beneficial to economic growth, sustainable development and job creation, and as a contribution to a rules-based system for managing globalisation. Further policy-oriented analysis and discussion are needed to support the development of investment rules by the international community.

What about core labour standards?

Concern over core labour standards – vital as they are – does not call into question the fundamentals of trade and investment liberalisation. Rather, it is a matter of finding the most effective way to ensure implementation of those core standards. Low standards are not generally a significant competitive factor in trade with the countries concerned and there tends to be a positive association over time between successfully sustained trade liberalisation and improvements in core labour standards. At the same time, OECD work has found that concerns expressed by certain developing countries that core standards would negatively affect their economic performance or their international position are unfounded; indeed it is possible that the observance of core standards would strengthen the long
term economic performance of all countries. Various forms of positive support to help raise core labour standards are provided through development co-operation programmes.

How to promote core labour standards

Four years of intense international discussions on labour standards-related matters have resulted in significant progress among governments on at least two key points: the identification of those labour standards that would be promoted internationally; and effective ways of carrying this out.

Which labour standards?

There is now broad consensus that this list should include four categories of «core» standards, which embody basic human rights and are «internationally recognised»:

- freedom of association and collective bargaining, i.e. the right of workers to form organisations of their own choice and to negotiate freely their working conditions with their employers
- elimination of exploitative forms of child labour, such as bonded labour and forms of child labour that put the health and safety of children at serious risk
- prohibition of forced labour, in the form of slavery and compulsory labour
- non-discrimination in employment, i.e. the right to equal respect and treatment for all workers.

What action to promote these standards?

The governments participating in the 1995 Copenhagen World Social Summit agreed to voluntarily promote adherence to the provisions of the ILO Conventions which deal with the above standards. There is indeed wide recognition that the ILO has a primary role in promoting these standards and this institution is now considering how it can enhance both its normative and implementation capacities.

A broadening consensus appears to be emerging on two important principles that should underpin discussions of how best to promote core labour standards internationally:

- these mechanisms must not put the comparative advantage of low-wage countries into question, in other words, have disguised protectionist objectives
- nor should they take the form of trade sanctions.

Do trade and investment liberalisation threaten the environment?

There are concerns that liberalisation of trade and investment may be fundamentally inimical to the environment or will lead to a «race to the bottom» in environmental standards. The fear is that developed nations will be pressured to relax, or precluded from improving, their environmental standards in the face of competitive pressure from developing countries with lower environmental standards and that firms will relocate to take advantage of lower environmental standards in developing countries. But the evidence shows that trade and investment liberalisation, by promoting a more efficient use of resources and sustaining growth, can make a vital contribution towards creating the conditions necessary for environmental improvement. There is a positive link between countries’ environmental performance and rising per capita income levels, security of property rights and administrative efficiency. That is reflected, for example, in the fact that standards for air and water quality in OECD countries are much higher than they were fifty years ago, and it is these countries that today apply the most stringent environmental regulations. Trade and investment liberalisation is, of course, only a part of the overall growth process, but it clearly plays a vital contributing part, fuelling the improvement in environmental quality that has gone with it. It has done so by promoting a more efficient allocation of resources (including environmental resources), by removing restrictions and distortions (e.g. subsidies) that are damaging to the environment, and by speeding the transfer, adoption and diffusion of environmentally friendly technologies.
The wealth creation that liberalisation contributes should also help to reduce poverty, which is often the underlying cause of environmental degradation in many developing countries. It will also provide the means to pay for the prevention or clean-up of pollution. It is no surprise, therefore, that developing countries with outward-oriented trade and investment policies achieve improved environmental standards compared to those with less open policies. Studies show that pollution intensity has grown most rapidly in those countries that remained most closed to world market forces. In turn, this lends support to the view that openness to foreign competition is more likely to raise than lower environmental standards.

Concerns are often expressed that, with liberalisation, investors will be increasingly attracted by «pollution havens». There can, of course, be exceptional cases of this kind. But they are not the rule. There is, indeed, scant evidence to support the view that high environmental standards exert strongly negative effects on competitiveness. Fears of a massive redeployment of production towards low-standard countries are greatly overstated. In fact, experience shows that openness to trade and investment generally translates into increased pressures for more stringent environmental standards. Moreover, multinational firms are adopting worldwide standards for environmental performance. It should also be borne in mind that over 60 per cent of FDI takes place in less pollution-intensive service industries and that investment in pollution-intensive industries in developing countries is lower as a share of total FDI than it was 25 years ago.

Of course, the concern that trade, investment, and economic growth should not harm the environment is real, and the need to avoid this is imperative. But it is vital to target the actual policies and situations that are the problem and to tailor the responses accordingly. Trade and investment liberalisation are not the root causes of environmental problems. Under trade agreements such as the WTO, governments retain the sovereign right to set their own environmental objectives. And they can apply any measures to enforce achievement of them within their territories – just as long as they are
not more trade restrictive than necessary and they do not apply a double standard by discriminating against the commerce of other countries. In fact, the real problems that arise can in many cases be traced to situations where the use of environmental resources is not properly priced and reflected in the prices of goods and services consumed by firms and people. What is needed here, however, is not a halt to liberalisation efforts, but sound environmental policies that are properly integrated with trade and investment policies.

While the demand for environmental quality is likely to rise as societies move up the income ladder, this is not inevitable. Neither is there any guarantee that significant improvements in environmental quality will be demanded early enough in the development path to cut the pollution intensity of production. Nor can we ignore the risk that liberalisation of trade and investment may exacerbate problems if environmental policies are poorly designed or weakly enforced. But that does not mean there is any reason to retreat from liberalisation. On the contrary, it underlines that countries need to have adequate environmental policies and infrastructure in place to address the environmental effects of economic growth generally, and that coherent and mutually supportive trade, investment and environment policies are of paramount importance. Development co-operation programmes in the environmental field are increasingly designed to help developing countries strengthen their own policies and capacities to raise standards in practice.

How does market openness affect national sovereignty?

There are concerns about the way in which market openness may affect national sovereignty. More particularly, there are concerns that increasing trade and investment flows, and multilateral rules for trade and investment, may erode the capacity of governments to exercise national “regulatory” sovereignty. That is, to decide the appropriate policies and regulatory approaches for their own country or region, on issues such as environmental protection or consumer health and safety, as well as on trade and investment matters. There is also a perception that multilateral agreements encourage or even require such regulatory standards to be reduced, eliminated or harmonised.

Trade and investment liberalisation in fact forms part of a country’s overall strategy to maintain and even strengthen its capacity to determine its own future (and thus its sovereignty), by improving its competitiveness and raising incomes, and making it less vulnerable to external shocks. Thus liberalisation and regulatory reform are undertaken by national governments (whether unilaterally or in the context of international negotiations between sovereign governments) to enhance national interests. Such decisions are made precisely in order to gain the added security, stability and enhanced prospects for national welfare, that internationally agreed rules provide. An agreement such as the WTO is essentially an exercise of national sovereignty rather than a surrender of it.

Multilateral trade and investment agreements do not regard all national regulatory measures simply as unnecessary. Nor do they require the removal of all barriers to foreign trade and investment or that all of these be lowered. Indeed, governments retain the sovereign right to set their own objectives on such matters. The rules do require countries to prepare, implement and administer national regulations that affect foreign goods, services and investment in a transparent, non-arbitrary and non-discriminatory way. But that is because governments have taken a sovereign decision to abide by such rules. And they have done so because they recognise that such principles help to promote fairness and stability in an international economy in which all countries have a stake and from which they benefit themselves. Such agreements explicitly provide that high-quality effective national regulation be permitted to work properly in a number of areas. Where the rules place limits on recourse to certain trade or investment restrictions, for environmental or other purposes, this arises from the agreement of sovereign member countries that it is in their mutual interest to have each other do so. Moreover, the WTO rules and
dispute settlement processes recognise that there can be legitimate grounds for exceptions from these rules in certain circumstances, or to achieve other policy objectives.

What the WTO rules do not require

- Do not define or seek to curtail member countries’ trade or non-trade policy objectives or prevent member countries from maintaining domestic regulatory measures necessary to achieve those objectives
- Do not require member countries to eliminate all barriers to imports of goods or services
- Do not require member countries to reduce tariffs or barriers to foreign services firms - rather, the WTO provides a multilateral forum for negotiation of reductions, and a mechanism for binding them to provide predictability and security of market access, where there is a freely arrived at agreement to do so
- Do not direct in detail national administrative/procedural systems for the use of trade measures, nor require member countries to adopt a uniform set of trade regulations
- Do not prevent member countries from providing public funds for a broad range of domestic policy and regulatory reasons
- Do not require member countries to accept each others’ product or service quality or safety standards. Rather, the WTO provides rules for national products standards, including criteria for the preparation, adoption and application by each country of measures used to fulfil its legitimate objectives. It also encourages, without mandating, regulatory co-operation aimed at the international harmonisation of standards or the development of mutual recognition agreements.

What is the role of politics and leadership?

Past experience makes it clear that liberalisation should be sustained in order to continue to improve the living standards of our citizens. More open economies typically grow faster, and the rising incomes they provide are likely, on balance, to provide greater freedom of choice, as well as greater efficiency. At the same time, proponents of market opening need to devote more time and effort to address concerns about trade and investment liberalisation. Efforts must also be made to explain that pressures on jobs and incomes or on the environment are best dealt with through targeted and co-ordinated policies addressing the problems at their root. Protectionist responses almost always make matters worse.

The liberalisation debate is a debate over ideas and it matters greatly that OECD Member governments be in a position to communicate why and how market liberalisation forms part of the answer to the concerns of citizens, rather than being their root cause. The immediacy of pains that liberalisation can generate and the more diffuse, longer-term, manner in which its benefits tend to materialise for economies as a whole, will always complicate the lives of advocates of market openness. Done properly, liberal trade and investment are, and must be seen as being, not only about greater freedom of choice but also about fairness. Fairness in ensuring that the general interest – concern for the welfare of all citizens – prevails over special interests; and in seeing to it that the dividends of liberalisation are distributed more equitably, both within and between countries. This is why the politics and exercise of leadership at the national and international level continue to matter greatly.
For further reading

- Trade Measures in Multilateral Environmental Agreements, forthcoming November 1999

- Trade and Competition Policies for Tomorrow, forthcoming November 1999
  ISBN 92-64-17129-0, US$20, pp. 73

- Post-Uruguay Round Tariff Regimes: Achievements and Outlook, forthcoming November 1999
  ISBN 92-64-17128-2, US$38, pp. 159

- Open Markets Matter: The Benefits of Trade and Investment Liberalisation (1998),

  Also available on Diskette:
  ISBN 92-64-05078-7 US$207
  Free on Internet: www.oecd.org/dstj/sti/stat-ana/stats/eas_afla.htm

- Economic Globalisation and the Environment,

- Foreign Direct Investment, Trade and Employment

- Globalisation and the Environment,

- Implementing the OECD Jobs Strategy: Lessons from Member Countries’ Experience (1997),

- Introduction to OECD Codes of Liberalisation of Capital Movements and Current Invisible Operations

- Investment Policies in Latin America and Multilateral Rules on Investment (1997),
  ISBN 92-64-15446-9, US$27, pp. 192

- Market Access After the Uruguay Round: Investment, Competition and Technology Perspectives (1996),

- OECD Recommendation on Combating Bribery in International Business Transactions
  Free on Internet: www.oecd.org/daf/nocorruption/index.htm

- The OECD Declaration and Decisions on International Investment and Multinational Enterprises
  Free on Internet: www.oecd.org/daf/cmis/codes/declarat.htm

- The OECD Guidelines for Multinational Enterprises
  Free on Internet: www.oecd.org/daf/cmis/cime/mneguide.htm

- The OECD Observer Nos. 202 and 206 and Special Issue on International Trade and Investment,

- The Performance of Foreign Affiliates in OECD Countries (1996),


- Towards Multilateral Investment Rules (1996),

- Trade, Employment and Labour Standards: A Study of Core Workers’ Rights and International Trade


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