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**Trade Liberalization and Poverty:  
Where Do We Stand?**

**Ramkishan S. Rajan and Graham Bird**

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**CIES DISCUSSION PAPER 0230**

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Where Do We Stand?**

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## 1. Introduction

Economic globalization, which is a process rather than an event, may be broadly defined as the shrinkage of economic distances (i.e. costs of doing business) between nations. This process has been greeted with as much enthusiasm as it has condemnation. Public protestations during recent WTO, IMF, World Bank and World Economic Forum (WEF) meetings and industrial country summits suggest that the road towards further global integration may be far from smooth. While some of the backlash against globalization - so-called "globaphobia" - undoubtedly lacks intellectual basis (Smadja, 2000), it would be a mistake to arbitrarily dismiss the recent anti-globalization protests and the *legitimate* social concerns that might have been raised<sup>1</sup>.

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. But what exactly are the links 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 (see Eichengreen, 2001 and references cited within), let alone poverty reduction. 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 can

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<sup>1</sup> Lal (1999) highlights some of the fears and dangers associated with globalization. Also see Rajan (2001).

lead to episodes of severe financial instability and distress (Cobham, 2001)<sup>2</sup>. Baldacci et al. (2002) confirm that financial crises negatively impact income distribution and poverty, and the adverse effects are stronger in countries which have relatively more skewed income distribution (also see World Bank, 2000).

One aspect of globalization that would tend to reduce poverty worldwide would involve allowing 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 (Bauer and Zimmermann, 2000 and Simon and Lynch, 1999). Consequently, the global market for unskilled labour remains extremely fragmented. As Streeten (2001) concludes:

(T)here is much less international migration than during 1870-1913. Barriers to immigration are higher now than they were then, when passports were unnecessary and people could move freely from one country to another to visit or work..The eighteenth-century French economist François Quesnay added to *laissez-faire* the concept of *laissez-passer* (unrestricted travel and migration), but this is forgotten today, perhaps because..it.. would interfere with..social stability and cohesion, or security, in the countries receiving the migrants...But.. these objections also apply to the free movement of goods and services. In any case, there is an inconsistency.

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 from

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<sup>2</sup> See Rajan (2002) for a recent discussion of international financial liberalization and its various definitions.

which East Asia including China appears to have benefited)<sup>3</sup>. 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), and prevents them from attracting more knowledge-intensive industries and building high quality public institutions (on this point, see 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)<sup>4</sup>.

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 globophobia is unjustified, so too is "globophilia" - 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).

Does trade liberalization work to the advantage or disadvantage of the poor? And what policies will maximize the chance that the poor do benefit? This paper examines the key elements - the effects of trade on growth (with indirect effects on poverty), and the effects of liberalization on income distribution and poverty.

The remainder of this paper is organized around three main sections. Recognizing that growth is a *necessary* condition for a sustained reduction in poverty, the next section discusses the analytical and empirical links between trade and growth.

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<sup>3</sup> See Casella (1999) for discussions of the importance of diasporas and networks in promoting trade and investment.

<sup>4</sup> It is in this context that many have suggested the imposition of a "brain drain tax" (Desai et al., 2001). Given that this proposal is a non-starter in the face of developed country opposition, Lowell and Findlay (2001) suggest a set of other measures that both developed and developing countries might take to minimize the costs of brain drain to the latter.

However, growth is by no means a *sufficient* condition for poverty reduction. Therefore, section 3 focuses on the issue of trade, income distribution and poverty. Section 4 briefly examines the complementary policies that need to be undertaken if significant inroads are to be made into reducing poverty. The final section offers a few concluding remarks.

## **2. Trade Liberalization and Income Growth**

### **2.1 What does the Literature Conclude?**

Trade liberalization ought to provide the usual Harberger Triangle welfare gains by reducing, if not entirely eliminating, the wedge between domestic and foreign prices. Assuming demand elasticity =  $\epsilon$  and tariff rate or tariff equivalent =  $t$ , the size of the welfare loss from protection, in a partial equilibrium analysis (i.e. the Harberger Triangle) is simply  $t\epsilon^2/2$ . So if the tariff equivalent is ten per cent and the elasticity of demand is one, the welfare loss is just half of one per cent (of consumer expenditure). Most empirical studies measuring these welfare losses find them to be about this level (Baldwin, 1992). Does this imply that trade protectionism is not “significantly” harmful? The answer is no for at least three reasons.

One, Tullock (1967) has noted that even in a static setting, the welfare costs of protectionism may actually be a much larger “rectangle” once the costs of monopoly power, tariffs, rent-seeking activities or other pre-existing distortions are all taken into account. Thus, removal of such distortions could significantly boost income. Two, but once again in a static sense, Romer (1994) has argued strongly that the non-rivalry of many goods which enter as inputs (like blueprints) implies that if such goods (characterized by large fixed costs and constant marginal costs) are impeded, there could be potentially large losses to the economy (as much 10-12 percent of GDP).

Three, there could be a host of other dynamic gains to be had from trade and the introduction of competition in terms of scale economies, technological innovations, learning-by-doing effects, etc. which in turn lead to sustained rates of growth (not just one-off increases in income levels) (Grossman and Helpman, 1991 and Srinivasan, 2001).

However, there are also endogenous growth models that suggest that trade may be growth-stunting (Grossman and Helpman, 1991 and Srinivasan, 2001). This may occur if the forces of dynamic comparative advantage push an economy away from the direction of activities that stimulate long-run growth. 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. Recent studies that have found a positive association between openness and trade include Coe et al. (1997), Dollar (1992), Edwards (1993, 1998) and Sachs and Warner (1995), and most recently, Morrissey et al. (2002) and Dollar and Kraay (2001b). 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)? Rodrik (2000b) for one holds the view that both are caused by the quality of institutions. Harrison (1996) concludes that the

results of previous studies on the direction of causality between openness and growth are “mixed”, with causality being bi-directional.

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<sup>5</sup>.

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 it links 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 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 the domestic and external macroeconomic

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<sup>5</sup> Dollar and Kraay (2001b) do also make an attempt to control for reverse causation from income growth to changes in trade shares.

environment, have not been properly controlled for. It is extremely difficult to sort out the effects of trade liberalization from other domestic policies 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 other non-trade policy actions or some combination of the two<sup>6</sup>. Indeed, the recent World Bank (2002) report entitled Globalization, Growth and Poverty which attempts to offer evidence on 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).

## 2.2 Implications for Policy: Focus on Growth<sup>7</sup>

What does all of this imply for policy? The link between growth and *trade openness* 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 but (b) that trade liberalization per se may not be sufficient to achieve this.

“Opening doors” and “getting the prices right” may be 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. Sharer

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<sup>6</sup> Rodrik and Rodriguez (2000) go on to assert, “the search for such a relationship is futile”.

<sup>7</sup> Section 3 discusses the issue of income distribution and poverty more specifically.

(2001) echoes a broadly similar view in his review of Africa's prospects in the global trading system:

The causes of Africa's weak trade performance are complex...A country's ability to improve its trade performance in the short run is determined mainly by its macroeconomic and structural policies. Trade and growth prospects are enhanced by a macroeconomic framework that emphasizes appropriate fiscal and monetary policies conducive to price stability, saving and investment, and a sustainable external current account position. These factors are critical in maintaining a stable economic environment and, thus, in encouraging productive activities.

Even in the widely cited study by Dollar and Kraay (2001b), the authors appropriately make the following important caveat:

It would be naïve to assert that all of this improvement in growth should be attributed to the greater openness of these globalizing economies: all of them have been engaged in wide-ranging economic reforms..China, Hungary, India, and Vietnam...strengthened property rights and carried out other reforms..Virtually all of the Latin American countries included in the grouping stabilized high inflation and adjusted fiscally<sup>8</sup>.

Beyond disciplined macro policies, most developing countries that have been successful global exporters have also found it necessary to encourage the inflow of export-oriented FDI which is able to exploit the country's comparative advantage. As McMillan et al (1999) note, "FDI is viewed as an important companion strategy to market liberalization, a way of jump-starting labour-intensive, export-oriented economic activity". FDI, particularly when it involves multinationals, brings in capital, technical know-how, organizational, managerial and marketing practices and marketing and global production networks, helping accelerate the process of economic development in host countries. Not surprisingly, there is broad agreement that in a relatively non-distorted domestic policy environment FDI fosters growth by promoting greater competition and trade and

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<sup>8</sup> Ironically, the Dollar and Kraay (2001b) study is somewhat less subject to the caveat/criticism as they do try to control for the effects of other contemporaneous changes in policies and institutions that may impact growth by including measures of monetary policy stability, financial development, and political instability.

facilitates a country's overall integration with the global marketplace (Lipsey, 2000 and Stiglitz, 1998)<sup>9</sup>.

### **3. Trade Liberalization and Poverty**

#### **3.1 Comparative Advantage**

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 into 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?

#### *a) Theory*

What does theory tell us about the functional distribution of outward-oriented growth? Starting with the workhorse 2x2x2 (two-factor, two-goods and two-countries) Stolper-Samuelson (SS) model, theory suggests that international trade will lead to a rise in 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 beneficiary of trade liberalization, i.e. openness in developing countries ought to be "pro-poor" in addition to being "pro-growth". Similarly, in the age-old Arthur Lewis

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<sup>9</sup> Of course, in a distorted trade and investment environment, capital inflows may be

(1954) dualistic paradigm with surplus labour reserves (elastic labour supply), trade and growth ought to be employment-intensive, thus benefiting the poor. Findlay (1995) has combined the insights from the conventional SS model with the Lewis framework to show how trade in a labour surplus economy can lead to a virtuous cycle of employment, capital accumulation and growth. This seems consistent with the East Asian experiences in the 1970s to mid 1990s<sup>10</sup>. However, if the reserve army of labour is delinked from the growth enclaves (e.g. rural versus urban segmentation for instance), growth might bypass one segment of the poor<sup>11</sup>. Similarly, even the simple SS model does not offer definitive conclusions if one or more assumptions are relaxed (see Annex 1 and Davis, 1996).

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. This is particularly so if one recognizes the possibility of different degrees of mobility of some or all factors over time,

*b) Empirics*

What do the data tell us? Empirical studies have by and large found that growth has *not* given rise to more unequal income distribution (Dollar and Kraay, 2001a, Morrissey et al., 2001, Roemer and Gugerty, 1997 and World Bank, 2000). 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

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“immiserizing” or growth reducing.

<sup>10</sup> More to the point, East Asia has long been characterized as having followed a “flying geese pattern” (FGP) of production and trade. The FGP has been used to describe the shifting pattern or spatial reorganization of international production and comparative advantage across East Asian countries. The FGP pattern has been largely investment-driven (Rajan and Sen, 2001).

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<sup>12</sup>; there appears to be as much tendency for income inequality to worsen slightly as there is for it to improve (Fields, 1989)<sup>13</sup>. Ghura et al. (2002) have recently estimated the elasticity of the income of the poor with respect to average income and find that economic growth raises the incomes of the poor but by less than one-to-one. This said, the evidence is far from unequivocal (for instance, see Timmer, 1997), especially once country-specific circumstances are considered.

### 3.2 Agglomeration and Fragmentation in the Global Economy

#### 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, 2003). 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

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<sup>11</sup> More specifically, with such segmented labour markets, adjustment will be reflected in increases in real wages and not employment. One can identify four sectors of the labour market in developing countries: formal urban, formal rural, informal urban and informal rural.

<sup>12</sup> While the conventional Kuznets hypothesis linked inequality with income *levels*, there has more recently been an attempt to relate inequality with income *growth*. Neither the level nor the growth versions of Kuznets hypothesis seem to be empirically valid in general. Even if there were a link, the issue of causation would be relevant as high levels of inequality could well depress growth (Alesina and Perotti, 1996 and Morrissey et al., 2001).

<sup>13</sup> 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.

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). To quote Krugman and Venables (1995):

(B)oth concerns about uneven development and worries about maintaining First World living standards in the face of Third World competition have some justification. In particular, they seem to correspond to different stages in the process of globalisation....an early stage of growing world inequality...As transport costs continue to fall...there eventually comes a second stage of convergence in real incomes, in which the peripheral nations definitely gain and the core may well lose (p.859).

Given this 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 of tariffs and other trade barriers so as to decelerate the “centrifugal” forces (i.e. forces causing dispersion from the core)<sup>14</sup>. However, this policy conclusion runs against 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*

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<sup>14</sup> The aim here would be to diminish the feasibility of moving to the outlying regions and servicing the core through trade.

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”, a term coined by Arndt (1996, 2001). He also uses the term “super-specialization” to describe this phenomenon<sup>15</sup>. The importance of intra-product specialization lies in 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<sup>16</sup>. The spread of industry to peripheries need not lead to deindustrialization of the cores.

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 (Ahulwalia, 2000 and Datt and Ravallion, 2002). 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

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<sup>15</sup> Other descriptive terms sometimes used include “international product fragmentation” (Jones and Kierzkowski, 2000), “production-sharing” (Yeats, 1999), and “slicing the value chain” (Krugman, 1995).

<sup>16</sup> 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.

growth, it would be a mistake to attribute all or even most of the increase in inequities to trade openness (Cornia and Court, 2001).

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 in which the Chinese authorities have been moving (Broadman and Sun, 1997), and is a policy that has been forcefully advocated for India (Ahluwalia, 2000).

#### **4. Other Complementary Steps**

##### **4.1 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. Martin (2001) has documented that many developing countries, including

relatively poor ones in Southern Africa, have seen a significant increase in the share of manufactures in their exports.

This said, many people in developing countries are still closely tied to the rural sector ; this is where the bulk of poverty is often concentrated. Accordingly, this sector cannot be ignored if significant inroads are to be made in reducing poverty and raising living standards in developing countries<sup>17</sup>. Ravallion and Datt (1996) have found that direct targeting of rural poverty in India will generate benefits to the urban poor, though not vice versa. The authors further suggest that growth in the rural sector has an equalizing income effect in the urban sector, while expansion of the urban sector actually exacerbates overall income inequalities (also see Datt and Ravallion, 2002).

In view of this, steps are needed to improve the productivity of the rural sector (Khan, 2001). Specific actions are needed to improve basic infrastructural services such as roads, irrigation, power and basic public health measures (sanitation and sewerage, supply of clean drinking water, etc). Virmani (2002) makes a particularly strong case for such rural infrastructure to be classified as “public goods” warranting government provision<sup>18</sup>.

In addition, various regulations, which hinder productivity improvements such as price controls, licensing requirements and trade restrictions may need to be revoked. Innovative methods of providing rural credit finance (micro finance) are also of importance. It is instructive to note that the pro-poor effects of East Asian growth pre-1997 were due to an astute combination of outward orientation along with complementary policies in agriculture (including land reforms) and widespread basic

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<sup>17</sup> This agriculture versus industry debate is, of course, an age-old one.

<sup>18</sup> However, in reality many public goods in developing countries tend to be fairly “costly” to the end user (i.e. rural poor) either because the poor are not able to access the services easily (due to lack of geographical proximity) or because middle-men/service providers attempt to extract informal payments to provide the service.

education (Birdsall, et al., 1995)<sup>19</sup>. Indeed, Cornia and Court (2001) refer to land concentration, urban bias and inequality in education as “traditional causes” of inequality.

There is a complex nexus between illiteracy, openness and agriculture<sup>20</sup>. Specifically, while trade in non-agricultural commodities may benefit low skilled urban labour, it may do little to benefit the poorest unskilled labour that lives in the rural areas. While this further suggests the need to improve basic literacy rates in these areas and to facilitate the extent of inter-regional labour mobility<sup>21</sup>, the importance of working towards liberalizing trade in agriculture may be critical.

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

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'

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<sup>19</sup> While stressing the importance of land reforms, Cornia and Court (2001) note:

Many land reform efforts in the past have been badly planned and implemented without paying much attention to the incentives of all actors involved and to the functioning of the input and credit markets (p.27).

Banerjee (1999) offers a timely reminder that such redistribution policies cost money and expend valuable administrative and political capital. The budgetary cost of programs is discussed in Section 4.2.

<sup>20</sup> An “adequate” level of education of the populace and “reasonable” infrastructure are also required if a country is to fully benefit from FDI (Borenzstein et al., 1998).

<sup>21</sup> 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.

current problems with the design and implementation of the rules of the game in international trade.

#### **4.2 Social Safety Nets**

More open economies are invariably more vulnerable to external shocks and disturbances. Indeed, Ghura et al. (2002) find that the poor are particularly susceptible to adverse movements in the price of tradables. 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 (also see Stiglitz, 1998). In order to counter this possibility, at least two sets of government policies may be needed.

First, in a dynamic environment, policies must be focused on basic re-training and re-tooling of individuals so that they are able to adapt to shifting comparative advantage. Policies in the short and medium term also need to focus on facilitating inter-sectoral mobility of labour and capital.

Second, adequate social safety nets need to be established to protect the least well off, and mechanisms created to compensate “losers” (Ravallion, 2002). As Baldacci et al. (2002) note of such safety nets:

The aim should be to have safety nets as permanent institutions to be deployed as needed. Medium-term planning is crucial in this respect, Setting up safety nets takes time and requires the ability of the government to react as short notice. Social safety nets should be flexible so that they can be adjusted to changes in the size and the characteristics of the poor when the economy is hit by a shock...The design of a safety net should take account of the poverty risks of different population groups, with effective targeting to the most vulnerable groups. As the poorest of the poor are often engaged in informal-sector activities, policies targeted at this group should be designed differently from those programs aimed at helping the vulnerable groups of workers in the formal sector (p.37).

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 also important to ensure that these social policies do not hinder or delay the process of reform. They are meant to supplement and not supplant growth-oriented structural reforms. Moreover, the budgetary costs of these programs need to be quantified and the programs well targeted (as there is always the danger that they will be 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 which 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 phytosanitary measures (SPS) and intellectual property rights (TRIPS); an amount that exceeds the typical budget of 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) the raising of other taxes which have distortionary effects; or (c) reductions in government expenditures which may impinge heavily on the poor<sup>22</sup>. Rodrik (2000a) goes so far as to suggest that these fiscal costs of deeper integration may not be worthwhile

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<sup>22</sup> Of course, none of these policy choices need occur if the trade taxes were prohibitive or the supply response following tariff reductions are “very significant”, such that tariff liberalization actually increases revenues. In addition, as is often noted, simplifying the tariff regime as part of an overall process of creating a more uniform and transparent structure may not lead to a decline in fiscal revenue, and will certainly simplify tax administration. See Mackenzie and Orsmond

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).

## 5. Concluding Remarks

It goes without saying that the permanent eradication of poverty ought to be a country's and indeed the international community's overarching objective. The issue of poverty is multidimensional and exceedingly complex. To understand its causes, it is essential to study the underlying economic and social circumstances and processes (World Bank, 2000)<sup>23</sup>. This paper has made no attempt to provide a detailed discussion of the causes and consequences of poverty. Rather, the aim of this paper has been much more modest, viz. to discuss some of the links between trade and poverty at a rather broad level, as well as to suggest ways of ensuring that trade liberalization benefits the poor.

One thing is reasonably clear. Trade and openness remain engines of growth and important instruments of development. An inward looking, statist development strategy is *not* a sensible policy option. Countries that have experienced rapid growth and have managed to make significant inroads into alleviating poverty have tended to be 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

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(1996) for a discussion of issues relating to the quality of fiscal adjustment and its impact on growth.

<sup>23</sup> Cassen (2002) notes that income - or lack of it - is just one aspect of poverty. He examines a broad range of indicators to obtain a clearer understanding about how "well-being" of the poor in India has changed in the 1990s.

of other policies to ensure that a country is successful in integrating more intensively with the world in a manner that favours growth and poverty reduction.

## Annex 1

### Why the Stolper-Samuelson Theorem may be of Limited Help in Analyzing Poverty

**The functional distribution of income is not the same as the personal distribution of income.**

The income of a given household is only indirectly linked to the returns to various factors of production. It depends on their ownership of the various factors, which is usually very difficult to ascertain empirically.

**Dimensionality.** The very powerful SS result holds only in a model with 2 factors and 2 goods. Once we move beyond this the results are much weaker. In an  $n \times n$  model each factor has an "enemy" - a good whose price increases definitely hurt the factor - but not necessarily a 'friend'. In non-square models, with different numbers of factors and goods, unambiguous results are even scarcer.

**Mobility of labour.** Independently of the number of different classes of labour distinguished, each is required to be perfectly mobile between all sectors and regions of the economy - i.e. there are perfect labour markets at the national level. If this is violated - i.e. labour markets are segmented - similar labourers in different markets must be treated as being different factors, and will fare differently from each other.

**Diversified equilibrium.** To be sure of SS effects, the country must be producing all goods, both before and after the price change in question. If we distinguish many different goods at different levels of sophistication, this is unlikely. If countries do not produce all goods, the basic mechanism can break down and perverse results are possible.

**Differentiated goods.** SS is based on a model in which goods are homogeneous across foreign and domestic suppliers. Many argue that goods are better thought of as differentiated, in which case the critical issue is how closely domestic varieties are substitutable for the foreign varieties whose prices have changed. If the answer is 'rather little', the prices of domestic varieties will be only slightly affected by trade shocks but there will be little quantity response to the price increase for the imported variety, so the terms of trade losses from the price increase will be correspondingly unmitigated.

**Constant returns to scale and smooth substitution between factors.** If industries are subject to economies of scale, their responses to price shocks will tend to be larger than a CRS approach suggests. Also, under such circumstances it is possible for all factors to gain or lose together, which weakens the inter-factor rivalry aspect of SS. Similarly, if technology is endogenous or if labour can be substituted for other factors only in discreet steps, there may be discontinuities in the way factor prices respond to shocks.

**Perfectly competitive goods and factor markets.** These are required for the direct and simple transmission of goods price shocks into factor price effects. Once there are economic rents in the system, transmission becomes more complex and difficult to predict.

**Non-traded goods.** If some goods are non-traded, their prices are no longer determined by world prices plus tariffs, but by the need to clear the domestic market. They will accommodate shocks through both price and quantity responses, rather than just the latter as for traded goods in a small country. This will tend to attenuate the rate at which tradable goods price shocks are translated into changes in the relative demands for different factors.

**Reference set of relative factor abundance:** Davis (1996) shows that countries that may be labour-abundant in a global sense may yet experience a worsening of income if it is capital-abundant in a regional or local sense.

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