

Trade and poverty



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I. Trends in developing country trade, 1990–2001

The last decade, 1990–2001, witnessed a rapid expansion of world trade, and an even more rapid expansion of developing countries' trade. World merchandise exports over this period grew at a rate of 5.4 percent per annum while developing country exports grew at 7.9 percent per annum. Thus, the share of developing country merchandise exports in world exports increased from 24.7 percent in 1990 to 31.4 percent in 2001 (Table 1). Developing country merchandise imports grew even faster than exports; and a similar picture emerges with respect to trade in services.

The strong overall growth in developing country trade over the last decade resulted to a significant extent from the very fast growth of a relatively small number of developing economies, many of whom, with the exception of China and, more recently India, are upper middle and higher income developing economies.² Analysis of the trade performance of developing countries by income group, shows that the fastest

growing are upper middle income countries like Brazil, Chile, Korea and Malaysia. Exports of higher income economies such as Hong Kong and Singapore, grew vigorously in the early 1990's but did not sustain their expansion in later periods.

The slowest growing are low income countries, other than China and India, many of which are in Africa. The Least Developed Countries (LDCs) as a group increased their share of world exports slightly over this period, from 0.5 percent of world exports in 1990 to 0.6 percent in 2001 (Table 2). While this is a welcome change in the long term downward trend of trade in these countries, its sustainability is uncertain, as the relatively strong performance occurred in the last two years (1999–2001) of the period and was concentrated in oil exporting LDCs such as Angola, Equatorial Guinea, Myanmar, Sudan and Yemen. Exports of 18 of the 49 LDCs, such as Burundi, Chad, Malawi, Mauritania and Zambia were lower in 2001 than in 1990.

The trade performance of different groups of developing

¹ This note was written by Constantine Michalopoulos, October 2003.

² LDCs refer to the 49 countries on the UN least developed countries' list.

countries depends very much on the composition of their exports as between manufactures and primary commodities and foodstuffs. Overall, developing countries have more than doubled their share of world exports of manufactures over the last two decades with growth especially rapid in the

1990's.³ The weak export performance of the LDCs and many low income countries is due in considerable part to their dependence for the bulk of their export earnings upon a small range of primary commodities, for which world demand is growing slowly.⁴

Table 1. World merchandise exports 1990–2001 (billion USD and percent)

	1990		1995		2001	
	value	%	value	%	value	%
Developed (23) ^a	2466	71.9	3464	68.3	3896	63.7
Developing (135) ^a	848	24.7	1434	28.3	1917	31.4
Transition (25) ^a	115	3.4	173	3.4	300	4.9
World total (183) ^a	3429	100.0	5071	100.0	6113	100.0

a. Number of economies. For definitions, see Michalopoulos (2001), Appendix 1.
Source: WTO.

Table 2. Exports of developing and transition economies, by income group, 1990–2001 (billion USD and percent of world exports)

	1990		1995		2001	
	value	%	value	%	value	%
Least developed (49) ^a	17	0.5	21	0.4	37	0.6
Low income (21) ^a	140	4.1	266	5.2	432	7.1
(Low income – China)	80	2.3	119	2.3	166	2.7
Lower Middle Income (44)	209	6.1	281	5.5	431	7.1
Upper Middle Income (31) ^a	336	9.8	557	11.0	790	12.9
High income (15) ^a	261	7.6	482	9.5	527	8.6

Note: The basic data source is the WTO. For 1990 and 1995 the data shown in Michalopoulos (2001), Table 2.1 were used, adjusted for the deletion of North Korea and the inclusion of Eritrea. Also the LDC and low income economies totals were adjusted for the inclusion of Senegal as an LDC. LDCs are defined as the 49 economies on the UN list; World Bank per capita income definitions are used to classify all other economies as follows: Low Income include all economies with per capita income in 1998 of less than USD 760 (except the Least Developed); Lower Middle Income: USD 760–3030; Upper Middle Income: USD 3030–9360; High Income: USD 9361 + (for details see Michalopoulos, 2001, Appendix 1).

³ World Bank (2000).

⁴ On average, the top three export commodities of LDCs account for over 70 percent of each country's exports.

GDP also grew during the last decade, but on average, much less than trade both for developed and developing countries. Using the ratio of total trade/GDP as an indicator of integration in world trade, suggests that developing countries on average were more integrated at the end of the twentieth century than ten years earlier. But the integration has been proceeding at a very different pace in different countries.⁵ These developments are a continuation of a long term trend in evidence over the past half century and an important dimension of the globalization process. They help explain the concerns of many countries about being left behind, becoming even further marginalized and not benefiting from globalization.

II. Poverty reduction

The 1990's also witnessed an overall reduction in absolute poverty in the developing countries. Using the most common measure, the number of extremely poor under a poverty line of less than USD 1 per day, declined by 125 million over the decade as a whole. But as in trade, so in poverty, the performance was very uneven. The reduction in the total number of poor worldwide was primarily the result of the strong performance in reducing poverty in China and East Asia and to a certain extent in India where a very large proportion of the world's poor live. If the China

totals are excluded, then the number of poor in the rest of the world actually increased with the bulk of the rise in poverty occurring in Africa and to a lesser extent the countries of the former Soviet Union.⁶

Progress in combating poverty depends on a host of social, political and economic factors. An important economic determinant of poverty reduction is GDP growth. There is extensive evidence that a country's growth performance is strongly related to its ability to reduce poverty over time. Thus, the benefits of growth for the poor typically are not offset by worsening in the income distribution.⁷ Cross country analyses conclude that, on average, incomes of the poor (the lowest 20 percent of the income distribution) increase proportionally with overall average incomes.⁸ Moreover, Ravallion (2001) shows that a one percent increase in mean income results, on average in more than twice a decrease in the number of people in absolute poverty. But the effect of growth on poverty is higher when incomes are initially distributed more equally than when they are distributed unequally.⁹ And there is no significant evidence of the contrary — i.e. that growth is bad for poverty.

But there is no simple relationship between growth and poverty that applies generally. While growth is, on average, likely to reduce poverty there is evidence of

⁵ This indicator is useful when employed to compare the links of a country's economy to international trade over time but has to be used with caution when making comparisons between countries. This is because, other things equal, large economies tend to have smaller ratios of trade to GDP than small economies. Also, large enclave type export sectors in some developing countries may give the false impression that the economy is well integrated in the world trading system, while in practice the bulk of economic activity may involve domestic production for subsistence.

⁶ World Bank (2002).

⁷ Bruno, Squire and Ravallion (1998).

⁸ Gallup, Radelet and Warner (1998), and Dollar and Kraay (2000).

⁹ Ravallion (1997).

‘anti-poor growth’ i.e. growth which results in less than proportionate increases in the incomes of the poor — which however, may still result in reductions in the numbers of the absolutely poor — as well as ‘pro-poor’ growth in which the poor increase their incomes faster than the average.

Trade performance, in turn, is one of many policies and factors that affect GDP growth and through it, poverty reduction. Trade policies in developed and developing countries, as well as other considerations — e.g. institutional capacity, factor endowments, affect trade performance and GDP growth — and thus may have an impact on poverty. Thus, the link between trade, trade policies and poverty is complex, often indirect and subject to a variety of other influences, both of a policy and of an institutional character.

III. Developing country trade policies and growth

A. General Perspectives

Given the broad link between growth and poverty alleviation, a great deal of analytical effort has been devoted to showing that liberal trade policies are conducive to economic growth. Over the 1990’s, the proposition that openness is good for economic growth was advanced by a number of cross countries studies.¹⁰ But the findings of some of these studies have been subjected to serious criticism: the restrictiveness of trade policy is difficult to measure and the openness indicators used in these studies to show links to growth are not good proxies for

trade policy.¹¹ There are also problems in identifying causality; and for trade policies to work in the medium to longer term, there is a need for other policies to also be in place — for example policies that promote macro-economic stability, encourage investment in physical and human capital, improve governance and allow effective conflict resolution.

The fact that openness is not a good proxy for trade policy is well understood. Countries have expanded their exports and trade in general under different kinds of trade regimes: some like Korea, Taiwan, and China have done so under complex trade regimes that provided extensive import protection while at the same time providing very substantial stimulus to export industries; others like Chile, Hong Kong and Singapore have expanded exports while maintaining a very liberal regime on imports. Still others like Mauritius and El Salvador have used export processing zones to stimulate growth in trade, while maintaining substantial import controls.¹² A key common element in all these experiences is that all countries that have successfully expanded trade have done so under regimes that did not disadvantage export industries. This meant relatively stable and, in some cases, undervalued real exchange rates, and the provision of export subsidies, or other incentives to offset the disincentives created by import protection. But it is important to realize that successful implementation of such complex policies involving both import protection and stimulus to exports places great demands on foreign trade

¹⁰ Sachs and Warner (1995), Edwards (1998) and Dollar and Kraay (2001).

¹¹ Rodríguez and Rodrik (1999).

¹² PRSP Sourcebook (2002).

policy design and trade institutions, which few developing countries can meet. Moreover, certain of the policy options available to all developing countries in earlier periods, e.g. unconstrained export subsidies or reverse engineering are being foreclosed by new international disciplines in the WTO, including the agreement on subsidies and countervailing measures and TRIPS.¹³

It is true that over time, countries have tended to increase both trade and output. As a consequence, causality is difficult to establish, although some studies have produced evidence that it runs primarily from increased trade to increased output growth.¹⁴ Even so, it is difficult to deny the importance of complementary policies in ensuring that the benefits of an open trade policy are lasting. This has been the conclusion of all case studies that have looked at experiences with trade liberalization at the country level.¹⁵ Macro-economic stability appears to be an essential condition for sustainable impact of trade reforms. But in terms of the effects of trade reform on the poor, a variety of additional policies need to be present as well.

An important aspect of the relationship between trade policy, growth and poverty results from the use of particular instruments such as quotas, licensing and other non-tariff barriers (NTBs) to limit imports. Starting with Krueger (1974) many have argued that the use of NTBs to control the inflow of imports leads to wasteful rent

seeking activities and corruption. Recent evidence shows a connection between higher rents stemming from trade restrictions and corruption which is harmful to growth and poverty alleviation.¹⁶ More generally, the political economy of trade policy suggests that trade restrictions, in both developed and developing countries tend to serve the interests of small powerful lobbies with political clout, at the expense of the economy as a whole. The poor are powerless and there has hardly ever been any evidence of a specific policy of import protection in any country that has been designed especially to help them.

B. Sectoral Perspectives

In addition to these general studies on the relationship between trade and growth, there have been various efforts to explore the links via particular aspects of the trade – output relationship. One obvious link is that which works through exports: a large increase in world demand for a country's exports will lead to an increase in overall incomes – and depending on the types of groups employed, i.e. the factor intensity of the country's exports could lead to an increase in the incomes of the poor. The increase in demand for a country's exports could come from factors outside the national sphere (so-called exogenous factors), or could be induced by domestic policy change. For example, Vietnam has increased substantially its exports of rice, with beneficial effects on poor rice farmers, as a conse-

¹³ These disciplines still do not apply in many respects to LDCs and low income countries with per capita income of less than USD 1000 which are partially exempted from commitments under the WTO agreement on subsidies and countervailing. Whether these exemptions are good for these developing countries is debatable (see Michalopoulos, 2001).

¹⁴ Frankel and Romer (1999).

¹⁵ Krueger (1978), and Papageorgiou et.al (1991).

¹⁶ Ades and Di Tella (1999).

quence of changed domestic policies which liberalized rice trade.

There has also been a lot of evidence over time both at the macro level¹⁷ and at the sectoral level¹⁸ between exports and productivity. But the direction of causality is unclear: does exporting stimulate productivity or do more efficient firms (and countries in which productivity is growing fast) tend to export more?

Trade policy could impact growth through other less direct ways. For example, modern technology is embodied in imports of capital and intermediate goods. Thus, one would expect that the openness of an economy to imports is related to its overall productivity, as shown by Coe, Helpman and Hoffmaister (1997). A lot of the sectoral analyses have focused on manufacturing and have shown that trade liberalization may increase productivity through the impact of competition on domestic producers.¹⁹ These findings are supported by firm level evidence that competition from imports leads to increases in technical efficiency but also that increased sectoral productivity results to a significant extent from sectoral rationalization i.e. the shrinking or elimination of inefficient firms.²⁰

The findings regarding the links between openness to imports and productivity, are not unambiguously positive for poverty reduction. If increased productivity results in reduced inputs rather than increased output, the short term effect may be reduction of

employment which could be focused on the poor. In Africa there is evidence that many industrial enterprises have been unable to cope with competition from imports with resulting reductions in employment,²¹ which could have had adverse effects on poverty.

The bulk of the analysis of the links between developing country trade policy and growth has focused on the trade policy regarding manufactures. Much less analysis has been made of the effects of openness in agriculture although this is the sector in which the bulk of the poor find employment and derive their incomes. The reason for this has been twofold. First, there is a continuing fascination with protection of domestic industries to promote industrialization and development, the so-called import substitution paradigm, despite extensive experience showing the limits of import substitution based on 'infant' industry protection. Second, border protection in agriculture accounts for a small proportion of the overall government interventions that affect incomes and output of the sector. Indeed, if one takes all these policies into account, and develops a measure of aggregate support to agriculture (AMS), there is substantial evidence that until recently very many developing countries penalized rather than supported agriculture.

The driving force for such policies in agriculture was the desire of governments to keep food prices low for urban consumers. At the same time, agricultural exports

¹⁷ Michalopoulos and Jay (1973).

¹⁸ Bigsten et. al (2000).

¹⁹ Jonsson and Subramanian (1999).

²⁰ Tybout and Westbrook (1995).

²¹ Lall (1999).

have been taxed as a means for generating revenue. The effect of both policies was to create adverse incentives for production and incomes to the farm sector.

On the other hand it is fair to say that the Green Revolution, which had undeniably positive effects to increasing productivity and incomes to farmers, including the poor, could not have occurred without developing countries being open to the foreign technology and the inputs, frequently imported, that were necessary for the revolution to take hold. Notwithstanding this experience, the links between agricultural trade policy and poverty alleviation are complex and tend to be situation and country specific.

C. Some Indirect Links

Even if increased trade enhances output growth, it is possible that opening up an economy to international trade, increases the volatility of output which in turn results in greater fluctuations of incomes and greater risks that individual households would fall below the poverty line.²² Large income fluctuations can have a devastating effect on poor households in developing countries where safety nets are seriously underdeveloped or completely lacking. However, a number of studies which have explored this issue have not found significant correlation between openness and increased volatility of incomes and outputs. One study has shown that output growth is more unstable in small states, which are generally more open than large ones.²³

Another concern raised by trade liberalization relates to the implications of reduced protection on government revenue. As developing countries depend on trade taxes for a significant share of total revenue, the concern is that reductions in protection will result in reduced revenues which in turn will result in reduced expenditures, some of which would have been directed to social programs or other benefits for the poor.²⁴

The evidence on this issue suggests that these fears are rather exaggerated. First, it appears, that a good deal of trade liberalization can occur which is actually revenue enhancing. This would result from the substitution of tariffs for non-tariff barriers which are still present in many developing countries. Lowering of tariff rates by itself may also not result in reductions in total revenue, if the initial tariff level did not maximize revenues; or if the lowering of the tariff rates is accompanied by reduced exemptions and improvements in collection efficiency — both of which provide a considerable margin in many developing countries. Finally, it is possible — and may well be in the long run interest of countries — to reduce reliance on trade taxes and substitute them with other forms of taxation.

In a number of World Bank supported trade reforms, experience with revenue generation was mixed. In three of five countries examined, the reforms resulted in increased revenues. In the two cases where they did not, the main reason appears to have been that

²² Opening up here is limited to trade and not to the financial sector. The latter raises a variety of other issues which go beyond the scope of this paper.

²³ Easterly and Kraay (2000).

²⁴ McCulloch, Winters and Ciera (2001).

tariffs were lowered but when NTBs were also removed there was no compensatory increase in tariffs, nor an enhanced effort of tariff collection.²⁵

There is considerable evidence that reductions in government expenditures have often resulted in reductions of spending on the poor.²⁶ But there has been no evidence which links reductions of revenues due to trade reform to reductions in aggregate expenditures which have led to cuts in programs that affect the poor.

D. The Present State of Developing Country Trade Policies

While all the debate about developing country policy has been going on, developing countries have in fact significantly liberalized their trade regimes over the last decade. Some of the liberalization was truly autonomous, some induced by pressure from the IMF and the World Bank and some resulted from the WTO Uruguay Round negotiations. The net result has been that average applied tariff rates have come down in most developing countries and averages for various regions have also declined significantly relative to the eighties. The same is true for the incidence of NTBs. One of the issues that has emerged, especially in Africa, has been the concern that trade liberalization has not yielded the hoped for results in growth and poverty reduction; and that, in certain situations, liberalization has destroyed what little industry existed.

Still, despite the liberalization that has occurred, tariff averages

are more than 30 percent in South Asia, and close to 20 percent in Africa and the Middle East. Tariffs are slightly higher in agriculture than in non-agricultural products. In a group of 42 countries accounting for 85 percent of trade of developing countries which were members of the WTO in 1999, average tariffs in agriculture were 21 percent compared to 17 percent on all other products (which includes raw materials, manufactures etc). There is strong evidence that tariffs tend to be higher in low income countries and decline in middle and higher income developing countries. The same tendency appears to be present for NTBs as well.²⁷ On the whole, developing countries appear to have substantially higher tariff protection than developed countries in manufactures and similar levels of tariff protection in agriculture.²⁸

Until very recently, developing country use of contingent protection instruments such as antidumping and safeguards was much smaller than that of developed countries. In the late 1990s, the use of anti-dumping by developing countries increased substantially, and in a number of years the number of antidumping actions initiated by them exceeded the number initiated by developed countries. But the antidumping actions were primarily initiated by a small group of middle and higher income developing countries which, on the whole, have far stronger institutional capacity and are better integrated in world trade than most developing countries.

²⁵ Greenaway and Milner (1991).

²⁶ Wodon, Ayers et al. (2000).

²⁷ Michalopoulos (2001).

²⁸ Keeping in mind of course that in agriculture, border protection is only a small part of aggregate measures of support, with the latter being many times higher in developed countries.

Almost no contingent protection measures have ever been taken by either developed or developing countries against LDCs.²⁹

IV. Trade reform and poverty

Generalizations about the relationship between trade, growth and poverty reduction need to be carefully scrutinized when it comes to give advice on what a particular developing country needs to do with regard to its trade policy at any point in time and what the effect of any specific package of trade reforms will be on the poor. This is because, while a particular trade liberalization, may be beneficial in the longer term and to the economy as a whole, it may also have short term adverse impacts on some sectors of the economy from which some of the poor derive their income. The sustainability of the reforms as well as their impact on reducing long term poverty will depend on a host of policy and institutional factors, which need to be examined before a judgement is reached about the impact of the reforms on the poor.

A useful starting point is to examine what is the impact of the existing trade policies and institutions on the poor. Many developing countries, especially low income ones, continue to protect manufacturing and penalize agriculture, from where most of the poor get their income. And some continue to use NTBs which are likely to yield benefits to the rich. Recent trends in trade suggest that low income countries in Africa and elsewhere (other than China and, to a certain extent, India and South East Asia) should be the focus of concern regarding the

links between trade policy and poverty. These are the countries which have made the least progress in integrating in world trade; and these are the countries in which it has been difficult to make progress in the fight against poverty.

Trade reform changes relative prices of tradeable goods (exports and imports) versus non-tradeables (domestic goods). It may involve the reduction in barriers to imports and/or exports or it may involve changes in the form of protection (from NTBs to tariffs) or in the institutional arrangements for international trade (for example the elimination of a state monopoly for marketing and export). Typically, the benefits from the reform are scattered among many and take time to materialize whereas the costs tend to be more short run and affect specific groups. How such reforms would affect the poor would depend in the first instance on who are the poor and what is the impact of the reforms on their incomes and the prices and availability of the goods they consume. But the impacts would also be significantly affected by other institutions and policies which affect the poor.

Who the poor are varies from country to country, but they are not a homogeneous group anywhere. In low-income countries, most are typically rural, and are either self-employed (small-scale farmers, informal sector) or wage-earners (on other farms or small enterprises). The poorest and least vocal are probably small-scale farmers and rural laborers not connected to the main markets and trying to subsist on marginal lands where they have been

²⁹ Michalopoulos (2001).

pushed by population pressure and other reasons. Both poverty and employment in certain professions or in the production of specific crops is gender specific, with women frequently suffering from less labor mobility and greater poverty.

In the short run, when the levels and productivity of factors are fixed and factors are not mobile between sectors, part of the answer to the question of the impact of trade reform on the poor is obtained by determining the impact on their assets. The main asset of the poor is unskilled labor, though they may possess some skills, small amounts of capital, and land in the case of small-scale farmers. Income from unskilled wages and income inputed from consumption of own production usually are the two largest sources of income for the poor frequently accounting for more than 80 percent of the income of the lower deciles in the income distribution.

The other side of the ledger is obtained by determining the impact of trade reform on the cost of the consumption basket of the poor, i.e., on the purchasing power of their earnings. A large portion of the consumption basket of the poor consists of food and shelter, usually more than 75 percent of the total.

The two effects may move in the opposite direction, with trade reform helping raise the incomes of the poor while raising the prices of some of the things they consume. Typically the income effect would be most important, as trade reform usually affects many prices of consumer products some of which may rise and some of which may fall thus cancelling their overall impact on the poor. At the

same time, the poor typically devote a lot of their consumption to food which in subsistence economies is also their main source of imputed income. Some examples of experience with trade reforms are worth citing:

- In Vietnam, liberalization of previously suppressed rice prices raised farmers incomes through increased exports — while also increasing the cost of food to urban consumers. But because the bulk of the poor were farmers and the initial distribution of income was relatively equal, it can be concluded that the trade reform resulted in pro-poor growth.
- In Mauritius, trade liberalization in the 1980's did not result in contraction of employment in import competing industries, while leading to significant expansion of overall employment, especially of women, in the production of textiles for export.
- In Zimbabwe, trade liberalization in the 1990's resulted in higher levels and lower prices of imports but also increased industrial unemployment and lower real wages with no apparent improvement in poverty — but deficiencies in complementary policies may have played an important role in the failure of the reforms

In some cases, changes of relative prices at the border may have little effect on rural low income households because of their isolation from the cash economy. In others the effect of such changes may not be felt or may be more than fully offset because of weaknesses in other policies and institutions (see below). Thus, it is crucial to check

as to whether the existing pattern of protection/subsidization has an important effect on a particular product(s) consumed by the poor; or impacts positively or negatively on the incomes of a significant number of the poor country-wide or in a particular region. Taxes or supports for important food staples or inputs to agriculture, in particular, should be examined. Similarly, it is important to explore whether the reform is going to destroy existing markets or create new ones through increased competition from imports. And whether it will allow poor consumers to obtain new goods, heretofore unavailable.³⁰ Finally, is the reform likely to affect different household members differently — as different crops have different ‘gender’ identities in some societies?

groups early on, in order to help design arrangements for dealing with the possible adverse impacts of the reform. Thus, the timing of the implementation of trade reforms needs to be closely linked to the establishment of the programs that deal with their impact on the poor.

It may be tempting to consider introducing specific trade restraints, for example tariffs, aimed at helping the producers of particular goods in whose production many poor are employed — for example a particular crop. Experience has shown that such policies often fail to reach their intended objective, however. This is because the bulk of benefits from protection tend to be obtained by large farmers; while the costs in the form of increased prices affect

Box 1. Trade and inequality

There is no evidence that trade openness—defined as the ratio of trade to GDP is associated with less or more income inequality.³¹ At the same time, it is extremely difficult to ascertain whether trade reforms which may result in a net absolute benefit to the poor, will also result in the poor receiving a larger share of total income. Hard as it is to link trade reform to poverty reduction, it is even harder to determine the effect of trade reform on the overall distribution of income. There is evidence that trade liberalization in some cases, particularly in Latin America, has resulted in increased disparities in wages. But overall distribution of income tends to change little over time and is affected by a variety of factors, including most importantly distribution of such assets as land. Nevertheless, it may be important from the social perspective to have some idea, however rough, if a specific set of trade reforms would tend to benefit primarily the non-poor, leaving the poor essentially unaffected, or marginally better off. If such an outcome appears likely, governments may wish to strengthen other policies and programs that are targeted to the poor so as to prevent a worsening of the overall income distribution.

Even if the trade reform adversely affects some groups of the poor in the short run, the judgement may still be made to proceed with the reforms — but it is important to identify such

many, including the poor — and there is always the net loss associated with protection which is not recouped by anyone (the so-called deadweight efficiency loss). Other more targeted programs for

³⁰ Winters (2000).

³¹ World Bank (2003).

helping poor farmers may be more appropriate. At the same time, funding for such programs may not be available. And in some cases protection may be necessary to offset export subsidies provided to farm products by developed countries (see below).

V. Complementary policies and institutions

A. Macro-economic stabilization and the exchange rate

A stable macroeconomic environment and a competitive real exchange rate are necessary for sustainable and effective trade reforms. Trade policies work through changes in relative prices. These are concealed in a regime of high and variable inflation — which itself is likely to hurt the poor. Exchange rate depreciation at the beginning of major trade reforms can help with the adjustment process. Great care must be taken to avoid a real exchange rate *appreciation* at a time of import liberalization. As this is largely determined by macroeconomic policies (monetary and fiscal policies), it is important that the two sets of reforms (macro and trade) are managed to be consistent.

B. Markets

Trade policy reforms work through changing relative prices for products. If markets do not work well, for a variety of reasons — lack of information, structures where producers or buyers have the monopoly, huge transport costs, then there is serious danger that trade policy reforms will not have the desired impact. When markets are not working well — which will often be the case in low income

countries, the question arises as to whether it is necessary to wait until they do before introducing trade reforms. There are no easy answers. International trade promotes competition and the operation of markets. Competition in small economies is more easy to introduce and monopolies easier to break if the economy is open to international trade than, if it is not. That said, it is important to identify critical obstacles to the operation of market signals and try to deal with them:

- *In agriculture*, are prices passed on to farmers, or are there government or private intermediaries which make large profits in the sale of farm products or farm inputs? Price transmission is likely to be problematic for poor people living in remote rural areas and governments need to consider additional interventions to ensure that it occurs. While there is little direct evidence that trade reform *per se* has hurt the poor, some of the biggest problems resulting from liberalization of farm trade in countries like Zambia and Zimbabwe have resulted from the introduction of private monopolies to substitute for government run marketing arrangements.³² But the problem in both cases did not arise from trade reform as such but from the absence of effective supporting policies to ensure competition and provide inputs to poor farmers in backward areas.
- *How do labor markets function* and are there serious impediments of various kinds (legal, cultural, transportation) to labor mobility? Labor market restrictions,

³² OXFAM (1999).

such as prohibitions on firing of workers, often result in an informal labor market sector, with high concentrations of poor. Reduction in the restraints in the labor market, especially combined with trade reform, can result in an expansion of the formal sector. This can have a strong impact on poverty reduction since the poor will move from the informal to the formal sector with the expansion of demand in the formal sector.

- *How do product markets function* and is there sufficient flexibility for private sector initiative? In particular, is there freedom of entry and exit and an effective bankruptcy procedure? Is licensing for establishment of new firms easy, transparent and not subject to corrupt practices?
- *Are there transport obstacles to trade?* High transport costs make it difficult to engage in trade. Landlocked economies that are far away from markets may have little that they can influence, both because of the absence of direct links and the difficulties of establishing transit arrangements; but sometimes there are government policies or institutions that can be modified which would lower transport costs. Within country transport costs may also be very high and result in offsetting any productivity gains at the farm level while raising costs of imported food to remote areas.

C. Trade Related Institutions

Success of trade policy reforms involves a variety of institutions both public and private. On the government side, besides the

Ministry of Trade – which is frequently not a powerful Ministry and is typically less effectively staffed and equipped than other Ministries, an effective and non-corrupt Customs Authority is critical to the success of reforms.

Other institutions to which particular attention needs to be paid in order to ensure that trade reforms benefit the poor include marketing and export finance. Both are necessary for export expansion that may raise the incomes of poor families. In the long run, developing an effective financial system is a key to development. But the poor have special problems in accessing credit in general, and have even greater problems in accessing trade related credit. In order for the poor to benefit, it may be useful to establish organizations such as a co-operatives which can put together large enough shipments from individual producers to supply foreign markets; and to be able to obtain financing linked to their exports — which individual poor farmers can not.

The success of any reform which depends on so many other complementary policies and institutions is bound to be uncertain, as will be its potential impact on the poor. One needs to be especially careful regarding the effects of any reform on the poor as they are least able to bear risks: they may be unwilling to take risks to increase their income, if by doing so they also increase their chances to make losses; because the losses will have dire consequences for their existence — as they do not have the resources, e.g. through savings to permit them to ride over a bad spell.

Keeping this in mind, the best outcomes for the poor can be

expected when, as a result of the overall reform process – of which trade reform is a part, growth accelerates in the economy as a whole. Experience of the impact of trade on employment in the 1980's suggests that there was little discernible impact on displaced workers most of whom found jobs quickly in expanding sectors.³³ But while this may be the case, it is important to explore a number of additional issues which appear to raise concerns especially in low income countries with a small formal sector. For example, is it possible to reduce the uncertainty regarding the introduction of cash crops whose world price fluctuates through market based approaches?³⁴

Last, governments should not refrain from liberalizing trade because somebody will lose in the short term; rather, if the losers are the poor they should assist them – through the establishment of an appropriate safety net. Protecting the poor should be a general objective of public policy and not only associated with trade reform. Thus, governments should implement programs to help the poor, whether trade reforms take place or not. Most analysts recommend the establishment of general safety nets, not ones specifically linked to trade adjustment. Having said that, it is important to recognize that in low income countries safety nets of any kind are often inadequate. Thus, establishing an effective safety net is a priority for all countries. Weakness in safety nets will undermine the success of many reforms, including those related to trade.

Given weaknesses in related policies and institutions which impact on the poor in low income countries, considerable care is needed in the pacing and sequencing of reforms. If a reform is preannounced to be implemented over a few years and it is a *credible* reform, then normal market adjustment and attrition will greatly reduce adjustment costs. However, this may come at the cost of the threat of reversal of the trade reforms, as entrenched interests will be granted time to mobilize opposition. Broad trade reforms frequently meet with less political resistance than cuts in protection to individual sectors, since they help the winners from reform, for example, export oriented industries, recognize their potential gains, and tend to reduce the costs even for industries that lose protection on their output. Given the damage non-tariff barriers are likely to cause to the economy as a whole and to the poor in particular, barriers such as those involving licensing and quantitative restrictions, should be tackled earlier rather than later. And tariff reform often needs to take place in the context of overall reform of the revenue system to ensure that it does not result in weakening overall revenue performance – which in turn takes time to implement.

VI. Developed country trade policies

Restrictions in the access of developing country exports to developed country markets and other distortions introduced by

³³ Papageorgiou et. al. (1990).

³⁴ Claessens and Duncan (1993).

developed country policies, especially in agriculture, hinder development and undermine efforts to reduce poverty. While developed country tariff protection of manufactures has declined to very low levels in general (1–2 percent), there are still pockets of protection which affect adversely incomes and employment of the poor in developing countries as they are typically concentrated on labor intensive products, in which developing countries tend to have a comparative advantage.

In Canada and the US tariff peaks are concentrated in agriculture, textiles and clothing; in the EU and Japan in agriculture, food processing and footwear. Canada, the EU and the US, in keeping with the letter but not the spirit of the Uruguay Round Agreement on Textiles and Clothing, have not phased out most quotas on textile and clothing trade. It has been estimated that the continued restrictions on textile and clothing trade by developed countries have cost the creation of more than 20 million jobs in developing countries, many of which would have permitted working families to get out of poverty.

Preferential trading schemes such as the Generalized System of Preferences offer limited benefits. They typically exclude ‘sensitive’ products, which are often the very products of export interest to developing countries; and their utilization rates are low partly due to restrictive rules of origin or environmental or technical and phytosanitary standards. More

recent initiatives, such as the EU ‘Everything but Arms’ (EBA) scheme that offers quota and tariff free market access to LDCs imports, is more promising by providing greater product coverage. It remains to be seen as to how much it will be utilized.

Restrictions to developed country market access resulting from the imposition of a variety of new sanitary and phytosanitary as well as technical barriers to trade are growing in importance. They have become a serious overall hindrance to developing country trade since many low income developing countries do not have the institutional capacity or can shoulder the costs for meeting new and complex requirements.

In agriculture, where roughly three quarters of the poor live, the problems of market access are compounded by developed country support policies and export subsidies. In 2001, OECD countries provided overall support to their farmers of more than USD 300 billion. The effect of some of these policies is to reduce food prices in the short term, with temporary benefits to poor consumers in developing countries. But their long term effect on developing country agriculture and on the worldwide efforts to reduce poverty is devastating. The example of the impact of OECD policies on cotton presented in the box below is only one of many horror stories of the effects of OECD agriculture supports on the poor worldwide.

Box 2. Cotton

In Benin, Burkina Faso, Chad, Mali and Togo, all of which are LDCs, cotton growing and trading is an important part of the economy, accounting on average for 10 percent of GDP and 30 percent of exports and involving 10 million people. Perhaps as many as 1 million of the farmers and the families they support are extremely poor, with land holdings of less than 5 acres and per capita income of less than USD 1 a day.

Production of good quality cotton is relatively efficient, with costs frequently less than 50 percent of those in developed countries. In 2001, supports to cotton farming by the US and the EU amounted to USD 5 billion, or slightly less than the value of world cotton exports for that year. Of these by far the largest support was provided by the US — which is planning to increase it in 2003 to USD 3.7 billion. But the greatest percent support was offered by the EU to Spanish cotton growers, amounting to 180 percent of the world price. The effect of these domestic supports as well as export subsidies was to substantially reduce the exports and incomes of the five LDCs and cost an estimated USD 1 billion in foregone income directly or indirectly. Most of these costs were borne by the very poor farmers engaged in cotton production in these countries. In the US, it is estimated that 50 percent of the benefits from cotton supports went to farmers holding 1000 acres or more.³⁵

VII. Conclusions and recommendations

The link between developing country trade policies and growth has been controversial and led to numerous studies and polemics. On balance, the weight of evidence suggests a generally positive long term link between a liberal trade policy and growth. Since growth is good for poverty alleviation, one may conclude that, again generally speaking, a more open trade regime, especially one which does not penalize exports, is likely to be better for growth and poverty reduction, than a closed one. And, as existing patterns of protection in all countries, developed and developing alike, tend to serve particular special interest groups, rather than the poor, reforms that tend to liberalize trade, especially through the elimination of non-tariff barriers, are likely to be supportive of long term poverty alleviation.

However, these generalizations have to be examined with great care when specific recommendations are made to individual countries to liberalize their trade regime. This is both because of the need to identify the specific impact of particular reforms on groups of the poor; and because of the need for a variety of supportive institutions as well as complementary policies to be in place to ensure that trade reforms are both sustainable and beneficial to the poor. Social impact assessments of proposed trade reforms need to be undertaken in advance of the reforms.

Low income countries which may need to introduce trade reforms and which have made the least progress in reducing poverty, typically do not have the institutional capacity either to ensure the sustainability of the reforms or to maximize the benefits and minimize the costs of the reforms on the poor. Given the uncertainty

³⁵ WTO (2003).

associated with any reforms and the narrow margins on which the poor survive, safety net arrangements and other mechanisms that reduce the risks to the poor are of great significance. In addition, great care is needed in the pacing and sequencing of reforms.

The international community has important responsibilities in providing both the support needed to ensure that reforms help the poor; and in pursuing trade policies that promote poverty alleviation.

In the sphere of assistance, priority should be given to the provision of financial and technical assistance to strengthen trade-related capacity of the low income developing countries as part of an overall poverty reduction strategy.

In the sphere of trade policy, the on-going multilateral trade negotiations in the WTO Doha Round offer great opportunities for developed countries to take steps that are beneficial to long term poverty reduction, especially in agriculture, on which most of the poor depend for their income.

These include:

- In agriculture: (a) elimination of developed country export subsidies and credits and reduction of tariff barriers and domestic support for

products of export interest to developing countries; (b) establishment of a special safeguard mechanism that permits developing countries to protect their agriculture against surges of imports that could hurt small farmers and the rural poor; (c) ensuring that developing country supports to small farmers and the rural poor, such as through the establishment of co-operatives, product diversification schemes, insurance against price fluctuations, supports to offset transport disadvantages etc, are not constrained by overall restrictions on aggregate measures of support to agriculture.

- In manufactures, further liberalization through the elimination of tariff peaks on developing country exports of labor intensive products such as textiles, clothing and shoes.

Estimates suggest that a ‘pro-poor’ Doha Round that cuts tariff peaks and averages in both developed and developing countries could increase global income by as much as USD 520 billion and could lift an additional 144 million people out of poverty by 2015, thus making a significant contribution to the attainment of the Millennium Development Goals.³⁶

³⁶ World Bank (2003).

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