Trade and Poverty in the Poor Countries

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While freer trade, or "openness" in trade, is now widely regarded as economically benign, in the sense that it increases the size of the pie,[1] the recent anti-globalization critics have suggested that it is *socially malign* on several dimensions, among them the question of poverty.[2]

Their contention is that trade accentuates, not ameliorates, and that it deepens, not diminishes, poverty in both the rich and the poor countries. The theoretical and empirical analysis of the impact of freer trade on poverty in the rich and in the poor countries is not symmetric, of course. We focus here only on the latter. In doing so, we distinguish between two different strands of argumentation: static and dynamic.

I. Static Arguments

The central effect on poverty is assumed to come from the effects on real wages of the unskilled workers, endowed with labor but no human or financial capital. The natural presumption following the Stolper-Samuelson argumentation, would be that, if anything, freer trade should help in the reduction of poverty in the poor countries which use their comparative advantage to export labor-intensive goods. This, in fact, is the central message of Anne Krueger's (1983) findings from a multi-country project on the subject of the effects of trade on wages and employment in developing countries.

Another approach also suggests that trade is beneficial for poverty reduction in the developing countries. Much empirical evidence suggests that inflation hurts the poor in these countries. It is equally clear that, if a country wishes to maintain an export-promoting, as distinct from an import-substituting, strategy (so that it is generally speaking opting for freer trade), then it will have to maintain macroeconomic stability. Thus, such macroeconomic stability must be regarded as endogenous to the policy choice in favor of freer trade.[3] Therefore, commitment to an outward-oriented trade policy indirectly assists the poor since they are vulnerable to inflation.

II. Dynamic Arguments

The more direct and salient analysis of the problem, however, has been in the growth context. Here, the central argument has proceeded in two steps: trade promotes growth; and growth reduces poverty.

In regard to the former, there are ample precedents for this hypothesis. Thus, Dennis Robertson (1940) long ago characterized trade as an "engine of growth." In regard to the latter, one could go back to Adam Smith (1776 [1937 p. 81]), who argued that when society is "advancing to the further acquisition . . . the condition of the labouring poor, of the great body of the people, seems to be the happiest." In modern times, the favorable link between growth and

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[1] The most prominent skeptic on this question is Dani Rodrik. We have controverted his arguments, at least to our satisfaction, in Srinivasan and Bhagwati (2001).

[2] The social issues and agenda include the impact on gender questions, on democracy, on labor rights or standards, and on culture (see Bhagwati, 2002).

[3] We believe that this is the correct causal way to regard the link between macroeconomic stability and trade performance: there are several cases of macroeconomic stability and absence of a policy of outward orientation, such as the Communist countries and India, but none of successful outward orientation and absence of macroeconomic stability. For an early statement of this view (and an argument that one of the reasons why outward orientation is usually better in overall economic performance than lack of it is due to the macroeconomic stability that it requires), see Bhagwati (1978). We thus reject the argument recently advanced by Rodrik that it is macroeconomic stability, not outward orientation, that matters in better performance; not merely does he ignore the fact that the link has already been discussed in the literature on trade strategy, but we believe he also gets causality wrong.

poverty has been the underpinning of the Indian planning efforts that began as far back as the mid-1950's.[4]

As one can readily imagine, it is easy to write down models which refute each of the foregoing two hypotheses; and in fact there is no dearth of such models. The real question then, as always but even more tellingly here, is which models get at the reality. Here, we would argue that the empirical evidence is more persuasively in support of the two propositions we have just stated. We therefore consider first the theoretical arguments and then the empirical evidence.

A. *Theoretical Possibilities*

Theoretical models of the effects of trade and growth, whether in steady state (i.e., long-run) or out (i.e., short-term), lead to different possibilities. Thus, in the Harrod-Domar model, if labor remains slack permanently and trade affects only efficiency in the use of resources, the growth rate will be permanently enhanced because of the lasting decline in the marginal capital–output ratio. On the other hand, in the Robert Solow (1956) economy, trade has no permanent effect, and the steady-state growth is independent of it. For an analysis of how trade policy works in different models of exogenous and endogenous growth, see Srinivasan and Bhagwati (2001).

Generally speaking, the effects of trade policy on growth must proceed through links between trade and the two "fundamentals": accumulation and innovation (in the use and productivity of resources). There are several reasons to think that trade will affect both favorably. Thus, the increased variety of inputs available from trade will enable an economy to get around constraints placed on access to such variety under protection, when absence of scale economies can reduce the available variety from domestic production alone. Then again, high protection is likely to constrain the marginal efficiency of capital by confining sales to domestic markets compared to open economies where the world defines the market, thereby reducing the rate of investment.[5]

As for the effect of growth on poverty, again different models are possible. If labor is in elastic supply to the growing areas, as in the Arthur Lewis models, then growth will pull more of the reserve army of labor into gainful employment. If growth is modeled in a way such that it does not affect a segmented pool of the poor, as in tribal areas that are not linked to the mainstream or in inner cities which are structurally delinked from the main city where growth is occurring, then growth will pass the poor by. Growth may even immiserize the poor further as when the poor are working tiny plots of land to produce farm products whose prices fall because of the larger farms implementing the Green Revolution.

B. *Trade, Growth, and Poverty: Empirical Evidence*

Regarding trade and growth, the best evidence is to be found in the detailed country studies pioneered by the OECD project directed by Ian Little et al. (1970) and the National Bureau of Economic Research (NBER) project directed by Bhagwati and Krueger. The recent reliance on cross-country regressions, by contrast, produces mixed evidence in both directions: for example, Jeffrey D. Sachs and Andrew Warner (1995) and Jeffrey Frankel and David Romer (1999) are on the positive side, and Anne Harrison (1996)[6] and Francisco Rodriguez and Rodrik (1999) are skeptical, the latter even leaning to being opposed. However, as we have argued in Srinivasan and Bhagwati (2001), in riposte to the criticisms from Rodrik, the cross-country regressions are a poor way to approach this question. The choice of period, of the sample, and of proxies, will often imply many effective degrees of freedom where one might almost get what one wants if one tries hard enough!

[4] The link between growth and poverty reduction can be found in the writings of many of India's leaders such as Jawaharlal Nehru. But the precise argument that rapid growth was the *principal* (though not an exclusive) way of targeting poverty among the bottom three deciles, and assuring them a "minimum" standard of living, was a result of the work by one of us (Bhagwati) in 1961–1962 in the Indian Planning Commission (see Bhagwati, 1988, 2000a).

[5] This argument, explaining the contrasting rates of accumulation and hence growth rates in East Asia and in India, is developed at length in Bhagwati (2000b).

[6] Harrison has a detailed tabulation of, and useful commentary on, the empirical studies up to 1996.

Nonetheless, it is interesting that practically no country that has been close to autarkic has managed to sustain a high growth performance over a sustained period. Furthermore, the work of David Dollar and Aart Kraay (2002) notes that, if one classifies countries into globalizers and nonglobalizers by reference to their relative performance in raising the trade share in GNP during 1977–1997, the former group has shown higher growth rates. Failure, like success, has many fathers, and no one cause will ever explain big outcomes like growth. Nonetheless, the many reasons why autarky would put a country behind make these empirical observations quite salient.[7]

The evidence on growth and poverty is best approached through focus on the two countries: China and India. The vast majority of the world's poor live in the rural areas of these two countries. Both countries achieved significant reductions in poverty during 1980–2000 when they grew rapidly. According to World Bank (2000 table 4-2) estimates, real GDP grew at an annual average rate of 10 percent in China and 6 percent in India during these two decades. No country in the world had as rapid growth as China, and fewer than ten countries exceeded the Indian growth rate. The effect on reduction in poverty in both countries was dramatic, entirely in keeping with the "Bhagwati hypothesis" of the early 1960's that growth is a principal driver of poverty reduction. Thus, according to the Asian Development Bank (2000 table 3-1) estimates, the incidence of poverty in China, by standard measures, declined from 28 percent in 1978 to 9 percent in 1998. By the Government of India's (2000 table 5) estimates, poverty incidence fell from 51 percent in 1977–1978 to 27 percent in 1999–2000.[8]

It is also relevant that these were also the decades in which both China and India increased their integration into the world economy. In fact, in the previous three decades (1950–1980) India's autarkic policies alongside other damaging policies (such as extreme interventionism and controls and proliferation of an inefficient public sector in economic activity well beyond utilities)[9] were associated with an annual growth rate of only 3.5 percent, with the natural consequence that the incidence of poverty fluctuated around 55 percent with no declining trend.

Obviously, the experience of the two giant economies of China and India in achieving faster growth and reduction in poverty through greater integration into the world economy, treating such integration as an opportunity rather than as a threat, is salutory. According to Dollar (2001), other economies such as Vietnam and Uganda have had similar experiences. Indeed, Dollar (2001 p. 17) argues that the only developing countries that have registered significant declines in poverty are those that also have integrated faster into the world economy on the dimensions of trade and direct investment. The opponents of trade who allege that it accentuates or bypasses poverty are therefore not credible.[10]

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[7] Rodrik has suggested that such associations prove little, since growth may have led to trade, rather than the other way around. The sophisticated in-depth country studies at the OECD and the NBER, however, suggest that trade did matter causally. There are also good reasons to believe that the outward-orientation of the Far Eastern strategy, which led to the Asian miracle, was critical in the story, as developed in Bhagwati (2000b).

[8] A commonly used indicator of poverty is the headcount ratio (i.e., the proportion of the population with monthly consumption expenditure or income per head below a poverty-line expenditure. Angus Deaton (2001) finds that this ratio registered a significant decline in 1999–2000 compared to 1977–1978.

[9] The full range of inefficient policies, going well beyond the lack of outward orientation in trade and direct foreign investment, was discussed in the early work of Bhagwati and Padma Desai (1970) and Bhagwati and Srinivasan (1975). An overview is provided also in Bhagwati (1993) and Srinivasan (2000), among several contributions to the analysis of Indian economic policy failings.

[10] We have not considered here the management of trade liberalization to get to freer trade. A valuable analysis of this problem, to ensure that the poor are not harmed, is provided by Neil McCulloch et al. (2001).

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