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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 pie¹, 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, 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 therefore only on the latter. But in doing so, we distinguish between two different strands of argumentation: static and dynamic. In the former case, we treat the resources and technology to be given and then ask: how does freer trade affect poverty in this static framework. In the latter case, we admit growth effects that impact on the state of poverty over time.

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.

Much recent work, based on a variety of different models, has chiefly explored the effects of liberalization in intra-industry trade (which bypasses most poor countries and hence is pertinent to our discussion only insofar as the developing countries have a significant modern sector in trade³) and alternatively of outsourcing from the North to the South (which does affect our discussion more generally). The main research along the latter lines is by Feenstra and Hanson (1996) (1999) and their work finds that the real wages of skilled labour has risen relative to that of unskilled workers from such outsourcing in both sets of countries; but this is consistent with the fact that the real wage of unskilled labour rises as well (a phenomenon that is seen notably in their work on the absolute real wage effects in the US of outsourcing in the United States over two recent decades).⁴

But yet 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.

Now, 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 the policy choice in favor of freer trade.⁵ 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 has been, however, 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 Sir Dennis Robertson (1940) long ago characterised trade as an “engine of growth”. In regard to the latter, one could go back to Adam Smith (1937, p.81) who stated that: “It is in the progressive state, while the society is advancing to the further acquisition, rather than when it has acquired its full complement of riches, that the condition of the labouring poor, of the great body of the people, seems to be the happiest and the most comfortable. It is hard in the stationary, and miserable in the declining state.”

And, in modern times, the favorable link between growth and poverty has been the underpinning of the Indian planning efforts that began as far back as the mid-1950s. Contrary to what many economists and policy institutions assert today, the removal of poverty was the objective, growth the policy instrument.⁶ That growth should be the principal, not the exclusive, strategy to remedy poverty, became a more salient and precise notion, however, when one of us (Bhagwati) was asked by the great Indian planner, Pitambar Pant, in 1961 to look into how the bottom three deciles in income distribution could be assured a minimum standard of living, he examined the available income distributions for different countries with diverse economic and political systems and came to the hypothesis and prescription that there seemed to be no compelling and systematic differences and hence the most sensible strategy was to grow the pie.⁷

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

1. 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 several 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, if we turn to the Solow (1956) economy, trade has no permanent effect and the steady state growth is independent of it. For details on how different current models of exogenous and endogenous growth are affected by trade policy, the reader can consult Srinivasan and Bhagwati (2001).

But let us say here that, 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 incentive and hence the rate of investment.⁸

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 where it does not affect a segmented pool of the poor, as in tribal areas that are not linked to the mainstream or inner cities which are structurally delinked from the main city where growth is occurring, then growth will pass the poor by. And 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. This is the case where the Green Revolution (and growth thanks to it) produces poverty and may bring about the Red revolution: a nightmare of the growth proponents and a dream of the revolutionaries!

2. 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, Maurice Scott and Tibor Scitovsky and the NBER project directed by Bhagwati and Krueger. The recent reliance on cross-country regressions, by contrast, produces mixed evidence in both directions: e.g. Sachs and Warner (1995), Frenkel and Romer (1999) are on the positive side, and Harrison (1996)⁹ and Rodriguez and Rodrik (1999) are skeptical, the latter even leaning to being opposed. But then, 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!

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. So does the work of David Dollar and Aart Kray (2001) which notes that, if one classifies countries into globalizers and non-globalizers by reference to their relative performance in raising the trade share in GNP in 1977-1997, the former group has also shown higher growth rates. Failure, like success, has many fathers: and no one cause will ever explain big outcomes as on growth. But the many reasons why an autarky would put a country behind, which we briefly noted earlier, make these empirical observations quite salient.¹⁰

The evidence on growth and poverty is perhaps best approached also through detailed focus on the two countries that have huge comparative advantage in poverty: China and India. Indeed, a vast majority of the world's poor live in the rural areas of China and India. 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% in China and 6% in India during these two decades. No country in the world had as rapid growth as China whereas 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 1960s that growth is a principal driver of reduced poverty. Thus, according to the Asian Development Bank (2000, Table 3-1) estimates, the incidence of poverty, by agreed measures, declined from 28% in 1978 to 9% in 1998 in China. By the Government of India's (2000, Table 5) estimates, poverty incidence fell from 51% in 1977-78 to 27% in 1999-2000.¹¹

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, the autarkic policies alongside other damaging policies such as extreme interventionism and controls as also proliferation of an inefficient public sector in economic activity well beyond utilities¹², India's annual growth rate was only 3.5% , with the natural consequence that the incidence of poverty fluctuated around 55% 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 salutary. Other economies also have had similar experiences. Thus, Dollar (2001) cites the examples of Vietnam and Uganda: in Vietnam, a ten-year experience with greater global integration has been associated with an estimated decline in poverty rate from 75% to 37%! Indeed, Dollar (2001, p.17) argues that the only developing countries which 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. It is hard therefore to concur with the many critics of freer trade (and direct foreign investment) that see the heavy hand of such globalization casting its evil spell on the poor of the poor countries. The empirical truth seems to be exactly the opposite.¹³

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Footnotes

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¹ The most prominent skeptic on this question is Dani Rodrik. But 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 labour rights or standards, on culture et.al. See the forthcoming book examining these issues, and concluding optimistically, by Bhagwati (2003), plus an early and incomplete statement of the arguments in Bhagwati (2002).

³ See, for example, the forthcoming paper by Beaulieu, Benarroch and Gaisford (2001) which uses a model of intra-industry trade to show why skilled labor benefits in both developing and developed countries.

⁴ While these authors concentrate on wage inequality, the effect on the absolute real wages of the unskilled (or “nonproduction”) workers is what we need for the argument in the text. The latter is what Feenstra has calculated, on request, from the estimates in the Feenstra-Hanson (1999) article. Feenstra’s (2001) important recent volume for the NBER on trade and wages also focuses on wage ratio between skilled and unskilled workers rather than on the absolute real wages of the unskilled. This distinction needs to be sharply kept in view, of course, as the change in the ratio can be adverse to unskilled workers whereas the absolute real wages of unskilled workers may rise nonetheless. Bhagwati and Arvind Panagariya (2002) are writing a substantial review of the different analytical approaches to, and the empirical evidence on, the latter issue for the Journal of Economic Literature.

⁵ 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’s (1978) synthesis volume for the Bhagwati-Krueger NBER project in the 1970s on trade strategy in several major developing countries. All this serves also to counter the argument recently advanced by Dani Rodrik that it is macroeconomic stability that

matters, not outward orientation, in better performance; not merely does he ignore the fact that the link has already been discussed in the literature on trade strategy but he also gets causality wrong, we believe.

⁶ The assertions that growth was the objective in early developmental efforts is unsupported by facts, as we have noted in several articles and lectures in the last two decades.

⁷ This “Bhagwati hypothesis” did not imply that better access by the poor to the growth process, through land reforms, improved access to credit, as also direct expenditures on education and health, were not to be deployed to enhance the effects of the growth process which remained the principal way of assaulting poverty in India. The recent statistical findings of David Dollar and his associates at the World Bank across several nations only corroborate this hypothesis developed almost four decades ago. See the fuller discussion of these issues in Bhagwati’s (1988) Sarabhai Memorial Lecture on Poverty and Public Policy.

⁸ This argument, explaining the contrasting rates of accumulation and hence growth rates in East Asia and in India, is developed at length in Bhagwati (1998). Indian industrialization was constrained, because of effective autarky, to the inevitably slow rate at which agriculture developed and increased incomes that would absorb the industrial products domestically. The productivity of the Far Eastern investment in turn was also aided by the fact that the export earnings associated with the strategy also enabled the importation of technology-embodied capital goods which, in turn, enjoyed high productivity due to high literacy.

⁹ Harrison has a detailed tabulation of, and useful commentary on, the empirical studies up to 1996.

¹⁰ Rodrik has suggested that such associations prove little since growth may have led to trade, rather than the other way around. This is true enough but not really worrying, as it happens. The sophisticated in-depth studies suggest that trade did matter causally. And there are 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 (1998). Besides, in the absence of trade, the growth (even if exogenous to trade in the sense that trade-led growth is endogenous to it) would likely not have been sustained.

¹¹ A commonly used indicator of poverty is the head-count ratio, i.e. the proportion of population with monthly consumption expenditure or income per head below a poverty line. In India this ratio is estimated from a national sample survey of consumption expenditures of households. The design of the survey for 1999-2000 was not comparable to surveys of earlier years. However Deaton (2001) finds, after adjusting for non-comparability, the poverty ratio in 1999-2000 to be higher, at 30% compared to the Indian

government's unadjusted estimate of 27%. Even this higher estimate shows a large decline compared to 1977-78.

¹² 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 Desai (1970) for the OECD project of Little et.al. (1970), and has been treated from different angles later also in Bhagwati and Srinivasan (1978) for the NBER project of Bhagwati and Krueger. A short overview is provided also in Bhagwati's (1999) Radhakrishnan Lectures and Srinivasan (2000) among several contributions to the analysis of Indian economic policy failings.

¹³ We have not considered here the management of trade liberalization, to get to freer trade. Thus, nothing requires that, faced with high trade barriers, a country's tariff reforms must be on a shock-therapy path: the optimum speed of reforms is by no means the maximal speed. A most helpful analysis of how trade liberalization must be institutionally managed to ensure that the poor are not hurt in the process, is provided by McCulloch et al (2001).