

Trade- Poverty Nexus in South Asia

Concept Note

Introduction

The relationship between trade liberalization and poverty alleviation remains a pressing issue in academic and public policy circles. While both are widely studied in isolation the link between the two is also the subject of much scholarship and policy attention. Today, the principle avenue of impact of trade on poverty reduction is thought to include an indirect two-stage relationship between trade and growth and growth and poverty reduction. In addition, a variety of direct impacts on prices, enterprises, government revenue, and vulnerability to shocks are also seen as relevant.

Background

While the topic remains high on the list of economic policy concerns, policymakers from the earliest days of modern development economics were aware of a relationship between international trade and domestic economic development and poverty reduction.

In the 1950s to 1970s the mainstream view was that liberal trade would limit the ability of developing countries to move into new higher-value-added industries, which itself was seen as a prerequisite of economic growth. Because of this so called 'infant industry argument', import-substitution policies were pursued by many developing countries including those in South Asia.

However, by the 1980's work done by Bela Belassa, Anne Krueger, and Robert Baldwin had convincingly undermined the theoretical case for infant industry protection and the experience of Latin America and Southeast Asia led most economists to view infant industry protection as a policy failure.¹ From the late 1970s through the mid 1990s trade liberalization was seen as a key driver of economic growth and was made a centerpiece of many reform packages adopted by developing countries.²

The current view over the impact of trade liberalization has tempered somewhat from the doomsday view of the first post-war decades and the overly optimistic views of the 1980s and 1990s. The emerging academic consensus is that trade liberalization by itself is a marginal plus for growth and therefore poverty reduction.³ Alan Winters and others have shown that the real potential for trade liberalization (whose static gains depend on the ability of the economy to switch resources into more efficient industries) to play a role in poverty alleviation is through the implementation of adjustment enhancing complementary policies such as labour market flexibility, human capital development, effective business friendly institutions, good governance, functioning credit markets, and infrastructure development.⁴

While the academic debate has closed in on the view that trade liberalization is in most cases of moderate benefit but under specific conditions a great benefit to growth and poverty reduction, public debate especially among the NGO community (such as Oxfam and the Make Poverty History campaign) have more often taken the view that trade liberalization is in most cases a great detriment but under specific conditions a moderate benefit to growth and poverty reduction.⁵ This throwback view of trade liberalization as a barrier to economic development can be seen to have played a significant role in the mindset of negotiators at the currently frozen Doha Development Agenda who were seen acting against their national economic interests and adopting mercantilist world views over negotiating trade 'concessions'⁶ A more nuanced understanding of the relationship between trade liberalization and poverty reduction is therefore very relevant to current policy debates.

Direct Links between Trade Liberalization and Poverty Reduction

The direct link between trade liberalization and poverty is difficult to measure, in large part because trade liberalization and poverty are themselves difficult to measure. Trade liberalization can be measured by average tariffs, tariff dispersion, or some alternative measure of applied or bound tariff rates. However, openness to trade also includes many non-tariff barriers such as quotas, customs procedures, health and safety standards, and the legal treatment of domestic and imported goods which are difficult to quantify. Standard measures such as the ratio of imports and exports to GDP may well be more accurately considered an outcome of trade liberalization rather than a measure of liberalization itself.

¹ See Baldwin (1969), Krueger (1974), Belassa (1982).

² See Dollar and Kraay (2002), Dollar and Kraay (2004), Sachs and Warner (1995), Frankel and Romer(1999).

³ A recent World Bank paper released before the Hong Kong Ministerial meeting of the Doha Development Agenda sharply reduced the estimated gains from trade liberalization both on a worldwide basis and specifically for developing countries. See Anderson, Martin, and Van der Mensbrugghe (2006).

⁴ See Winters *et al* (2004).

⁵ See Winters *et al* (2004), Oxfam (2002), Make Poverty History (2005).

⁶ This situation has lead groups such as the Institute of International Economics to call for a renewed effort to educate the public over the actual benefits of trade liberalization. See Graham (2006).

Poverty is also difficult to measure. The standard use of a poverty line tells us nothing about the extent or depth of poverty of those below the line and only about the number of individuals or households crossing it. Poverty lines will also vary across countries or even regions within a country due to norms of 'acceptable' levels of consumption and varying contents of the consumption bundle used in the analysis. The use of a single measure of poverty in cross-country analysis is therefore problematic.

However, three principle avenues of direct impact between trade liberalization and poverty reduction can be identified.

Price Effects

Trade liberalization changes the prices of goods and services which are both produced and consumed by the individual or household. Wider consumer choice and cheaper prices resulting from trade liberalization are seen to have a relatively strong impact on the utility of the poor in the importing economy. The impact of poverty therefore depends on whether the poor household is a net producer or consumer of the liberalized good or service. Because of this, an incidence of trade liberalization is likely to have varying impacts across the demographic group labeled as 'the poor'. For example, the poverty impact of a liberalization in the agricultural sector will vary between net food importing and net food exporting countries as well as between urban (non-food producing) and rural (food producing) poor within developing countries.

Ultimately the impact on the poor will depend on their ability of the poor household to adjust to the price shock by buying a cheaper alternative or switching to a more profitable industry. Adjustment requires physical assets, natural assets, access to credit, human capital, as well as facilitating institutions. Because of these varied factors, adjustment or responsiveness to price changes might be different in the short and long-term.⁷ Additionally, the price impacts of a liberalized good may be significantly different than the more likely simultaneous liberalization of a number of goods and services.

Profits, Wages, Employment Effects

The traditional Heckscher-Ohlin theory posits that trade liberalization will cause economies to specialize in the production of the goods or services whose production is relatively intensive in the economy's abundant factor. In the case of many developing countries which are thought to have relatively abundant supplies of unskilled labour, this will cause production to focus on goods requiring relatively large amounts of unskilled labour. The Stolper-Samuelson theorem adds that wages will accrue towards the relatively intensive factor. In this case the prediction would be that under more open trade, developing countries would focus on the production of goods and services intensive in the use of unskilled labour and that the wages of unskilled labour would increase, therefore reducing poverty. However, this approach is probably too simple to explain real world outcomes. Additionally, this model also assumes that workers (and other factors of production) can move easily from one contracting importing-competing industries to expanding export industries.

Wages will also increase if trade liberalization leads to productivity improvements. These improvements are likely to occur due to increased competition which forces innovation and technological adoption by previously sheltered domestic firms, as well as by allowing for the import of foreign made technology inputs.

Government Spending Effects

Another potential direct impact between trade liberalization and poverty reduction is the impact of liberalization on government spending. There is a concern that a reduction in tariffs will reduce government revenue and therefore spending on social expenditure, anti-poverty programs, as well as investment in other areas which promote growth and subsequently poverty alleviation. However, this need not be the case. First, if the liberalization involves moving from quantitative restrictions to tariffs, revenue may increase. Also, a move to a low uniform tax rate may improve collection and compliance and higher revenues. An indirect impact of trade liberalization may be to restrict arbitrary and highly variable policymaking which is a deterrent to investment. If the policy arena is more predictable growth enhancing investment may increase, therefore increasing the economy's taxable output. Finally, World Bank and International Monetary Fund guidelines emphasize the need to maintain social spending through reform, and historical case studies indicate that countries tend to maintain anti-poverty programs even in the face of reduced government revenue.⁸

Shocks, risks, and vulnerability

Economic shocks can be positive in nature (increase in the price of an export good, access to new cost saving technology, a good harvest) or negative (loss of a job, price increase of a consumption good, drought or flooding.) Due to their lack of surplus assets and income, poor households may find it difficult to maintain consumption

⁷ See Winters (2003).

⁸ See Winters *et al* (2004).

patterns in the face of negative economic shocks. In general, trade liberalization makes the domestic economy more susceptible to foreign shocks but mitigates the impact of domestic shocks. For example, a country that relies solely on domestically produced food will be highly impacted by local weather conditions, however, if liberalized the impact of a surprisingly good or bad domestic harvest will be mitigated by the world price of food. On the other hand, liberalization may lead to increased returns to riskier activities. This may not benefit the poor if they prefer less risky activities or there are information market failures regarding the nature of the new activities. The impact of trade liberalization on these shocks therefore has strong implications for its impact on poverty.

Links between Trade Liberalization and Growth

The link between trade liberalization and growth, while not empirically 'proven' is well established in economic theory. However, whether the gains are merely static (a one-off permanent improvement in output due the more efficient allocation of resources) or a long-run increase in growth rate are less clear. Trade liberalization is also thought to have a role in promoting macroeconomic stability, competition, access to technology through direct imports and trading partners' R&D expenditure embodied in their exports, reduced scope for corruption, freeing of administrative resources, and more stable rule making. These all have a positive impact on economic growth.⁹

Links between Growth and Poverty Reduction

Economic growth will have a positive impact on poverty unless inequality in the economy is very high.¹⁰ While growth may cause an increase in income inequality, the pro-poor effects of growth tend to dominate.¹¹ In a much celebrated paper, Dollar and Kraay (2002) found that "the incomes of the poorest fifth of the population grew one-for-one with GDP per head in a sample of eighty countries over four decades." An important indirect impact of growth of poverty reduction is that income growth in any segment of the society increases the potential resources available domestically to pursue poverty alleviation policies.

Adjustment Costs

Throughout the entire discussion of the impact of trade liberalization is the question of economic adjustment. Can workers easily move into expanding industries? What are the factors and policies which inhibit or promote such adjustment? Will new industries quickly emerge to replace the ones contracting under import competition? Do the poor have the knowledge and resources necessary to adjust to changes in profits, wages, and risk? As Winters *et al* (2001) states, much of the debate over trade liberalization (and the use of the market in development in general) departs on the depth and extent of adjustment costs. While most economists take a quantitative focus on aggregate change in the medium term once adjustment has happened, non-economists tend to take a more qualitative approach focusing on short term impacts and relying more on personal experience. Empirical work on the actual adjustment experience of economies undergoing trade liberalization is therefore necessary to shed light on the debate.

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⁹ See Winters (2003).

¹⁰ See Winters (2003).

¹¹ See Demery, L. and L. Squire (1996).