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Removal of protectionism, foreign investment and welfare in a model of informal sector

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Abstract

The paper develops a three-sector general equilibrium model with two informal sectors with complete mobility of labor between these sectors and with a positive relationship between wage income and labor's efficiency to show that the results relating to foreign capital inflow and removal of protectionism may be counterintuitive to the conventional wisdom. The paper is also devoted to explain why some developing countries implement tariff reforms very slowly compared to others, even after formally choosing free trade as their development strategies, in a more general fashion than the existing *tariff-jumping theory*. © 2002 Elsevier Science B.V. All rights reserved.

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1. Introduction

Until recently, the less developed countries followed a stringent trade policy and adopted an inward-oriented strategy, making use of discriminating policies like tariffs, quotas, restricting free inflow of foreign capital and import of commodities. Only since the conclusion of the multilateral agreement and the formation of the World Trade Organization (WTO) in the Uruguay round of discussions, there have been revolutionary changes in liberalizing international trade across countries whether developed or developing. Liberalization involves both inflow of foreign capital as well as reduction of protection of domestic industries and integrating the domestic market with the world market.

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Nomenclature

a_{Li}	labor–output ratio in the *i*th sector, $i = 1, 2, 3$
a_{Ki}	capital–output ratio in the *i*th sector, $i = 1, 2, 3$
h	efficiency of the representative worker
K_j	stock of capital of type j, $j = 1, 2$
$\overline{L}$	labor endowment in physical unit (normalized to unity)
P_i	world price of the *i*th commodity, $i = 1, 2, 3$
r	return to capital of type j, $j = 1, 2$
t	ad-valorem rate of tariff on the import of commodity 3
W	wage rate (per efficiency unit) in the two informal sectors
$\overline{W}$	institutionally given wage rate (per efficiency unit) in the formal sector
$\hat{}$	proportionate change.

Greek letters

θ_{ji}	distributive share of the *j*th input in the *i*th industry
λ_{ji}	proportion of the *j*th input employed in the *i*th sector, $i = 1, 2, 3$; and $j = L, K_1, K_2$

It has been observed that some developing countries, notably the non-OECD countries, are relatively slow in carrying out tariff reforms compared to other countries, although they have opted for the policy of free trade as their development strategy and have been able to attract substantial amount of foreign direct investment (FDI) during the last decade. The explanation is provided by the *tariff-jumping theory*[1] that suggests a positive correlation between the amount of FDI in a country and the tariff rate imposed by it. There is no doubt that the major driving force behind FDI by the multinational corporations (MNCs) in the developing countries is the higher rate of return on their capital in these countries vis-à-vis the international market. Countries with protected domestic markets are likely to attract foreign investment[2], but only for the purpose of jumping the tariff walls and reaping a good harvest by serving their markets directly. On the contrary, reductions of import tariffs imply larger volumes of imports, lower rates of return to capital and smaller amounts of FDI in these countries.

While many developing countries undertake tariff reforms slowly and yearn for foreign capital, the effects of inflow of foreign capital in such economies are, in general, discouraging according to both trade and development theorists. Brecher and Alejandro (1977) have analyzed the welfare effects of foreign capital inflow in a two-commodity, two-factor full employment model and Khan (1982) has considered a mobile capital Harris–Todaro model with urban unemployment. The important result, common to both is

[1] See for example, Massimo (1992) and Noriyuki (1990) for details.

[2] Although the supply of foreign capital in an economy is positively related to the rate of return on capital in the host country the actual amount of foreign capital that is allowed to go into a developing economy in many cases is directly regulated by its government. In the process of liberalization the governments of these countries are allowing more and more foreign capital to enter into their economies. See Marjit (1994) in this context.

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