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Trade Liberalisation and Poverty

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The picture in brief

- Trade policy potentially affects poverty through its effects on both growth and income distribution. The effects of trade on income distribution have been more firmly established than its impact on growth. This is significant given that poverty reduction is very sensitive to income distribution.
- Trade policy theory does not unambiguously suggest that protection has a negative impact on growth in developing countries. However, those countries applying more open trade regimes, together with fiscal discipline and good governance, have enjoyed higher growth rates than those implementing restrictive policies.
- An open and simple trade policy can foster some external discipline, helping to reduce distortions on domestic markets, and to narrow the scope for wrong or unbalanced policies in other areas, as well as rent-seeking and corruption which do not normally favour the poor.
- If trade policy benefits the relatively well-off by, for instance, protecting import competing sectors controlled by capital owners, then trade liberalisation is likely to redistribute income to the poor.
- Protection rarely helps the poor. Trade policy is not usually as effective as other more targeted fiscal measures (e.g. food stamps) in protecting sections of population or their incomes.

Some challenges

- For long-run sustained high growth rates and eventual eradication of poverty, a comprehensive strategy is needed with investment in human resources and the development of infrastructure as well as the rule of law. Freer trade, however important, is only one component of this strategy.
- Trade liberalisation is more likely to be poverty-reducing when the poor have more access to land, credit and primary education and easier access to markets via infrastructural improvements (e.g. feeder roads in certain regions).
- Defining general policy guidelines to make trade liberalisation policies work to alleviate poverty is difficult, mainly because the poor are diverse. An effective policy package must be specifically tailored to address these differences.
- Our current knowledge in identifying poor groups and their characteristics is growing but still limited. We need to know more about the way specific trade policy changes affect them, including whether they have the 'assets' (skills, capital, land, etc.) that are likely to gain from trade liberalisation, to what extent they interact with markets and how vulnerable they are to change. More empirical research in specific economies is needed to identify the likely shifts in trade patterns from trade liberalisation.

What is the question?

Increasing *international flows* of trade and capital are too often seen as a major cause of *widening gaps in living standards* between populations in the North and the South or within these regions. However, serious attempts at understanding the possible ways in which the two are connected are rare, mostly because measuring their reciprocal influence is quite difficult.

Apart from the complex public emotions related to these themes, two aspects make a serious study of trade and poverty particularly difficult. The first is that, in international trade analysis, it is essential to take account of the 'general equilibrium', in which everything affects everything else. For example, should one measure the effects of a change in trade protection as if that change is occurring in isolation in a country that faces given world prices? Or should one consider simultaneous changes in various countries and also modifications in other policies that may be put in place to offset tariff revenue losses? Or again, should one look at trade-induced variations in the returns to 'factors' (capital, land and labour) separately from movements in the prices of consumption goods; or consider their joint impact on the poor? Partial and general equilibrium approaches can produce opposing poverty predictions and contradictory policy advice.

Second, changes in trade volumes and international prices are determined – together with variations in poverty levels – by many different variables. Thus when looking at real world data, it is difficult to take account of all these variables, and a clear relationship between trade and poverty is hard to establish. Researchers may come to opposite conclusions according to which counterfactual situation they compare with actual observations. Abstracting from specific country cases, East Asia and Latin America display two contrasting situations where increasing trade flows were accompanied respectively by lower and growing poverty levels. Clearly, in such cases, the counterfactual should include not only lower trade flows but also variations in other variables (e.g. growth rates, technology, macro-balance stability, and levels of development) which, in turn, may interact with trade flows.

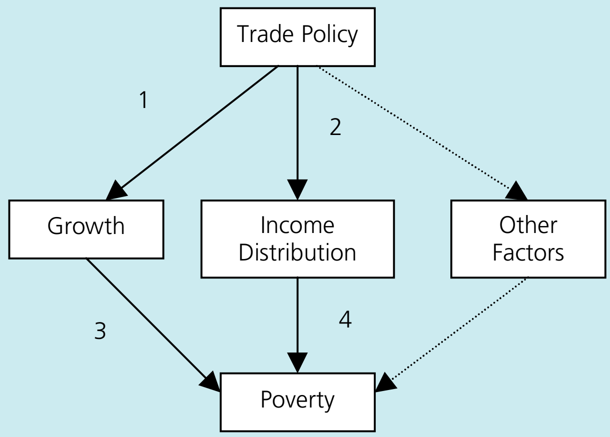
A conceptual framework to analyse trade liberalisation and poverty linkages

In this *ODI Poverty Briefing*, we limit our attention to the specific issue of *how trade liberalisation and poverty levels may be linked within a given developing country.* In particular the paper focuses on what economists have to say on the following chain of linkages: trade policy affects trade flows which modify the prices of goods and factors; increased trade, in turn, influences growth and income distribution; these changes alter poverty levels. The Chart schematically represents these linkages (with arrows), ignoring a series of other important issues such as the feedback effect of increased poverty and inequality on growth and trade, and global issues such as the world distribution of poverty or the determination of international prices for traded goods. It also assumes a concern with a money-income concept of poverty (e.g. numbers of people falling below a given income level) and it takes no account of many other dimensions of poverty.

Though trade policy may have a number of objectives, in the real world its immediate effect is normally to influence trade flows. To meet its goals, a trade ministry may use various instruments to change price differentials between domestic and foreign goods. We assume that trade liberalisation consists of the removal of restrictions and brings about a convergence of domestic towards international prices, and stronger incentives to trade. This is what has happened in the OECD countries since the end of the Second World War and more recently, in developing countries which have embarked upon unilateral liberalisation reforms or have entered multilateral trade negotiations under the WTO system. Most economists agree that this trade liberalisation process has played a major role in post-war *growth in trade volumes* although other factors, notably technological progress, may also have contributed.

However, the effects of trade liberalisation on *GDP growth* and *income distribution* continue to be a source of hot debate. Since economic growth and income distribution are the main determinants of poverty levels, knowledge of the way increased trade affects these two variables is essential to our understanding of how trade liberalisation may influence poverty.

Schematic representation of trade policy and poverty linkages



Trade, openness and growth (Chart: Arrow 1)

What does economic theory tell us about trade and growth (Arrow 1 in the Chart)? We can broadly distinguish three categories of models. In the first, the 'static economic models', the removal of trade restriction expands GDP. However, this result assumes that markets function well and without significant distortions, which is not always the case in practice because of poor information, monopolies, political interference, etc. Indeed, if there is 'market failure' then barriers to trade may increase GDP. In the second category of models, where growth is driven exogenously by technological progress, the long-run GDP growth rate is unaffected by trade policy (although the latter may have some influence during the transition from a controlled economy to a market driven one). In the final category, technology change is central. With models of this category, it is possible to construct cases where a 'small country' (i.e. an economy for which the prices of its exports and imports are given in international markets) grows faster by protecting a 'high-tech' sector from imports.

The bottom line is that in a small country, the theory of trade policy does not suggest unambiguously that protection is unfavourable to its growth.

Given these theoretical insights, what does observation of the real world tell us? Researchers have looked at statistical data and have found some positive relationships between the degree of 'openness' of economies and their growth. The results might be summed up as follows: developing countries applying more open trade regimes have enjoyed higher growth rates than those implementing restrictive policies. This conclusion depends crucially on how openness is defined. When it is strictly limited to include only measures taken at the borders of countries, then growth seems to be almost unaffected by greater openness. When openness is measured by a wider range of potentially influential policies – including the level and variability of barriers, distortions in the 'real exchange rate' (i.e. degree of international competitiveness), degree of state monopoly of major export products, forms of government (e.g. socialist) and others – then growth appears to be boosted whenever a country moves towards a more open regime.

Two further major conclusions may be drawn from the trade and growth literature. First, an open and simple trade policy implies a certain external discipline that inevitably reduces the discretion and arbitrariness of public officials and as a consequence, also discourages the private sector from engaging in rent-seeking activities and corruption. In addition, ineffective and unbalanced policies in other economic areas seem less likely to be undertaken, when an open trade regime is in place. Second, without a comprehensive strategy involving investment in human resources, infrastructure and the rule of law, freer trade alone does not guarantee sustained growth rates.

Trade liberalisation and the distribution of income (Chart: Arrow 2)

The strong redistribution effects of trade liberalisation have been firmly established by economists. Recent research has shown for example, that in sub-Saharan Africa, a reduction of average tariffs from 40% to 10% entails real income losses of 35% for urban employers and 41% for recipients of trade rents, compared with a gain to farmers of 20%. The overall net gain to the economy is estimated at 2.5%. The relatively small size of this efficiency gain compared to the redistribution effects makes trade liberalisation a very hard reform for policy makers to implement.

The standard result of trade liberalisation in economies that are abundant in labour and capital-scarce is that labour gains at the expense of capital owners (see Box for the mechanics). There is some plausibility in assuming that poor people are more likely to be found in the wage earners' group than among capital owners. Hence trade liberalisation should redistribute income towards some poorer groups of people. Where trade restrictions are protecting skilled labour-intensive sectors, their removal will shift income towards *unskilled* labourers, and unskilled labourers are more likely to be among the poor and the poorest. But when natural resources are important as a third factor of production, the picture can be more complicated. For instance, in Latin America and Africa, trade liberalisation may actually result in a shift in the distribution of earnings *away from* unskilled workers by expanding exports of certain sectors that are intensive in the combined use of natural resources and skilled labour (e.g. mining) (see Box).

Income redistribution with trade liberalisation

The setting is a stylised labour-abundant but capital-scarce and small developing country. It produces and exports labour-intensive primary goods, and protects its import-competing capital intensive manufacturing activities. When trade is liberalised, *domestic* prices converge towards the international levels; i.e. domestic prices for manufactures go down relative to domestic primary goods prices. Manufacturing activities are no longer profitable given that cheaper foreign goods substitute their output. Hence they contract and start releasing capital, which is then employed in the primary sectors. Because primary activities are more labour-intensive, new capital is absorbed in them at a lower rate than it is released from manufacturing. The result is that the price for capital decreases and wage rates increase in real terms. This changes income distribution in favour of labour/ wage earners at the expense of capital owners. Where primary products are intensive in their use of *unskilled* labour, the shift in earnings favours unskilled workers.

If a third factor of production – natural resources – is included, and if primary products require complementary inputs of natural resources and skilled workers, then their expansion following trade liberalisation may bid up the rewards to both of these factors at the expenses of unskilled labour. A similar result emerges if a country is assumed to be producing three commodities (export crops, subsistence agriculture, and manufactures) using three factors (land, skilled and unskilled labour) in different combinations. Assume export crops are more land-intensive and less unskilled-labour intensive than subsistence agriculture and skilled labour does not perfectly move across sectors: trade liberalisation, by raising export crops' domestic prices causes an expansion of the export sector at the expense of subsistence farming. This lowers employment opportunities for unskilled workers and reduces their wages.

But do these processes happen in reality? Unfortunately data for the actual effect of trade liberalisation (which is not easily measurable in isolation from other reforms/shocks) on income distribution are not directly available, nor are, they easily compiled. Although household surveys in developing countries have improved considerably in recent years, a systematic link between open trade policy and more pro-poor income distribution has not been unequivocally established.

If we look at the broad picture, East Asia and Latin America are two regions that have embarked on extensive trade liberalisation policies. In the former, income distribution, or more specifically wage inequality between skilled and unskilled labour, has improved, but by contrast it has worsened in the latter. Various explanations have been put forward for this puzzling contrast:

- The initial conditions in the two areas differed in terms of skilled/unskilled labour supplies, with East Asia registering a faster inflow of skilled workers in their labour markets.

- Natural resource endowments differed, with Latin America better endowed.
- Trade policy instruments differed, with the use of selective export incentives in East Asia and general tariff reductions in Latin America.
- The external global environment was more favourable during the opening up of East Asia in the 1960–70s which predated the entry of large low-income exporters (Bangladesh, China, India, Indonesia and Pakistan) that affected the later liberalisation efforts of Latin America.
- Recent technological progress made trade-induced change relatively less beneficial to unskilled labour than it was two decades ago.

The contribution of these other factors to Latin American inequalities must be considered in addition to trade policy. Furthermore, to these should be added another important factor widening wage inequalities: labour market imperfections. Crucial to the effects on income distribution of 'trade opening' is the transmission of changes from output prices to factor prices. This transmission is enhanced, diminished, or distorted by the labour markets. Two characteristics of developing countries play an important role in this context: the first is the presence in their labour markets of institutional rigidities and the second is the segmentation of these markets. For instance, minimum wages and union behaviour may only operate for specific groups of workers (formal) or specific sectors (public sector or other regulated sectors). In the presence of these rigidities and imperfect compliance, it is easy to show that a trade-induced price shock which adversely affects a labour-intensive sector, may not be felt by those formal sector (and often more skilled) workers who are protected, but it may exacerbate the negative impact on the non-protected informal (less skilled) workers.

From growth and income distribution to poverty (Chart: Arrows 3 and 4)

The starting question was 'how do trade-induced growth and income distribution changes affect poor people'? A policy of trade liberalisation can produce positive effects on GDP growth and income distribution and, abstracting from the possible complex links between growth and inequality, it should thus help reduce poverty. Furthermore, the effects of liberalisation appear stronger on income distribution than on growth, and poverty is very sensitive to income distribution (see the forthcoming *ODI Poverty Briefing* by Hanmer and Naschold). Hence, trade reform may have quite a powerful outcome in reducing poverty. Of course the final net positive result on poverty will vary from one case to another, as we see next.

From theory to practice

As usual, the reality is more complex. Other factors are critical for a successful poverty-reducing trade reform.

- First, poor people need to interact with markets to benefit. Yet they may rely on goods that have no explicit prices (e.g. environment) or own factors that are not easily marketable (a woman assisting her children) or live in remote areas without good transport. Trade liberalisation effects on these groups may not work in easily predictable ways. We need a better understanding of the connection between a simple model of the distribution of income among broad categories like capital, skilled and unskilled labour, and the likely personal income benefits to poor people.
- Second, positive trade liberalisation effects may eventually relieve the poor, but in the short/medium term the whole adjustment process may be more harmful than helpful. We need to know much more about this. In order to benefit, the poor need to enjoy trade-induced price reductions for consumer goods, as well as reduced input and increased output prices which they face as producers. Trade policy change may or may not have this result or be intended to do so. Moreover, the poor may experience increased income risks in the short-run when they switch from producing subsistence-local goods to producing tradeable goods. Given the imperfect working of credit markets (see *ODI Poverty Briefing* 'The Poor and their Money', March 1999) these risks may considerably worsen conditions for the poor.
- Third, poor developing countries do not usually enjoy large government budgets and normally trade taxes are a high proportion of their revenues. If tariffs are dismantled, transforming the fiscal structure of these countries may take some time and those social expenditures, which tend to protect the poor, may be vulnerable when revenues from trade taxes shrink.
- Fourth, trade restrictions should not however be justified as direct pro-poor measures. Economists have shown that to be effective, policy instruments should be directly linked to their objectives. A tariff may benefit poor people only indirectly through the expenditure of the revenues it generates, but it may also create additional distortions that harm them. A more direct policy, such as a food or school subsidy, would be much more effective to alleviate poverty than protectionist measures.

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