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Export quality and income distribution in a small dependent economy

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Abstract

This paper provides a simple general equilibrium structure to analyze the two-way causation between choice of export quality by a small open economy and domestic income distribution. The important policy conclusion of our analysis is the following: When direct quality regulations are costly to impose or may not have desirable consequences for income distribution, the target level of export quality may be met through appropriate direct and indirect income redistribution policies such as wage policies or standard trade policies. © 2001 Elsevier Science Inc. All rights reserved.

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1. Introduction

A major recent concern of policymakers of those LDCs adopting outward-oriented development strategies is the frequent poor quality of their exports. With foreign buyers becoming increasingly sensitive to this issue, poor qualities are limiting the extent to which these countries can develop export markets. This has serious implications for import-dependent domestic production and full utilization of abundant factors in the face of factor market rigidities.

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The major explanation of this low-quality phenomena that has been put forward in the literature emphasizes *informational externality*. When product quality is not directly observable, foreign buyers associate quality of any import item with its *country of origin* and are willing to pay a price equal to their *perceptions*, based on some exogenous information, about average quality of that country of origin. This results in the well-known Lemons Effect (Akerlof (1970)) whereby LDC exporters would choose suboptimal qualities. Under such circumstances, Chiang and Masson (1987) and Donnenfeld and Mayer (1987) have demonstrated that policies such as restrictions on the number of LDC producers or voluntary export restraints may improve export quality.[1]

By adopting a single factor model of production, these analyses often overlook the distributional and employment consequences of such policy prescriptions. In a general equilibrium framework with more than one factor and good, choice of export quality is sensitive to relative factor prices and hence to domestic income distribution. Moreover, if the economy produces nontradeables, the market for which must clear *domestically*, traded sectors compete with nontraded sectors for the scarce domestic factors, implying that demand for nontradeables also affects quality choice.[2]

Several issues emerge in such a context. First, any (policy-induced) change in export quality reallocates factors across different sectors and thereby affects income distribution. This particular direction of causation has so far not been properly addressed. By contrast, the existing literature stresses the link between income distribution and product quality from the demand side (e.g., Flam & Helpman, 1987).[3]

Second, the choice of best quality may not be consistent with full employment if there exist factor market rigidities. Consider, for example, the case of labour market inflexibilities prevalent in many LDCs, such as institutionally given money wage rates. If higher-quality products are relatively capital-intensive, any attempt to improve export quality through direct or indirect policy measures, such as minimum quality restrictions, may be accompanied by a fall in employment. This indicates a conflict of policy targets: a trade-off between higher export quality and greater aggregate employment. Such issues are not only important in themselves but also have in many instances influenced the choice and sequencing of the liberal trade policies.

Third, for products with observable qualities (*search goods* in the terminology of Nelson, 1974), low-quality phenomena can be explained in terms of distorted factor prices due to factor market rigidities or, as is often contended, due to trade restrictions (Desai, 1980; Lall, 1984).

In this paper, we highlight these supply side issues related to the choice of product quality for a small open economy. The important policy conclusion of our analysis is the

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[1] Bond (1984) analysed trade and gains from trade in the presence of such informational externalities.

[2] Falvey and Kierzkowski (1987) did consider two factors of production. But by assuming capital is used only in the vertically differentiated sector and that qualities differed in amounts of capital used they did not focus on this aspect. Their primary concern was to explain co-existence of intra as well as inter-industry trade.

[3] We do not deny the importance of such demand links. However, once we shift our focus to supply side links, the *two-way causation*, export quality and income distribution affecting each other, becomes evident.