

# Policy Brief

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## Trade, Inequality, and Morocco

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### Summary

International trade has become a pervasive feature of our lives, yet it remains controversial and resisted across the world. High and rising income inequality, which is often blamed on international trade, especially trade with China, is one reason. But the main driver of inequality is new technology, not international trade. Although trade interacts with new technology in ways that often lead to higher inequality, trade and technology also lie at the root of economic advance. So the solution is to adapt to them, not to stop them. In Morocco, improved education outcomes are very important in this regard.

This is the era of hyper-globalization and rapid growth. Consumers search on line for the best-priced merchandise from all over the world, and trade has surged from 25% to 60% of world GDP over the last 50 years<sup>2</sup>. Why, then, is trade still so controversial? The unemployment and dislocation caused by the global financial crisis provides only a part of the explanation. In the United States, the great crisis of 2008-2009 came on the heels of stagnant incomes for the vast majority of households over 30 years, a period which also saw nearly all the income gains accrue at the top of the income and wealth pyramid. Trade, especially trade with China and other low-income countries is often blamed for the very high and rising inequality. Very high inequality contributes to a number of ills, such as extremely limited opportunity for the children of poor families, poor health outcomes, crime, capture of the legislative process and of government agencies by moneyed interests, and profound political divisions that impede the formulation and execution of economic reforms<sup>3</sup>. Rising income inequality is not only an American problem, however. With few exceptions, it has been a common feature around the world, in both advanced and

developing countries, most notably in many of the largest developing countries such as China and India. A recent IMF report<sup>4</sup> found that over the last 30 years inequality has risen in every region of the world except in Latin America, which includes several countries with the world's highest inequality, surpassed only by South Africa.

There is broad agreement among economists that unskilled-labor-saving technologies, and not trade, have played the central role in increased inequality, and many believe that the ongoing ICT revolution pretty much guarantees that the trend will continue. I share these views. I believe, however, that trade, interacting with these technologies, has significantly contributed to the inequality trend in both advanced and developing countries. Since technology and trade also lie at the root of the unprecedented post-war advance in average living standards around the world, the policy response is not to try to suppress or reverse trade (or technology, for that matter), even if that were possible, but to adapt to it and to mitigate its effects on the most vulnerable.

<sup>1</sup> This Policy Brief draws on an article by the author in the November 2015 issue of *Current History*. Excellent research assistance was provided by Rim Berahab.

<sup>2</sup> World Development Indicators Database, World Bank.

<sup>3</sup> See Dadush, Dervis et al., 2013

<sup>4</sup> Globalization and Inequality, World Economic Outlook chapter 4, IMF (2007).

Dozens of trade deals are being negotiated around the world today, including giant “mega-regional” arrangements, such as the Trans Pacific Partnership (TPP) and the Transatlantic Trade and Investment Partnership (TTIP) and bilateral agreements such as the Deep and Comprehensive Trade Agreement between the EU and Morocco. These new trade deals remain necessary to sustain economic growth as previous trade deals were in the past. New trade deals may or may not lead to even more inequality, depending on the way they are configured, on other reforms that accompany them, and on specific country circumstances. This note reviews the evidence and thinking on the nexus between trade, growth and inequality. It also briefly discusses Morocco, an interesting case of a lower-middle income country which has globalized rapidly, and has achieved solid economic growth but where inequality remains high.

### An Ancient Controversy

The debate over trade is not new. Adam Smith and David Ricardo, writing around the turn of the 19<sup>th</sup> century, when Britain had affirmed its commercial preeminence and was leading the industrial revolution, conducted the first systematic analysis of the gains from trade. Their conclusions were in sharp contrast to dominant mercantilist thinking at the time, a world view which stressed the need to protect domestic industries and saw exports and trade surpluses as good and imports as bad. Smith’s analysis of the welfare-enhancing “invisible hand” of markets, his arguments in favor of exchange, of the international division of labor and of capturing economies of scale in world markets, and Ricardo’s advocacy of specialization along lines of comparative advantage lay the foundations of modern economics.

However, their profound insights made little impression in the United States at the time. The great emerging nation of the era comprehensively protected its infant manufacturing sector while relentlessly copying European technology, a policy that it pursued quite consistently throughout the 19<sup>th</sup> and well into the 20<sup>th</sup> century, and culminated in the trade-suffocating Smoot-Hawley tariff hike during the worst of the Great Depression. It was only

after World War 2 that the United States, having achieved a dominant position as the world’s leading industrial power, took up the banner of free trade. In the immediate post-war years, it was the turn of the newly-independent developing countries to become the champions of import substitution, to resist protection of intellectual property, and to adopt industrial policies designed to pick and protect their presumed winners or the politically powerful – precisely the policies that the United States had practiced during its development phase. Those policies may or may not have worked very well for the young United States – we have no way to be sure whether under free trade the United States might have emerged even faster. What we do know, however, is that import substitution did not yield the desired results in developing countries and, soon enough, a big turn towards exports and much freer imports ensued.

The big shift towards more outward-looking economic regimes was initially inspired by the extraordinary export and growth success of a small number of developing economies in Asia. The movement gained momentum in the wake of the oil crises of the 1970s – when economies had to look for ways to cover their surging oil bills. Subsequently, the Latin American debt crises of the 1980s discredited import substitution. Morocco conformed to these trends. The country suffered a major balance of payments and debt crisis in 1983 which led it to revise its policies<sup>5</sup>. Meanwhile, the belief in central planning was undermined by stagnating living standards and lagging technologies across the communist bloc. As many observers predicted at the time, the fall of the Berlin Wall which ensued heralded the mother of all trade booms, lasting through the 1990s and early 2000s. The intensification of globalization was accompanied by spectacular growth in many developing countries, led by China which surpassed the United States and Germany to become the world’s largest exporter.

During this period, many economists became convinced that, in addition to the allocative and efficiency effects stressed by Smith and Ricardo, trade brought potentially even greater benefits, especially to developing nations, by inducing backward firms and economies to learn from the

<sup>5</sup> The Kingdom of Morocco, Issues and Prospects in the Public Sector, World Bank (1992).

<sup>6</sup> Attracting “desirable” FDI: theory and evidence by Peter Enderwick in Transnational Corporations, UNCTAD 2005

technological frontier. Imports of advanced machines were shown to enhance economic growth. Development Agencies began to recognize the value of foreign direct investment (FDI) more as learning than as a finance vehicle. FDI, which grew even faster than trade, distributed the value chain of both the most advanced manufacturers and service providers in cheaper locations or closer to the largest markets, and created millions of jobs in the developing world. According to UNCTAD research<sup>6</sup> the sales of foreign subsidiaries of multinational enterprises in their host country exceed world exports by a wide margin. The techniques and methods employed by these state-of-the-art overseas factories and service centers are systematically emulated or copied by less productive local enterprises. Not surprisingly, countries compete fiercely to attract FDI.

### Unfinished Business

A contemporary panoramic shows that the advance towards an open and predictable trading system has been nothing short of remarkable, as has been the rise of living standards around the world. For example, average real per capita income in the United States has roughly trebled since 1950, and incomes in developing countries have grown much faster still. Over a billion people have been lifted out of absolute poverty in the last 15 years<sup>7</sup>. At the same time, high tariff structures have been dismantled. The average tariff in the advanced country is now around 2-3%<sup>8</sup>, and their tariffs are bound at near current levels, which means they cannot be raised without violating WTO rules. Moreover, countries must apply the Most Favored Nation (MFN) clause, meaning that all WTO members must accord WTO members – which account for 97% of world trade – at least the same tariff treatment, or treat them more favorably under certain specified circumstances. Quotas and subsidies have been outlawed, except, mainly at the insistence of advanced countries, in agriculture, which remains a heavily protected sector across the world. According to a recent WTO paper, over the last twenty years, the applied tariffs of WTO members have declined on average by 15%<sup>9</sup>, and the share of developing country exports which now enter advanced

countries duty-free has increased from 55% to 80%<sup>10</sup>. Spontaneous trade liberalization, more generous preference regimes, regional trade deals, and the lagged effects of multilateral trade rounds preceding the ill-fated Doha negotiations all played a role.

MFN tariffs in developing countries, are on average near 10%. Though these tariffs are much higher than in the advanced countries, they are about 1/3 the level they reached during the height of import substitution. However, for the most part the tariffs of developing countries are not bound in the WTO or are bound at very high levels, which means that – unless they are limited by a bilateral or regional agreement – most developing countries (China is a notable exception on account of its demanding WTO accession protocol) have plenty of room to legally raise their MFN tariffs should they decide to do so.

Morocco's experience broadly conforms to these trends. Its MFN tariffs have come down greatly and are now near the developing country average and, as in other developing countries, exhibit a high degree of variation across sectors, with some such as garments, shoes, and agriculture heavily protected, and a higher degree of protection for consumer products than for intermediate goods and raw materials<sup>11</sup> (Morocco's trade weighted average MFN tariffs for 2012 is around 9.7). However, Morocco also stands out in that it applies very low or zero tariffs on the near-totality of its imports from the European Union and the United States, which together account for nearly 60%<sup>12</sup> of its imports. While this means that Moroccan trade is now much freer than its MFN tariffs suggest, it also implies that Morocco may be purchasing products from relatively high cost producers in many instances, which it could instead be purchasing in Asia, for example. It also means that, on account of this discrimination, Morocco will struggle to develop further its trade links with Sub-Saharan Africa, a region that is of increasing strategic and economic importance.

Notwithstanding the progress over the last several decades, there is still a long way to go before we secure world free trade. By world free trade I intend zero tariffs on all goods, no quotas or subsidies, and complete

<sup>6</sup> Attracting “desirable” FDI: theory and evidence by Peter Enderwick in *Transnational Corporations*, UNCTAD 2005

<sup>7</sup> UNCTAD, *Millennium Development Goals and Beyond 2015*.

<sup>8</sup> World Development Indicators Database, World Bank.

<sup>9</sup> *Trade and Tariffs*, WTO (2014).

<sup>10</sup> Least-developed countries 'trade during the “super-cycle” and the great trade collapse: Patterns and stylized facts, Economic Research and Statistics Division, WTO (2013).

<sup>11</sup> Trade Policy Review, chapter 3: Trade policies and practices by measures, Report by the secretariat, Kingdom of Morocco, WTO (2009).

<sup>12</sup> Commerce extérieur du Maroc, Office des changes.

freedom of entry in service sectors across the world, as well as equal treatment for foreign investors and suppliers, all bound by international treaty in the WTO. In addition to this admittedly distant or even utopian vision, an enormous unfinished trade agenda lies behind the border. This is the need to address domestic regulations and practices that have the effect, sometimes intended but more often unintended, of restricting trade

The cost of complying with these regulations, together with the cost of transport, going through customs, and the costs of distribution through wholesalers and retailers, add up to “trade costs”, which, it is estimated, can easily amount to one or two times the price of the product at the factory door. Economists have identified excessive trade costs<sup>13</sup> as a much more important barrier to trade today than tariffs. Numerous ongoing bilateral and regional trade negotiations are designed to address them. The Bali Trade Facilitation agreement which still requires ratification by 2/3 of members to take effect under the WTO, deals with a relatively narrow set of these behind-the-border issues, namely customs and regulations affecting international transport and logistics, but arguably these are the issues of most immediate concern to exporters and importers alike. The World Bank’s Trade Logistics Indicator, which is based on surveys of operators, suggest that Morocco performs quite well on trade facilitation, considerably better than the average for other Lower-Middle Income countries, although its logistics performance falls well short of that of the better performing developing countries.

Developing and advanced countries have different agendas in addressing the impediments to trade, even though within each group, there exist a wide spectrum of interests which often leads to the dividing line being crossed. Many developing countries, Morocco among them, are aiming to reduce the hugely distorting tariffs, quotas, and subsidies in advanced countries that limit their agricultural exports. They are also looking to limit the relatively high tariffs that advanced countries apply in labor-intensive manufactures, such as garments and shoes. In the context of North-South regional agreements, such as the Central American Free Trade Agreement, or the EU’s Mediterranean agreements, developing countries are also those most interested in more liberal rules-of-origin, which are often so complex and restrictive that exporters prefer to pay the full duty rather than trying to document

their right to preferential treatment. For example, there is heavy underutilization of preferential treatment by Moroccan exporters to the EU on account of these difficulties<sup>14</sup>.

Advanced countries, on their part, are looking to limit tariffs in developing countries across the manufacturing sector, as well as, in many instances, improved access for their (subsidized) agricultural and processed food exports. They are also aiming at access to markets in services such as finance and insurance, and for much improved protection of intellectual property. In addition, advanced countries are typically those most concerned with behind-the-border impediments to trade such as subsidies or licenses accorded to State-Owned enterprises.

### Trade, Technology and Inequality:

The traditional view of trade is that it is triggered by differences in factor endowments, unskilled labor, skilled labor, land, capital and energy, and that it will, therefore, occur predominantly among countries with different factor endowments. In a model with two-factors, labor and capital, traditional trade theory predicts that trade will lead to reduced inequality in labor-abundant developing countries as wages there rise relative to the return to capital and to increased inequality in labor-scarce advanced countries as wages there fall relative to the return on capital. The traditional model may have been adequately descriptive of trade in past centuries, when, as in Ricardo’s famous example, England exported clothing and Portugal exported wine, capital was not mobile, and technologies changed slowly, but it fails the empirical test today. Contrary to its predictions, what we observe is that trade takes place predominantly between economies with similar endowments, namely advanced countries exporting to each other highly differentiated products in the same industry, such as cars and machine tools. Crucially, we also observe that increased trade has been associated with increased inequality not just in advanced but also in developing countries.

Prompted to explain this reality, economists have come up with a number of alternative narratives in recent years, some of which have been tested econometrically or using case studies. As already mentioned, economists now broadly agree that the most powerful underlying force driving

<sup>13</sup>Defined as those due to inappropriate regulations, inadequate transport infrastructure, inefficient customs, bribes, etc

<sup>14</sup> Hasnaoui R., 2012, “la contrainte des règles d’origine dans le cas de l’accord préférentiel conclu entre le Maroc et l’UE”, Université Mohamed V Souissi, Faculté des Sciences Juridiques Economiques et Sociales.

increased inequality is not trade by itself but skill-biased technological change, i.e. machines and methods that reduce the need for unskilled labor, and that also boost the demand for more specialized and skilled workers. Economists have shown definitively that changes in aggregate exports and imports are far too small relative to the size of the economy to account for the large shifts in industrial structure, employment, relative wages and inequality that we observe. However, even though trade on its own cannot account for the observed changes in inequality, the new stories stress that the mutually reinforcing effect of trade on skill-biased technological change can have powerful dis-equalizing effects.

Take, first, the case of advanced countries confronted with the opening up of trade with a large low-wage economy. Trade-competing firms in the advanced countries are heterogeneous – they may operate in the same industry but they produce diverse products and vary greatly in their efficiency. Trade quickly kills the least efficient firms in sectors where the low-wage economy has an advantage, namely those that produce standardized products and which are highly labor-intensive. Those firms that survive do so on the basis of three non-exclusive strategies: they automate so as to save on labor, they outsource their most labor-intensive activities to the low-wage economy, and they move upmarket into highly differentiated or technologically advanced niches. Under all these scenarios, the demand for unskilled labor declines, and the demand for skilled labor and for capital increases. The dislocation of unskilled labor that results is much larger than could be deduced from shifts in the advanced country's trade balance, since it is the mix of imports and exports that changes in the direction of making imports more intensive in unskilled-labor and exports more intensive in skilled labor. Moreover, outsourcing of unskilled-labor intensive activities results in less investment and growth of those activities over time. Finally, while it is the import-competing and export sectors that lead in automation, those techniques are likely to spread throughout the economy, reducing the demand for unskilled labor even further.

What about the effect of trade on inequality in the low-wage or developing economy? Without a doubt, as predicted by the traditional models, the demand for unskilled labor caused by opening up of trade with high-wage economies will tend to raise the wages of the unskilled.

However, there are three offsetting influences that can cause inequality to rise anyway. First, as argued by Arthur Lewis, the existence of abundant excess labor in the country side whose reservation wage is low can retard the rise in wages of unskilled workers, especially at a time when hundreds of millions of unskilled workers are joining the global economy. Second, as in the advanced economy, the opening of trade will favor the most efficient firms and those most able to adopt the higher standards demanded by world markets, and this will lead to increased demand for advanced machines. According to the International Federation of Robotics by far the world's fastest growing market for industrial robots is China, where robot installations grew at about 25% per year between 2005 and 2012<sup>1</sup>. Multinational enterprises from advanced countries invariably bring these advanced techniques with them as part of their outsourcing strategy in developing countries or as they penetrate manufacturing and service sectors such as insurance or retailing. Third, as in the advanced country, in the developing country the interaction of trade and technology also affects the income distribution by stimulating the adoption of advanced techniques throughout the economy, not only in the traded sector. The effect of these shifts is a sharp rise in the demand for skilled labor, which is relatively scarce in developing countries, as well as a rise in the demand for capital. Even though the demand for unskilled workers also rises, they remain in excess supply, and their wages rise relatively slowly, resulting in increased inequality.

The connecting thread in all these stories is that trade and more broadly international exchange prompt the spread of the most advanced technologies and encourages every firm exposed to increased competition, whether in advanced or developing countries, to become more efficient, thus raising the demand for skilled labor and capital needed to achieve that efficiency. Though these effects are most pronounced in trade between low-wage and high-wage economies, they are also visible in trade among economies of similar income. Moreover, capital, and to a lesser extent, the most highly skilled professionals, are more mobile factors than unskilled workers so that they can more easily exploit international arbitrage opportunities in factor prices. With increased trade, the push for efficiency, and the need to equip large numbers of unskilled workers, the demand for capital rises across the world.

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<sup>15</sup> China has also seen a very rapid decline in the share of labor income in GDP. See Martin Ford "The Rise of the Robots" Basic Books, 2015

The overall picture, then, is that trade and technology combine to boost efficiency and economic growth across the world, but also tend to cause inequality to increase in both advanced and developing countries. While in developing countries one can expect increased inequality to be accompanied eventually by a rise of wages of unskilled workers as they are absorbed into the urban and modern sector, the prognosis is less clear for the wages of unskilled workers in advanced countries, making the policy dilemma there sharper. However, as already mentioned, the solution is not to stop trade or technology but to find ways to facilitate the adjustment of losers from the process, by redistributing some of the gains of the winners. These measures can be directly growth-enhancing, for example by eliminating inefficient subsidies, closing distortive tax loopholes, and investing in health, education and infrastructure in disadvantaged regions or to support vulnerable groups.

### Implications

As it globalized, Morocco has seen notable advances in living standards and human development indicators, such as in health, gender and education access, which have benefited all sectors of the population. Since 2000 growth accelerated<sup>16</sup> and poverty rates declined sharply. Although the available data on income and regional inequality exhibits no clear trend over the period 1990 to 2007, Morocco continues to exhibit many of the characteristics of a highly unequal and dual economy, with vast differences in income, health and education outcomes across social groups and the cities, which host the country's prosperous elites, and the countryside<sup>17</sup>. Clearly, urban elites have benefited greatly from access to imported consumer goods, from the many investment opportunities that opened up with accelerated growth, and the most qualified professionals have found high-paying employment in the export sectors or in multinational enterprises and their related upstream activities. As in many other developing countries (and not infrequently in advanced countries), Morocco's data on income inequality, which is based on household surveys, should be viewed with caution. Obtaining accurate information from high-income house-

holds is especially challenging. Still, the latest available estimate of the Gini coefficient is 0.4<sup>18</sup>, which is high but near the average of Lower-Middle-Income countries.

When examining the trade-growth-inequality nexus in Morocco, the issue that is of greatest concern is the weakness of education outcomes across a wide spectrum of the high-school student population. This is reflected in some of the lowest standardized test scores for countries of similar income levels and lower test scores than those of many low-income countries<sup>19</sup>. Such weak outcomes undermine Morocco's international competitiveness, its capacity to openness to trade and foreign investment into learning and efficiency improvement, and are also likely to accentuate the inequality-inducing effects of trade, widening the gap between skilled and unskilled workers.

Also of concern is the high rate of unemployment among Morocco's university graduates, a feature it shares with many other countries in the Middle East and North-Africa region. In theory, as set out in the preceding, the globalization of Morocco should be leading to excess demand for these workers. However, as in the case of high-school students, the quality of education at the university level appears to be severely impaired or very uneven. In addition, the shortage of jobs for university graduates may reflect weaknesses in the country's investment climate, including rigid labor regulations and lack of confidence by private sector operators, especially of large companies most likely to employ university graduates.

As Morocco continues to pursue its technological upgrading and integration in the global economy through trade and foreign investment, there are important opportunities to fine-tune its trade regime, for example by making its tariff schedule more uniform, mitigating the trade-diverting effects of its trade agreements with the EU and the US and by insisting on more liberal rules of origin and better access for its agricultural exports. However, in its efforts to accelerate growth and mitigate the disqualifying effects of trade and technology, nothing is more important than reform of the country's ineffectual education system.

<sup>16</sup> As distinct from education outcomes measured by literacy and numeracy tests, whose results have been less encouraging

<sup>17</sup> "Poverty and Inequality in Morocco, Tunisia and Mauritania" African Development Bank 2011

<sup>18</sup> High Commission of Planning. Evolution des niveaux de vie, des inégalités et de la pauvreté au Maroc (2009).

<sup>19</sup> Les réussites et les défis du système d'éducation au Maroc, Shanta Devarajan, Banque Mondiale.

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