TRADE LIBERALIZATION AND POVERTY: REVISITING THE AGE-OLD DEBATE

by

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This paper is an abbreviated version of Rajan (2002).

1. Introduction

Among the most important concerns as an economy liberalizes and integrates with the world economy is the need to protect the most vulnerable in society and ensure that their well-being improves over time. What is the link between economic globalization and poverty? The issue is far from straightforward. As a first step to answering the question, it is important to keep in mind that economic globalization involves at least three separate but not necessarily mutually exclusive trends: *globalization of production and trade*, *globalization of finance and capital flows* and *globalization of labour*.

At the risk of generalizing, there is limited evidence to suggest that globalization of finance and capital flows (other than foreign direct investment) has had a discernible positive impact of growth, let alone poverty reduction (Cobham, 2001). Indeed, all that can be said with certainty is that if international financial liberalization does not take place in a well-sequenced and timed manner it could lead to episodes of severe financial instability and distress.

One aspect of globalization that would undoubtedly reduce poverty worldwide would be to allow greater mobility across national borders of unskilled labour. However, social and political compulsions and biases prevent many industrial countries from taking a more *laissez faire* attitude towards such cross-border flows. Consequently, the global market for unskilled labour remains extremely fragmented.

This said, there is an intense competition between countries for skilled personnel (“global talent”). The economic implications of this “brain drain” (defined loosely as the out-migration of human capital from developing to developed countries) for developing countries is not altogether apparent. On the one hand, the developing countries from which the emigrants originate stand to gain through (a) remittances (which in turn adds to the country's Gross National Product); (b) the establishment of diasporic business and trade networks; and (c) other externalities from return migrants (something that East Asia including China appears to have benefited from). On the other hand, the emigration of skilled workers denies poor source countries the opportunity to recoup the costs of subsidizing higher education (particularly relevant for countries like India), as well as prevents them from attracting more knowledge-intensive industries and building high quality public institutions (Desai, et al., 2001). A recent report by the International Labour Organization (ILO) suggests that, on a net basis, the losses to developing countries from the brain drain can be substantial (Lowell and Findlay, 2001). -- It is in this context that many have suggested the imposition of a "brain drain tax".

This leaves the third aspect of globalization, viz. trade and production. Watkins (2002) makes the following pertinent observation:

> Openness - along with associated free market reforms - holds the key to making globalization work for the poor…International trade has the potential to act as a powerful catalyst for poverty reduction, as the experience of East Asia demonstrates. It can provide poor countries and people with access to the markets, technologies, and ideas needed to sustain higher and more equitable patterns of growth … But if globaphobia is unjustified, so too is "globaphilia" - an affliction, widespread on Nineteenth Street in Washington, that holds that increased integration through trade and openness is an almost automatic passport to more rapid growth and poverty reduction (p.1).

What is the nexus between trade liberalization and poverty? This question can be sub-divided into two parts. One, recognizing that growth is a *necessary* condition for a sustained reduction in poverty, what is the link between trade and growth. Two, since growth is by no means a *sufficient* condition for poverty reduction, what is the nexus between trade and income distribution?

2. Trade and Growth

There are a number of trade and growth models that suggest that trade may be either growth stimulating or growth-stunting. The outcome depends on whether the forces of dynamic comparative advantage push an economy towards or away from the direction of activities that stimulate long-run growth (Srinivasan, 2001). Thus, as Rodrik and Rodriguez (2000) note, "there should be no theoretical presumption in favor of finding [an] unambiguous negative relationship between trade barriers and growth rates in the types of cross-national data typically analyzed". Accordingly, as with most things, the nexus between trade and growth can only be settled empirically.

It is fair to say that the bulk of the empirical literature using cross-country data has found international trade in goods to be growth inducing[1]. There are, however, two important problems with most existing studies.

First, while the studies may have unearthed a positive association between trade and growth, most are unable to conclude anything about causality per se. Does openness lead to growth; does growth lead to openness (for instance, the richer country gets the more likely it is to dismantle trade barriers); or are both caused by a third factor (i.e. are trade and income both endogenous)?

In an important study, Frankel and Romer (1999) attempt to decipher the causation between trade and growth. The authors undertake a cross-sectional study involving 100 countries during the period since 1960. They deal with the potential endogeneity problem of the trade variable by instrumenting it with a set of variables usually used in the estimation of the gravity model for trade flows. While results vary on the basis of the specific data set and equations used, the general conclusion is that openness in general does have a statistically and economically significant effect on growth.

[1] Detailed references are available in Rajan (2002) and Rodriguez and Rodrik (2002).

Second, even if the causality from trade to growth is accepted, the Frankel-Rose study, like all others, is subject to an important criticism in that they link growth with trade *outcome* measures (export, imports) rather than trade *policy* measures (like tariffs and nontariff barriers). This point was first clearly made by Moon (1997) but more recently and forcefully by Dani Rodrik (for instance, see Rodrik and Rodriguez, 2000 and Rodrik, 2000b). As Rodrik (2000b) notes:

> Saying that participation in world trade is good for a country is as meaningful as saying that upgrading technological capabilities is good for growth…The tools at the disposal of governments are tariff and non-tariff barriers, not imports or exports … (T)ariff measures are a reasonable proxy for trade restrictions … (T)he relevant question for policy makers is not whether trade per se is good or bad … but what the correct sequencing of policies is and how much priority deep trade liberalization should receive early in the reform process..(pp.1 - 3).

In other words, while there does exist a link between *de facto* trade openness and growth, one cannot say for sure that there is a nexus between trade liberalization and growth as a host of factors such as macroeconomic environment, external environment and such have not been properly controlled for. It is extremely difficult to sort out the effects of trade liberalization from other domestic policy options particularly as countries that undergo trade reforms do so as part of an overall growth-enhancing policy package. Increased openness may be the result of trade liberalization per se or because of other nontrade policy actions or some combination of the two. Indeed, the recent World Bank (2002) report entitled <u>Globalization, Growth and Poverty</u>, which attempts to offer evidence of the benefits of being a "globalizer" implicitly, recognizes that there may *not* be a direct link between trade policy measures and outcomes. As the report states:

> We label the top third "more globalized"..(countries) .. without any sense implying that they adopted pro-trade policies. The rise in trade may have been due to other policies or even to pure chance … (In fact) … (w)hether there is a casual connection from opening up trade to faster growth is not the issue (pp.34 and 36).

What does all of this imply for policy? The link between growth and *trade openness* per se as opposed to growth and *trade liberalization* suggests (a) that governments should certainly aim to enhance their effective degree of trade integration with the rest of the world and (b) trade liberalization per se may not be sufficient to achieve this. “Opening doors” and “getting the prices right” are clearly necessary but insufficient to ensure an outward oriented policy is successful in terms of promoting export-led growth. At the least, for trade liberalization to translate into *de facto* openness and growth, it is imperative that appropriate macroeconomic and exchange rate policies also be in place. In other words, to be successful, trade reforms must be part of a logically consistent package of sound macroeconomic policies and structural reforms.

3. Trade Liberalization and Income Distribution

3.1 Functional Distribution

Even if trade liberalization is linked to more rapid growth, this does not necessarily imply that it is an effective instrument for reducing poverty. For instance, if a growth strategy based on trade openness leads to a significant worsening of income inequality of households at the bottom of the income strata, it may not make any discernible in-roads in alleviating poverty. In such circumstances it would be necessary for outward orientation to promote growth at a “sufficiently rapid” pace for the poor to have any chance of benefiting via “trickle down” effects. However, the political sustainability of such inequitable growth is doubtful; the distributional character of economic growth matters as much as the rate of growth. But does outward orientation lead to “equitable” growth?

What does theory tell us about the functional distribution of outward-oriented growth? Starting with the workhouse 2x2x2 (two-factor, two-goods and two-countries)

Stolper-Samuelson model, theory suggests that international trade will lead to a rise is the relative returns of the abundant factor; unskilled labour in the case of developing countries. Thus, according to theory, the poor (unskilled labour) will be the largest beneficiaries of trade liberalization, i.e. openness in developing countries ought to be "pro-poor" in addition to being "pro-growth". However, even the simple Stolper-Samuelson model does not offer definitive conclusions if one or more assumptions are relaxed (Winters, 2001). If one recognizes the possibility of different degrees of mobility of some or all factors over time, the income distribution consequences of trade liberalization is further complicated (Rajan, 2002).

In short, theory does not offer categorical insights with regard to the functional distribution of income; the impact on trade liberalization on income distribution is, among other things, time-dependent.

What do the data tell us? Empirical studies have by and large found that growth has *not* given rise to more unequal income distribution[2]. Thus, as Dollar and Kraay (2002) note, "(t)he combination of increases in growth and little systematic change in inequality in the globalizers has considerably boosted efforts to reduce poverty". In other words, the Kuznets Curve hypothesis (which purports the existence of a U-shaped nexus between income and inequality) does not appear to be empirically valid. Measures of income distribution have generally been stable over time within countries; there appears to be as much tendency for income inequality to worsen slightly as there is for it to improve[3]. This said, the evidence is far from unequivocal, especially once country-specific circumstances are considered.

[2] See Rajan (2002) for detailed references.

[3] It is, of course, plausible that poverty may worsen even if some measures of income inequality do not change -- e.g. lower and upper middle income households improve significantly while the poorest households see a worsening of income.

Table 1 offers an indication of patterns of income inequality changes in 73 countries between the 1960s and 1990s based on the World Income Inequality Database (Cornia and Court, 2001)[4]. While outward oriented growth in a number of countries in Asia such as Malaysia and the Philippines appear to have been matched by decreasing inequality (though both remain relatively inequitable societies), others like China, Korea and Thailand have experienced a worsening of inequities.

While Table 1 suggests that inequality in India has remained unchanged between 1960s and 1990s, more recent evidence indicates that inequalities in the country have been rising since the initiation of the economic liberalization since mid 1991[5]. While liberalization has been important in promoting mid-skill level software exports, the reforms in India do not appear to have generated significant employment in the export-oriented, labour intensive manufacturing industries. This compares unfavorably to the experiences of the East Asian economies in the 1980s and 1990s which have emerged as important global players in labour-intensive manufacturing (Rajan and Sen, 2001). Apparently they have not been able to "pull up" the poor from poverty (Jha, 2002).

However, contrary to a number of other critics, the reforms in India per se are not *ex-ante* biased towards the capital and skill-intensive sectors and thus "anti-poor". Rather, they have become so *ex-post* mainly because of draconian labour laws and resulting labour market distortions and rigidities. From a policy angle, it is imperative that distortions that bias domestic relative factor prices against unskilled and semi-skilled labour inputs are eliminated. More flexible functioning of the labour market and greater emphasis on cordial tripartite relations between labour-management-government are needed if a country is to be competitive as a location for labour-intensive investments

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[4] The World Income Inequality Database (WIID) may be accessed from the UNU-WIDER website: http://www.wider.unu.edu/wiid/wiid.htm

and the reforms are to be unskilled labour friendly and thus "pro-poor". Given the acute difficulties that governments often face in curbing labour union "militancy" and labour market distortions at a national level, institutional innovations such as export platforms which are generally free from such competitiveness-hindering constraints and high tariffs, gain greater relevance (Radelet, 1999).

3.2 Geographical Distribution

a) Agglomeration

While the simple SS model (with incomplete specialization) is intuitively appealing, it is unable to capture an important dynamic of the global economy, viz. the tendency for agglomeration or the geographical concentration of industries in particular countries and particular regions within a country - "cores" (Anderson, 2002). This phenomenon of "firm-congestion" or bunching together spatially helps explain why regions with similar underlying characteristics sometimes turn out to be very different, i.e. "history matters for economic geography". The new economic geographers and old school development economists have stressed the existence of scale economies (or market size effects and linkages), thick labour markets and pure external economies as reasons for this cumulative causation and specific spatial configurations of production (Hanson, 2000 offers a recent literature review) - so-called "centripetal forces".

The foregoing literature has largely been silent on the specifics of dispersion of economic activity. If anything, the dynamics described previously - whereby there will come a time when the centrifugal forces offset centripetal forces - suggests that the longer-run shift of production from the core to the peripheries will be a zero-sum game, with the latter gaining at the expense of the former (Hanson, 2000). Given this

[5] For instance, see Ahluwalia (2000), Deaton and Dreze (2002) and Jha (2002).

perception, in the face of possible “hollowing out” or de-industrialization due to escalating costs and concomitant diminishing attractiveness, might there not be a plausible case for the erection/escalation tariffs and other trade barriers so as to decelerate the “centrifugal” forces (i.e. forces causing dispersion from the core)[6]. However, this policy conclusion runs counter to conventional wisdom regarding the benefits of free trade and the general presumption that factor intensities of goods and factor endowments of countries play a significant role in international trade.

b) Fragmentation

The implicit assumption in the agglomeration literature is the inability to unbundle products into its parts, components and accessories (PCAs). With major improvements in transportation, coordination and communication technologies, globalization provides vastly increased opportunities for the fragmentation of previously integrated goods and activities into their constituent PCAs. This in turn may be dispersed across countries on the basis of comparative advantage. International trade is in fact increasingly characterized by “intra-product specialization” or “international product fragmentation”. The importance of this sort of trade dynamic is the fact that globalization, by expanding opportunities for international specialization and trade, will be beneficial to all parties involved (i.e. the “cores” as well as the “peripheries”). Thus, in the longer-term, economic globalization and free trade will be an unambiguously positive-sum game[7]. The spread of industry to peripheries need not lead to deindustralization of the cores.

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[6] The aim here would be to diminish the feasibility of moving to the outlying regions and servicing the core through trade.

[7] Needless to say that this statement presupposes that the necessary institutional structures are in place to allow for a country to exploit the opportunities that are available in the global market place.

This agglomeration-cum-fragmentation literature does, however, reveal that a country in the “early” stages of integrating with the world could experience a worsening of inequalities. For instance, in the case of China, coastal provinces have attracted the bulk of FDI inflows (Broadman and Sun, 1997 and Tseng and Zebregs, 2002). A broadly similar pattern is discernible in India (see references in footnote 8). While the existence of agglomeration effects can be expected to exacerbate regional disparities, as the literature further suggests, there ought to be a dispersal of various PCAs of the product across various regions over time. -- This said, as with the case of growth, it would be a mistake to attribute all or even most of the increase in inequities to openness to trade.

What does all this imply for policy? Given the dangers of growing inter-regional inequities (particularly if these inequities between regions coincide with differences in ethnic groups as in India), it has sometimes been suggested that there should be greater centralization of investment policies and/or direct targeting of federal transfers to the “backward” regions so as to facilitate balanced regional growth.

While there may be merit in such a policy recommendation, its potential benefits must be weighed against (a) the contemporary political realities which are moving in the direction of greater autonomy to individual states and providing “greater voice” to local communities; (b) “x-efficiency” gains by way of competition between states for resources; and (c) the demonstration effects of policies pursued in other jurisdictions that create greater demands and pressures by citizens for comparable levels of service. Arguably, a more sustainable way to attain some degree of balanced regional growth would be for the central government to facilitate the development of infrastructure along with other policies to encourage inflows of manufacturing industries into underdeveloped regions. This appears to be the direction the Chinese authorities have been moving in

(Broadman and Sun, 1997), and is a policy that has been forcefully advocated for India (Ahluwalia, 2000).

4. Rural and Agricultural Sector

The discussion of agglomeration-cum-fragmentation is admittedly more relevant to trade in manufactures (and services) than to agricultural goods and other primary commodities. While many developing countries, including relatively poor ones in Southern Africa have seen a significant increase in the share of manufactures in their exports (Martin, 2001), a large proportion of the populace in developing countries is still closely tied to the rural sector and in agriculture. This sector is where the bulk of the poverty is concentrated and can therefore not be ignored if significant inroads are to be made in reducing poverty and raising living standards in developing countries.

There is a complex nexus between illiteracy, openness and agriculture. Specifically, while the simple two factor SS model non-agricultural commodities may well benefit low skill urban labour, it may do little to benefit the "completely" unskilled labour and thus the most poor in society in the rural areas. While this further suggests the need to improve basic literacy rates in the rural areas and to facilitate the extent of inter-regional labour mobility[8], the importance of working towards liberalizing trade in agriculture is critical.

In relation to this, industrial country protectionism and market access impediments in the agriculture sector are extremely harmful to developing countries. The World Bank President James Wolfensohn (2000) is exactly correct when he notes the following of industrial countries and leaders:

[8] Steps to improve rural infrastructure and productivity of rural workers benefits not just agriculture production but could also make the rural areas more appealing for low-skill intensive manufacturing and related services.

> If we care about the poorest developing countries, a special focus is needed on agricultural trade liberalization. They depend far more heavily than the better-off developing countries on agriculture for their GDP and exports….It makes no sense to exhort poor countries to compete and pay their way in the world while we simultaneously deny them the means to do so, by restricting their market access in areas such as agriculture where they have a comparative advantage..We must work flexibly and creatively towards a world trading system that really makes a difference for developing countries..In order to have a balanced and inclusive world trade system, we need to pay special attention to developing countries' current problems with the design and implementation of the rules of the game in international trade.

5. Concluding Remarks

Trade and openness remain engines of growth and important instruments of development. Inward looking, statist development strategies are *not* a sensible policy options. It is a fact that countries that have experienced rapid growth and have managed to make significant inroads into alleviating poverty have been those that have integrated with the global economy in a market-consistent manner. However, the weight of evidence suggests that it would be simple-minded to think that trade liberalization per se is able to generate trade and income growth on a sustained basis, let alone alleviate poverty. Trade liberalization must be accompanied by a milieu of other policies to ensure that a country is successful in integrating more intensively with the world in a manner that is favorable to growth and poverty reduction. These include - but by no means are limited to - sound macroeconomic policies, strong institutions, and a favorable investment climate including removing regulations that restrict the degree of flexibility of domestic labour market operation (which in turn may prevents the realization of gains from comparative advantage), and such.

More open economies are invariably more susceptible to external shocks and disturbances. Thus, while openness and complementary policies could reduce absolute poverty, they may increase the probability of a household falling into poverty in the event of a sharp adverse shock. In order to counter this possibility, at least two sets of government policies need to be in place.

First, in a dynamic environment, policies must be focused on continued basic re-training and re-tooling of individuals so that they are be able to adapt to shifting comparative advantage.

Second, there is a need to establish adequate social safety nets to protect the least well off and mechanisms to compensate “losers”.

Needless to say, while the need for well-designed social safety nets to mitigate the possible harmful effects - at least in the “short-term” - on the poor is particularly relevant, it is important to ensure that these social policies do not hinder or delay the process of reforms. They are meant to supplement and not supplant growth-oriented structural reforms. It is also important that the budgetary costs of these programs be quantified and well targeted (as there is always the danger that these programs are captured by vested interests).

The issue of budgetary costs and need for prioritization of policies is not only relevant to social programs. For instance, Finger and Schuler (2001) recognize that trade liberalization is no longer just an issue of reducing trade barriers. The comprehensiveness of the WTO regime requires significant strengthening of institutional and administrative capacities in developing countries and can be extremely costly to implement. The authors estimate that it costs a typical developing country US$ 150 million to enforce behind the border requirements like customs valuation, sanitary and photosanitary measures (SPS) and intellectual property rights (TRIPS). This amount exceeds the typical budgets of most many poor countries.

The budgetary impact of trade liberalization in terms of tariff reductions must also be kept in mind. Lower trade tax revenue could lead to one of three outcomes: (a) worsening of the budget deficit (with consequent macroeconomic consequences); (b) raising of other taxes with consequent distortionary effects; or (c) reductions in government expenditures which tend often to impinge heavily on the poor. Rodrik (2000a) goes so far as to suggest that these fiscal costs of deeper integration may not be worthwhile in view of the development alternatives that exist (such as improved education for girls, improvements in basic infrastructure, overcoming other institutional deficiencies and investments in health and nutrition).

To conclude, Winters (2001) offers a useful checklist to help policy makers appraise the impact of trade reforms on poverty.

- Will the effects of changed border prices be passed through to the rest of the economy?
- Is reform likely to destroy effective markets or create them and allow poor consumers to obtain new goods?
- Is it likely to affect different household members differently?
- Will its spillovers be concentrated on areas/activities of relevance to the poor?
- What factors are used intensively in the most affected sectors? What will be the mix of wage and employment effects? Will wages exceed poverty levels?
- Will the reform actually affect government revenue strongly?
- Will it lead to discontinuous switches in activities? If so, will the new activities be riskier than the old ones? growth it stimulates be particularly un-equalizing?
- Will the reform imply major shocks for particular localities?
- Will transitional unemployment be concentrated on the poor?

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Table 1
Income Inequality Changes in 73 Countries from 1960s to 1990s

Inequality	**Developed countries**	**Developing countries**	**Transitional Countries**	**Total**
Rising	12: Australia, Canada, Denmark, Finland, Italy, Japan, Netherlands, New Zealand, Spain, Sweden, UK, USA	15: Argentina, Chile, China, Columbia, Costa Rica, Guatemala, Hong Kong, Mexico, Pakistan, Panama, South Africa, Sri Lanka, Taiwan, Thailand, Venezuela	21: Armenia, Azerbaijan, Bulgaria, Croatia, Czech Rep. Estonia, Georgia Hungary, Kazakhstan, Kyrgyztan, Latvia, Lithuania, Macedonia, Moldova, Poland, Romania, Russia, Slovakia, Slovenia, Ukraine, Yugoslavia	48
Constant	3: Austria, Belgium, Germany	12:Bangladesh Brazil, Cote d'Ivoire Dominican Rep, El Salvador, India, Indonesia, Puerto Rico, Senegal Singapore, Tanzania, Turkey	1. Belarus	16
Declining	2. France, Norway	7: Bahamas, Honduras, Jamaica, South Korea, Malaysia, Philippines, Tunisia	0	9
All	**17**	**34**	**22**	**73**

Source: Reproduced from Cornia and Court (2001)