

Trade Liberalisation, Economic Growth and Poverty Reduction Strategies

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Executive Summary

This paper reviews the debates over the relationships between trade regimes, economic growth and poverty reduction. The theoretical positions on these relationships are reviewed as well as the empirical tests of the relationships. It is concluded that, based on the empirical evidence to date, trade liberalisation appears to have a positive impact on growth; although the impact seems to depend on the existence of important economic institutions and complementary policies. Also, there remain questions about the direction of causality between trade openness and economic growth.

It is also concluded that there is strong evidence that economic growth reduces absolute poverty. However, the relationship between economic growth and income inequality (relative poverty) remains ambiguous.

There is neither theoretical nor empirical support for a positive causal relationship between trade liberalisation and reductions in absolute poverty. However, it is argued that trying to design trade liberalisation strategies with the aim of reducing absolute poverty is not a sensible policy objective. Rather, designing a trade liberalisation program and establishing the conditions for poor people to maximise their participation in economic growth should be separate, but complementary, objectives.

A conceptual framework is suggested which can be used to aid the design of trade liberalisation reforms on a country-specific basis that recognises the need for the necessary complementary institutions and policies. The framework also provides a checklist for removing obstacles to the poor participating in whatever economic growth does take place.

Introduction

The widely-accepted view among economists is that, with other things the same, countries with few restrictions on trade will have faster economic growth than countries that heavily restrict trade, and that absolute poverty will be reduced more quickly with faster economic growth. It follows that countries are encouraged to reduce trade barriers in order to reduce absolute poverty. Trade liberalisation is seen as leading to faster economic growth because it reduces distortions in price relativities and allows those activities with a comparative advantage to develop. Poor countries usually have high ratios of labour to land and labour to capital and thus have a comparative advantage in labour-intensive activities. Development of labour-intensive activities in these countries provides income-generating employment for larger numbers of poor people than trade-restricting policies that distort relative prices in favour of capital-intensive activities. But even poor countries with a high ratio of land (or natural resources, more generally) to labour will find that removal of trade barriers that favour capital-intensive industry development will see increased employment of the low-skilled labour.

The logic of this argument appears quite straightforward if one understands and accepts the theory of comparative advantage. Why then is there so much resistance to trade liberalisation policies—not only from ‘anti-globalisation’ demonstrators but also from within the economics profession? Resistance comes in part from those who lose as the result of the removal of trade barriers. Removal of trade barriers leads to a decline in the value of assets of protected industries and to the loss of jobs in those industries. Therefore, both labour and capital in protected industries will join forces to protest against reductions in trade barriers.

But debate over the benefits of trade liberalisation for poverty reduction also arises between economists. Differences exist over the impact of trade liberalisation on economic growth and over the relationship between economic growth and reductions in poverty. This paper reviews these debates and examines whether it is possible to design trade liberalisation strategies that will lead to faster economic growth and reductions in absolute poverty.

The review shows that trade reform is difficult to implement and sustain and that the trade liberalisation strategy adopted should be carefully tailored to the circumstances of the particular country in order to achieve faster growth. Complementary policy reforms and new or improved institutions may often be necessary and the sequencing of these various reforms can be critical. It is contended that a trade liberalisation strategy should not be thought of as a policy to reduce absolute poverty. Rather, trade liberalisation strategies should be designed so as to achieve trade liberalisation in the most effective way and to minimise adjustment costs. The poverty reduction strategy should be separate and should focus on identifying and removing obstacles to the poor participating in economic activities. In this way the impact of trade liberalisation on economic growth and the reduction of absolute poverty as the result of growth should both be maximised. Income and food security for labour displaced by the trade liberalisation should also be treated as a separate objective and handled with a separate policy instrument. Although, as recognised later, the capacity of poor countries to redistribute income is limited.

A. The Relationship between Trade Liberalisation and Economic Growth

Broadly there have been three phases in thinking about the relationship between the trade policy regime of a country and its rate of economic growth: neoclassical, endogenous growth and the institutional approach (see Appendix 1 for a review of the literature). In the neoclassical approach, trade patterns among countries are determined by comparative advantage, i.e., where each country maximises its welfare by concentrating on the activities in which it is most economically efficient. The gains from trade may be static—such as improvements in the allocative efficiency of resources use—or dynamic—such as imported technology or “learning-by-doing” effects. But generally, in the neoclassical theory, trade liberalisation does not lead to a long-run increase in the rate of growth, only to an increase in the level of income (see Appendix1).

The endogenous growth approach found reasons for trade policy to have impacts on both the level of income and the long-run rate of growth of an economy through scale, allocation, spillover, and redundancy effects. Scale effects are assumed to be derived

from the closer integration of the country with the world market, while allocative effects arise from the resource reallocation leading to the accumulation of factors of production such as human or physical capital or R&D. For developing countries, protection that denies access to imported capital goods embodying improved technology is thought to be a particularly growth-inhibiting factor. The spillover effect is a related effect with trade leading to the diffusion of new knowledge. Similarly, open trade leads to the reduction of unnecessary duplication of research, eliminating redundancy in R&D.

While the impact of institutions has not, as yet, been incorporated into economic growth theory, the recent surge of interest in the basic economic institutions believed to be so important for the effective operation of a market economy has led economists to focus on the role of institutions in the process of economic reform. Without law and order, well-defined property rights (particularly over land), and impartially-enforced contracts, economic activity will be highly constrained. Non-democratic political systems such as in China or in Suharto-led Indonesia, can provide the necessary security of property rights and credibility of enforcement of contracts as a sufficient basis for rapid economic growth, just as in a democracy. However, as seen recently in Indonesia, a regime change in a dictatorship may lead to a breakdown of these institutions, which is less likely in a stable democracy. Establishment of these basic institutions has been very difficult in some transition economies such as Russia; in others, such as with the adoption of land use rights for farmers in Vietnam, it has been spectacularly successful. If these basic institutions are not in place, then the expected positive response to trade reform may not appear.

But privatisation of an economy and opening up to external trade may not have the expected growth effects if trade within the country is not free. Therefore, ensuring effective competition through government regulation of markets is another important institution. The role of the government in the economy is increasingly being seen as a facilitator of commerce, rather than being involved in economic activities itself. In this role its job is to lower the costs of transformation and exchange.

Investors' response to trade reform measures will also be affected by the credibility of government policies. Hence, establishment of a stable macro-economic situation through good fiscal and monetary policy is seen as essential to attract investment in response to economic reform programs. If the government's policies are seen as unsustainable, or there has been substantial political and policy instability in the past, investors will be reluctant to respond.

Establishment of these basic institutions necessary for good economic growth may take a long time. Recent writings also make the point that institutions appropriate to one socio-economic situation may not be appropriate for a culturally and economically different situation. These concerns are reflected in the emphasis on the country-specific design of economic reform programs.

B. Design of Trade Liberalisation and Poverty Reduction Strategies

Hoekman *et al* (2001) of the World Bank set out what they see as the important issues to take account of in implementing trade liberalisation as part of a strategy for alleviating poverty, especially in least developed countries. Whether intended or not, there is a presumption that trade policy can be designed to deliver economic growth in a way that benefits those living in poverty. Any such presumption is not justified by the existing state of knowledge. We have seen from the literature review (Appendix 1) that there is an empirical association between trade liberalisation and economic growth, but the direction of causality is not agreed. Indeed, Rodriguez and Rodrik (2000) argue that export performance and economic growth may be jointly determined by the strength of a country's institutions. Moreover, there is no evidence that adoption of particular trade reform strategies leads to particular forms of economic growth. Further, while it is generally agreed that there is also an empirical association between economic growth and reduction in absolute poverty, there is no agreement about how to generate economic growth so that it favours the poor. However, as mentioned later, there is agreement about the types of economic growth that disadvantage the poor.

The following appears to be a statement which would find fairly wide agreement: (i) an open trading regime is a component of a package of policies that should lead to robust economic growth; (ii) however, complementary institutions and policies will usually need to be in place for any trade liberalisation to be effective; (iii) the design of these policies and institutions should be made specifically for each country; and (iv) given robust and sustained growth, absolute poverty will fall.

Further, given the state of knowledge about the relationships between trade liberalisation, growth, and absolute poverty, it appears sensible to follow Tinbergen's Rule (one policy instrument for each policy goal) and treat economic growth and absolute poverty reduction as two distinct goals. Therefore, we need two policy instruments for the two goals. Trade reform can be thought of as part of a growth policy package. Another policy instrument is therefore needed for meeting poverty reduction objectives. Government welfare policy is the standard policy instrument for this goal.

However, given their relatively small taxation base, welfare policies only ever play a minor role in poor countries. The reason that people are poor is that they do not have control over sufficient income-earning assets (defined in a broad sense as land, education, health, and access to credit) to generate a high enough level of income. Therefore, the key policy issue for absolute poverty reduction is to identify and remove the constraints to the poor gaining control over these assets. This will allow them to participate in economic activities and in any growth that does take place. Identifying the constraints to poor people participating in the growth process should be the number one priority of poverty analysis (Duncan and Pollard 2002).

Duncan and Pollard (2002) set out a conceptual framework in which to think about the actions that may need to be taken to maximise the chances that trade liberalisation will lead to economic growth and to ensure that the poor will be able to participate in any economic growth (see diagram below). The figure is designed to be read from the bottom up. The implication is that in prioritising interventions in support of poverty reduction, we have to identify where, along the path from civil and social order to poverty

reduction, the constraints lie to effective participation of people in the growth process. The idea is that these constraints should be tackled from the bottom up. However, it is recognised (see later) that some changes/reforms will take a long time, and the questions arise as to what may be possible in the short run and what may be done to speed up the process of change?

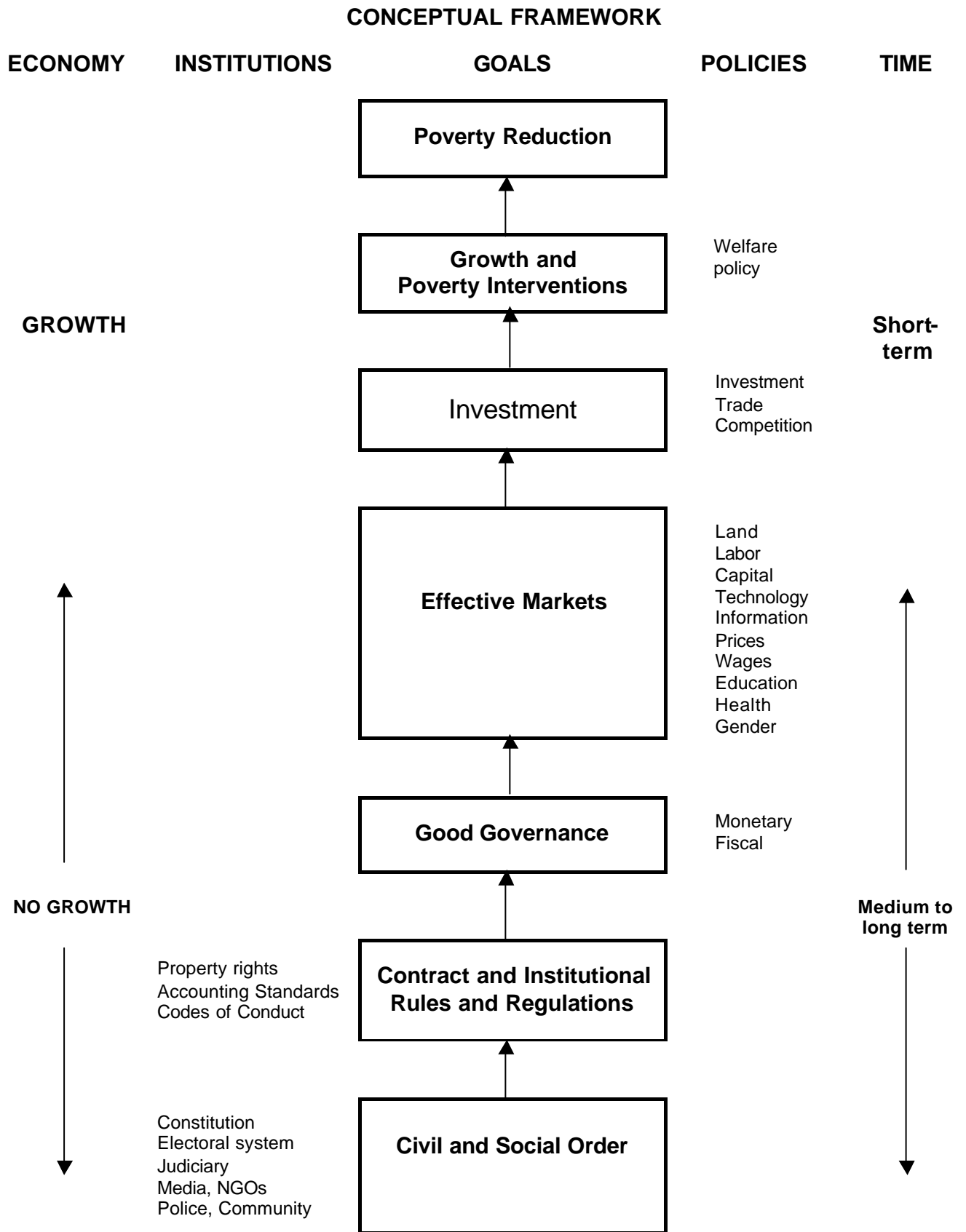
To the immediate left of the central boxes (goals) are listed the institutions that have to be in place for the particular goal to be achieved. To the immediate right are policies that can be carried out effectively when the goal has been achieved or the policies that influence how well the goal is achieved. To the far right of the figure is noted the length of time that will likely be needed to achieve the goals (short, medium, or long term). To the far left of the figure is shown whether generally rising incomes can be expected, given institutional or other constraints.

Trade reform is a policy that is intended to lead to a good investment response. The implication of the diagram is that the effectiveness of the trade reform will not only depend upon the effectiveness of other policies directly affecting investment (such as policies towards domestic and foreign investment and market competition) but also will depend upon all the policies that determine how effectively input markets function (land, labour, capital, technology, etc). However, the effectiveness of input and output markets depend in turn on good governance, the basic institutions determining the ability of people to make contracts, and civil and social order.

Looking at the diagram from the bottom up, unless civil and social order has been established, it is likely that only intervention in the form of assistance to bring about peace and humanitarian aid will be useful. At this level, institutions that have to be established are the police and the judiciary. Self policing by the community—in the sense that there needs to be a degree of trust and concern for others—is also important in the maintenance of civil order.

The next building block that must be in place comprises the institutions that form the basis of a market economy, i.e., property rights and impartial enforcements of contracts, as well as less formal institutions such as codes of conduct.

Figure 1



If these basic building blocks are in place, good governance and effective factor and output markets should be the focus. Secure property rights and impartial contract enforcement are the basis for effective markets; however, there also has to be effective regulation of market activity to ensure freedom of entry and thereby avoid anti-competitive pricing as well as ensuring provision of quality goods and services and health and safety standards. Establishing factor markets that are open to participation by all, and do not discriminate in terms of gender, ethnicity, religion, etc., is fundamental to the exploitation of a country's comparative advantages and having inclusive economic growth. The mobilisation of factor markets is discussed in the box below.

Mobilisation of Factor Markets

The response of firms to the incentives created by the removal of protection will depend a great deal on the ability of the factor markets (labour, land and capital) to respond.

Labour market flexibility may be adversely affected by minimum wage laws or by the public sector playing a wage leadership role that raises wage costs for private sector activities. However, while minimum wage legislation may be in place, the wage rates established may not be 'binding' if they are set at levels below what the market is willing to pay in line with productivity. In other cases, the minimum wages (and workplace standards) may be circumvented in one way or another.

There is a complementarity between skilled workers and unskilled workers. If the necessary skilled workers are not available, the unskilled workers will not be employed. Hence, restrictions on the employment of expatriate labour with specialised skills can inhibit investment and the employment of unskilled labour. The absence of title to land, including situations of customary ownership of land, may also inhibit the movement of labour from one part of a country to another.

The cost of adjustment borne by labour in the affected industries is usually the focus of most concern with trade reform programs. There is the question whether the adjustment

costs are reduced if the trade liberalisation is phased in rather than being carried out all at once. It may be argued that phasing in tariff reductions distributes the job destruction over a longer period. Thus, workers who lose jobs will be competing with a smaller number of other unemployed (Borland 1998). As Borland notes, however, the differential impact of a phased implementation may be reduced or even lost if firms respond immediately to the announcement rather than wait until the tariff reductions are phased in. If other employment is available, labour may be more likely to respond immediately. In that case the adjustment costs for labour will be small. Thus, ensuring that conditions for investment and job growth are favourable will reduce adjustment costs. Where this is not the case, trade policy reform may only lead to job losses, and a build-up of antipathy towards reform programs.

Poor security of title to land is the situation in many developing countries. If investors cannot acquire a secure title to land (whether freehold or leasehold), investment will be sub-optimal and the response to trade liberalisation will be poor. Security of title implies that the land ownership must be well-defined and that the government can and will enforce the rights to the land. Without such security, the investment that takes place will tend to be of a short-term or “foot-loose” nature, or will have to earn above-normal rates of profit to compensate for the security risk—which usually means that the Government will be asked to create monopoly rents through restrictions on entry of some kind.

Customary ownership of land does not necessarily pose a problem if some form of long-term leasehold can be developed that has the support of the landowners and the government. However, these circumstances are rarely found. It was the case in Fiji with the operation of leases managed by the Native Land Trust Board (NLTB) until the landowners no longer felt that they were receiving a fair deal. The NLTB was a monopoly and as supervision and regulation of its activities weakened, in an environment of poor governance, its monopoly position was abused.

Secure title to land is critical to the availability of competitively-priced credit (Chalamwong and Feder 1988). A country without the possibility of using land titles as

collateral is unlikely to be able to develop a mature financial sector.¹ Credit will only be made available for short periods, such as less than one year, using personal guarantees as security or securitizing short-run income flows such as crop harvests. Lending will be largely confined to the informal market, involving short-term loans at high interest rates.

Infrastructure and essential service costs can also have a big impact on the investment environment. Efforts are being made in many countries to improve the quality of infrastructure and essential services—such as transport, power, water and telecommunications—and reduce its costs through corporatisation and privatisation. However, small countries pose acute obstacles to improving these services in this way because of the difficulty of ensuring competition (Howlett 1985).

Still, state operation of these kinds of services pose two significant problems. First, there is a conflict of interest in the state being the regulator of commerce while being engaged in the supply of services. Second, budgetary support of state-owned enterprises and political interference in their operation distorts the incentives for productivity improvements. Therefore, it is preferable to privatise these activities and for the government to adopt effective regulatory practices.² The fact that there is only one supplier is not necessarily a problem; the issue is whether there **could** be additional suppliers, i.e., the market is contestable. If there are restrictions on entry it is often because of some action by government that gives preference to the existing supplier.

As with other private investment, investors in infrastructure and utility services will be affected by the investment environment. If the investment environment is poor (e.g., poor security of access to land, law and order problems), sales of government activities can be at 'fire sale' prices (see Duncan *et al* 1999).

¹ The use of land title as collateral means that in the event of default on a loan the lender must be able to take possession of the asset and sell the title (freehold or leasehold).

² However, regulation can be subject to regulatory 'capture', whereby there is strategic manipulation by firms of the regulatory process itself. There is also the problem of asymmetric information in that the firm controls the flow of information about costs to the regulator. Therefore, the best form of regulation is to ensure freedom of entry of new suppliers, where possible.

Good health and education have become the main income-generating assets for most people. Provision of the opportunity for all people to be educated and to be free of debilitating infections and disease will allow them to participate to the full in the labour market.

With these building blocks in place, investment should be effective in promoting economic growth—particularly growth in which all can share. Ensuring a good investment response should also ensure a good response to trade liberalisation.

C. The Practical Constraints to Trade Liberalisation

As shown in Appendix 2, trade reform is a particularly difficult type of reform to implement. A considerable literature has been devoted to analyzing the reasons for the economic reforms that have taken place over the past 20 years or so and why they have or have not been sustained. Haggard and Webb (1996) conclude that a response to Rodrik's (1994) view that trade reform is so difficult because of the large size of the income transfers relative to the efficiency gains (see Appendix 2) is to adopt 'packages' of reforms. In contrast to trade reform, macroeconomic reform is believed to have a high ratio of efficiency gains to income transfers. Haggard and Webb believe that the combination of these two types of reform explains the large number of successful trade liberalisations undertaken by developing countries in the 1980s. From the eight country reform programs they examined, Haggard and Webb (1996) also concluded that forms of compensation could be useful components of a reform package. They saw compensation in the form of improved health or education services, expanded social safety nets, and improved social legislation as more effective than measures such as wage increases and direct subsidies, which would make any needed fiscal adjustment so much harder. Moreover, once granted, subsidies are hard to remove.

Haggard and Webb also found external funding assistance not to be very important in achieving reform. This conclusion is consistent with that of Burnside and Dollar (1997),

who found from a study of 56 developing countries that aid had been very effective in changing countries' policies. Unless countries already had a good policy environment, provision of aid had little impact on growth. But this conclusion is also consistent with the conceptual framework presented above which shows that it is important to target the aid so that the constraints to effective reform are overcome. In that case, aid may well be more helpful to reform.

Much is now made of the need for "ownership" of reform policies, and there is no doubt that reforms will not be implemented and sustained unless there is the political will to do so. But economic reform means taking away "rents" from vested interests that are in a politically powerful position. Hence, reform ultimately means changing the balance of political power within the country. One of the factors that appears to have been important in making such changes is the creation of a group of highly-trained nationals who can provide information about the costs to the country of government interventions such as restrictions on trade. Moreover, it has been shown to be important for such technocrats to be protected against changes in political regimes (Bates and Krueger 1993).

One way to convince people of the benefits of open trade has been the use of free trade zones or export processing zones. The demonstration effect of showing how export-oriented, labour-intensive industries can generate many jobs, in contrast to protected, capital-intensive industries, has in some cases proven useful in changing the balance of political power away from the vested interests in protected industries. Some countries, such as Japan and Korea, used measures such as subsidising credit to exporting industries to offset the costs they bear from other industries being protected. However, providing such offsetting assistance can lead to difficulties in removing it, unless the government is in a sufficiently strong position to do so as was the case in Japan and Korea.

The trade liberalisation strategy should involve the removal of non-tariff barriers such as import quotas and, if necessary, their replacement by tariffs. Non-tariff barriers to trade are usually very costly in terms of their resource misallocation effects, and the "rents"

they create are usually going to private interests rather than to the government, as with tariffs. Desirably, tariffs should be uniform across industries to minimise the allocation distortions in the use of resources. Moreover, variable tariffs create opportunities for corruption of the customs service, as it provides the opportunity for customs officials to vary the good's description to incur a lower tariff. It has been noted that where tariffs are made more uniform and tariff levels reduced that tariff revenues can increase due to the removal of opportunities for corruption.

Reduction of tariffs reduces government revenue, and where tariff revenue is an important part of government revenue, there will be reluctance to change. Alternative revenue sources will need to be found. The most widely adopted replacement tax has been the value-added tax (VAT) or goods and services tax (GST). This tax is applied equally to both domestic and imported goods and services and therefore does not have the production-distorting effects of a trade tax.

However, for developing countries with poor administrative and transport and communications infrastructure, implementation of a VAT can prove difficult. Moreover, for some small countries, such as some Pacific island countries, most consumption expenditure is on imports. In such cases it may be preferable to maintain a customs tax system for ease of collection, but have a relatively low, uniform "revenue" tariff—except perhaps for "luxury" or "sin" goods such as alcohol, cigarettes, and expensive automobiles.

Export taxes should be avoided, particularly where the export commodities are being produced by the poor, such as with smallholder export crops (coffee, cocoa, etc). Such taxes transfer income from the smallholders to domestic processors, as was the case with the ban (similar to a very high tax) on the export of logs in Indonesia. Where the export commodity is a state-owned resource such as minerals, it is preferable to use a resource-rent tax or profits tax rather than an export tax, to avoid the economic distortion of the trade tax.

As restrictions on imports mean restrictions on exports, with protection the real exchange rate is higher than it would be in the absence of protection.³ Hence, with trade reform the exchange rate should support the trade liberalisation. If the country has a floating exchange rate, this adjustment will occur automatically. However, if the country has a fixed exchange rate, there should be a devaluation so that there is an increase in exports to match the increase in imports due to the removal of protection. If there is a constraint on the rate at which devaluation can take place, trade liberalisation may have to proceed at a rate consistent with the devaluation. Care should be taken with monetary policy to see that domestic prices do not increase and lead to a real appreciation of the exchange rate that will negate the trade liberalisation.

As a major focus of trade liberalisation is to encourage exports, complementary measures will include the establishment of facilities to ensure that exports meet international standards with respect to quality, health and safety. These facilities may be provided by government in the early stages but private industry should be encouraged to take over this role.

Trade liberalisation will often see firms in developing countries attempting to export for the first time. This is a daunting task, requiring knowledge about foreign markets and establishing marketing and distribution networks in other countries. For this reason, joint ventures with established foreign firms have often proved to be the best way to enter export activity. Hence, restrictions on foreign investment should be removed.

Trade liberalisation can mean that domestic prices become more unstable than international prices (though not always). The fear of increased price instability can lead to resistance to trade liberalisation by import-competing industries or by consumers. Governments have often used domestic price stabilisation schemes in order to counter this risk. But price stabilisation schemes create numerous problems. For import-competing industries they often become price and income support schemes rather than

³ To ensure balance between imports and exports over the long term, when imports are reduced through protection, exports have to be reduced. This is achieved through appreciation of the real exchange rate.

price stabilisation schemes. As well, the government becomes the bearer of the price risk, which creates a highly uncertain contingent liability against the government budget. Hedging schemes that shift the price risk from farmers or the government to exporters or traders, and through them to overseas speculators, are preferred. However, in order for hedging schemes (using commodity futures or options) to be implemented, the capital market must be sufficiently open. In fact, some countries ban trading in futures markets.

Concerns over job losses will be one of the most powerful forms of resistance to trade liberalisation. Experience has shown that such concerns are often not warranted, as alternative employment opportunities become available with trade liberalisation. However, the response to the trade liberalisation by new and expanding activities will depend upon how well the various constraints have been handled. Even if all possible constraints have been freed up, it will still be politically useful to have some form of social safety net in place. It must be recognised, however, that poor countries have very limited resources for welfare programs. Moreover, it is difficult to justify a social safety net targeted solely to those losing jobs due to trade liberalisation. Hence, any social safety net program should be generally applicable. Still, the difficulties of targeting safety net programs must be recognised. Programs that involve self-identification (e.g., for the poor) appear to be best.

More generally, the inevitably lagged response to the various reforms that may be involved in a comprehensive trade liberalisation package (tariff reductions, exchange rate changes, reforms of investment and tax regimes, needed infrastructure, changes to labour market legislation, and changes to property rights to land) will raise problems in terms of the public acceptance of the measures. However, the delay should not invite the government to start “picking winners” by supporting the creation of new industries.

A major problem leading to a poor response to reforms can occur when the government in the past has proven not to be credible with respect to policy changes. Investors will be reluctant to respond to policy changes unless they are sure that the new policies will be sustained. Public education about the expected response to the reforms and public

assurances that the reforms will be sustained should be helpful in overcoming resistance to the reforms and pressures to “backslide”.

D. Prioritisation of Assistance for Trade Liberalisation and Poverty Reduction

Any strategy for development that is focused on the reduction of poverty should begin with a Poverty Analysis that identifies the poor and describes their characteristics comprehensively. But even more importantly, the analysis should go further to identify the reasons why the poor are not able to participate in economic activities to a greater extent. It is suggested that this analysis should be undertaken having in mind a conceptual framework something like the Duncan/Pollard framework presented here. This framework is consistent with the idea of the Integrated Framework for Development being promoted by the World Bank and the IMF. The Integrated Framework sees trade liberalisation strategies being developed and implemented as a part of the country’s overall development strategy, not something done in isolation.

In the extended Poverty Analysis, particular attention should be given to the poor’s assets (or lack of them)—education, health, land, capital—as their access to and security over these income-generating assets will determine their ability to contribute to and share in the country’s growth. For example, government provision of infrastructure (or lack of it) may be inhibiting the poor’s access to public services as well as to input and output markets. Other important information to draw from the Poverty Analysis includes: (i) policies, regulations, institutions, and cultural and social norms that may be restricting the poor’s ability to participate fully in economic activities; (ii) the kinds of risks (both physical and economic) to which the poor are vulnerable, as well as the risks that the government’s fiscal and monetary policies are exposed to and which could affect the government’s ability to maintain economic growth and its ability to directly assist the poor; (iii) the composition of the household income of the poor (this information is particularly important to understanding how the poor are managing the risks they face); and (iv) the effectiveness of factor markets (land, labour, and capital) as well as the provision and quality of public infrastructure and essential services.

A basic question for most countries is how to remove the obstacles preventing the poor from participating fully in the economy. Political, cultural, social and economic norms are likely to be very important in determining the existing situation and creating the vested interests that will wish to maintain the *status quo*. Change will usually be difficult to achieve. Hence, a question that arises is: what measures can be taken in the short run that might help in the process of change? For example, putting in roads or other infrastructure may enhance the demand for secure access to land and therefore may lead to pressure for secure individual tenure to land, which in turn can promote the credit market.

The Duncan/Pollard framework should also prove useful in developing a trade liberalisation strategy that includes the prioritisation of activities. Here again, the basic question is: what constraints are there to a robust response to the reforms? Prioritisation of activities should be considered in terms of reading the Duncan/Pollard diagram from the bottom to the top. At a most basic level, investors must be able to have confidence in the signing of contracts; they must be able to get secure title to land; and they must find the government's policies—including the reforms—credible. Otherwise, there will be a poor response to the reforms.

Further, factor and output markets must be functional so that investors can access credit and labour at undistorted market prices. Investment policies that do not discriminate between the private and public sectors, nor between domestic and foreign investors, should be in place. Other internal barriers to trade should be removed so that the benefits of freer international trade flow through to producers and consumers.

No doubt, it will often be impossible to implement all of these changes, and experience has shown that it is often not necessary to have all such reforms in place in order for freer trade to have a positive impact on economic growth. However, experience has also shown that without sufficient complementary reforms or changes, trade liberalisation has

yielded disappointing results—generating net job losses and antipathy towards reform more generally.

Appendix 1

A Review of the Literature on Trade, Growth and Poverty Reduction

(i) Trade and Growth

The idea that the trade policy regime of a country has an impact on the country's growth is not new and goes back at least to Adam Smith. Broadly, there have been three theoretical approaches to the trade and growth nexus: Neoclassical, Endogenous Growth, and the Institutional approach. The predictability of these approaches has so far been mixed at best. Estimation of the impact of trade liberalisation on growth gives ambiguous results and the direction and magnitude of the impact appear to depend on the circumstances of the country.

Neoclassical approach

The neoclassical approach to the trade-growth nexus invokes general equilibrium models with constant or decreasing returns to scale. Moreover, it is built upon the choices of rational individuals acting solely through markets. Trade patterns among countries are determined by comparative advantage, either in the form of technology differences, as in Ricardian models, or of resource endowments, as in Heckscher-Ohlin models. The neoclassical models of international trade theory in general predict that a country will have static gains from lowering its trade barriers.

Perhaps one of the most important static gains from trade liberalisation predicted by neoclassical models is the increase in allocative efficiency. Since trade policy has an important impact on the transmission of international price signals, lowering trade barriers will lead to a reallocation of resources to the sectors with comparative advantage. As a result, resources are used more efficiently and the welfare of the country as a whole will rise.

Another gain from trade liberalisation predicted in some neoclassical studies linking trade and productivity is that lowering trade barriers can create a so-called X-efficiency gain by

having a positive impact on the efforts of workers and managers in the economy. Increased foreign competition due to lower barriers has an invigorating effect similar to that of a “cold shower” and workers/managers have to raise their efforts to survive the fiercer foreign competition. Yet the gains from trade liberalisation are—by nature of the neoclassical models—static, and trade policy like other government policies has only level effects, not growth effects—a well-known prediction of neoclassical growth models as in Solow (1956) and Swan (1956).

Critics of the Neoclassical approach: The validity of the key assumptions on which the neoclassical approach is built has been questioned by a number of economists. Most notably, Rodrik (1988) and Devarajan and Rodrik (1989) argue that scale economies and imperfect competition are prevalent in developing countries. They show that under these conditions, the welfare impact of trade liberalisation becomes complicated. A welfare change can be decomposed into three components: the well-known neoclassical protection component given by the difference between external and internal prices; an “excess profits” component reflecting imperfect competition; and a component reflecting economies of scale that depends upon, among other things, output. They construct general equilibrium models for Turkey and Cameroon to demonstrate how the reduction in the latter two welfare components as a result of trade liberalisation may outweigh the neoclassical gain in the first component, and the country can be worse off if trade barriers are lowered. The theoretical possibility of a welfare-reducing impact from trade liberalisation in the presence of imperfect competition and increasing returns to scale has been pointed out in other studies such as Ocampo and Taylor (1998) and Eaton and Grossman (1986).

Endogenous growth approach:

The dynamic gains of trade liberalisation are closely linked to writings on endogenous growth (“new growth”) theory that have proliferated since the mid-1980s. Much has been made of the endogenous growth theory, however, in many ways it differs only slightly from the neoclassical model. Certain features are common to all growth models. First, they incorporate a produced “accumulable” factor, which is a durable input whose

stock increases over time—physical capital, human capital, or technology. Second, if an increase in the productivity of the inputs producing the accumulable factor occurs at some point, an increase will occur in the rate of accumulation and the growth of output in subsequent periods. A key difference between the neoclassical and endogenous growth models is how long this increased growth lasts. In neoclassical theory, the increase in the growth rate eventually converges to zero, whereas in the endogenous growth theory the increase can be permanent. The source of this difference is the assumptions about the income share of the accumulable factor. If this share is low, as in the neoclassical model, any increase in, say, capital, in one period does not yield a large increase in production of capital, thus dampening the accumulation process, causing it to converge. If the share is high, as in the endogenous growth models, any increase in capital inputs will yield a larger increase in production of new capital, causing the accumulation process to last longer, possibly indefinitely, in which case permanent growth effects are possible.

According to the endogenous growth theory approach, trade policy can impact on income and long-run growth through (i) scale effects; (ii) allocation effects; (iii) spillover effects; and (iv) redundancy effects.

Scale effects: A common feature of endogenous growth models is that the size of markets or scale of factor endowments directly affects the long-run growth rate. The integration of markets through trade can create scale effects via the integration of goods markets or flows of intangible and non-rival “knowledge capital”.

Examples of dynamic gains from trade via scale effects can be found in the models of Rivera-Batiz and Romer (1991) and Grossman and Helpman (1991a). To focus on scale effects, relative prices or technological designs or blue prints are fixed by assuming a Ricardian structure of the economy. Market expansion created by trade raises the profitability of R&D and leads to an increase in the growth rate.

Scale effects remain a disputed property of endogenous growth models. Jones (1995) argues that scale effects are at odds with the existing empirical evidence of OECD countries.

Allocation effects: The static gains from the reallocation of resources in neoclassical models can be sustained and transformed into a growth effect if the changes in the composition of national output are related to the production of accumulable factors. If more resources are allocated to the sector producing the accumulable factor,⁴ growth will be enhanced.

For developing countries, access to cheap imported capital goods is perhaps the most compelling mechanism linking trade and growth. Protection policies that restrict the import of capital equipment reduce real investment and lower the rate at which physical capital accumulates. As a result, the rate of long-run growth is—as commonly predicted by the endogenous growth theory—reduced, and if technical progress is embodied in capital goods, the negative impact of protection on growth will be magnified.

Spillover effects: One important consequence of international trade is the diffusion and integration of technological knowledge. Integrating world markets facilitates access to the knowledge available in other nations. Technical progress embodied in goods represents an opportunity for countries engaging in international trade to learn from trading partners.

In the literature investigating the nexus between growth and trade via technological spillovers, the diffusion process is modeled in two main ways. The diffusion can be a non-purposeful activity and trade simply provides economies access to a world pool of knowledge that is freely available. This approach is taken by, for instance, Feenstra (1996) and Grossman and Helpman (1990, 1991c). Another approach is to model the diffusion as a purposeful activity in which the less developed countries can imitate

⁴ The accumulable factor could be R&D as in Grossman and Helpman (1990), or human capital as in Lucas (1988) or physical capital as in Rebelo (1991) and Jones and Manuelli (1990).

technology available in the more developed countries. Examples of these leader-follower models of technological progress can be found in Segerstrom *et al.* (1990), Barro and Sala-i-Martin (1995) and Eaton and Kortum (1996).

Redundancy effects: The redundancy effect of trade policy on growth is closely related to the characteristics of knowledge. Since knowledge is a non-rival good, opening the economy can reduce the unnecessary waste of resources devoted to R&D from a global point of view. Increased foreign competition in R&D as a result of trade liberalisation can eliminate redundancy in research across countries. Consequently, the global resources devoted to R&D will be used more effectively and the larger global stock of knowledge provides an extra boost to growth. Theoretical models in which the redundancy effect is used can be found in Grossman and Helpman (1991a) and Rivera-Batiz and Romer (1991).

Other papers relax this assumption to model technological diffusion between countries explicitly. Technology diffusion may occur through the imitation process, in which the follower country carries out costly imitation of products already developed in the leader country. There could be some hazard to the imitation process if successful innovators seek patents in other (follower) countries, or if there is strong international enforcement of the relevant intellectual property rights.⁵

Possibilities of adverse impact of trade on growth in endogenous growth approach:

It should be noted that in the majority of the models of the trade-growth literature, the ultimate impact of trade policy on growth depends largely on the pattern of comparative advantage. This is particularly true for R&D-based growth models in which the long-run rates of growth are determined by the resources devoted to the R&D sector. If the changes in relative prices associated with trade liberalisation cause a movement of resources away from the high-tech or innovative sector, or the sector producing the accumulable factor, a freer trading regime will reduce the rates of long-run growth.

⁵ See Grossman and Helpman (1991a, 1991b), Barro and Sala-i-Martin (1995, Chapter 8), Eaton and Kortum (1996).

The theoretical possibility that trade liberalisation might have a negative effect on economic performance has been demonstrated in various endogenous growth studies. In Lucas (1988), free trade might cause a country sufficiently far from its steady state to become completely specialised in the low-technology good with its short-run comparative advantage, although it has a long-run comparative advantage in high-technology goods. In theory, the best option for trade policy in this case is to have restricted or prohibited trade until the economy has gained short-run comparative advantage in the high-tech goods. Young (1991) shows that trade liberalisation might cause the less developed countries to specialise in the production of “old” goods with little gains from learning by doing. Consequently, growth could be higher for less developed countries under autarky than under free trade, despite some static gains from free trade. Grossman and Helpman (1991a) also present a model of a growth-contracting impact of trade liberalisation if foreign competition tends to reduce incentives to invest in R&D in the host country.

Institutional approach:

With the resurgence of institutional economics in the 1990s, economists (and aid donors) have turned their attention to the role of institutional factors in examining the impact of changes in levels of tariffs and quotas on economic performance. In the view of New Institutional Economics (NIE), trade reform is institutional reform and the changes in tariffs and quotas typically constitute only a small part of a much more complex process. Trade liberalisation is associated with changes in the government’s relationship with the private sector and with the rest of the world. Trade liberalisation sets new rules and expectations regarding how these policy choices are made and implemented, and establishes new constraints and opportunities for economic policy.

As North (1990) describes them, economic institutions range from taboos, customs, and traditions in what are called traditional societies, to formal, written constitutions and laws governing economic, political and social behaviour in a modern society. North (1990), Olson (1996), and de Soto (2000) stressed the overriding importance for economic

growth of property rights and enforcement of contracts. Well-defined and secure property rights and impartial enforcement of contracts between parties are the basis for a market economy. If these conditions do not hold, market activity will be infeasible or highly sub-optimal. In particular, people will be reluctant to invest in fixed assets and engage in long-term contracts.

Aron (2000:105) sums up the institutional constraints in poor countries as follows:

When institutions are poorly defined or there are few formal institutions, economic activities are restricted to interpersonal exchanges. In such cases, repeat activities and cultural homogeneity facilitate self-enforcement. Transaction costs may be low in such an environment, but transformation costs are high because the economy operates at a very low level of specialization....It is clear, however, that firms or agents in an environment of weak institutions cannot engage in complex, long-term, and multiple-contract exchange with effective enforcement as they do in industrial countries. A basic structure of property rights that encourages long-term contracting appears essential for the creation of capital markets and growth.

If basic institutions necessary for the creation of capital and full participation of society in economic activity are not in place, trade reforms, investments in infrastructure, education and health, and public sector reforms will be ineffective and will likely only lead to increased income inequality—favouring those who already have access to factor markets. These kinds of basic institutions will likely take a long time to establish. In that case, a poverty reduction strategy will have to give attention to what may be done in the short to medium term to assist in bringing about desirable institutional changes.

While governments may be keen to implement these kinds of measures, there will often be resistance from groups or individuals benefiting from the *status quo*. However, demand for changes to institutions and policies may be fostered by actions that increase the value to the community of new institutions and policies. Development assistance

agencies can assist countries move toward commitment to these measures through technical assistance that demonstrates the benefits of different institutions and policies. Experience has also shown that high-level training of local people is very effective in leading to ownership of these growth-enhancing measures (Bates and Krueger 1993, Haggard and Webb 1996).

In general, this stream of literature believes that trade liberalisation has a positive impact on growth, but the positive direction of the impact is conditional, and incentives created by price reforms such as in external trade and taxation will not work in the absence of appropriate institutions. In this view, trade liberalisation now affects economic performance not only through changes in relative prices in a mechanical way, but also through a number of institutional arrangements. The roles of the following five types of market-supporting institutions are argued to be of significance for good economic performance: (i) property rights, (ii) regulatory institutions, (iii) institutions for macroeconomic stabilisation, (iv) institutions for social insurance, and (v) institutions for conflict management.

Rodrik (2001) argues that adoption of trade liberalisation policies has often entailed the importation of institutions. Membership of the WTO, for example, requires the adoption of a certain set of institutional norms. Imported institutions can be ill-suited or counterproductive and successful institutional reform requires an adequate combination of imported blueprints and local flavour. He also argues that the trade regime must accept, rather than eliminate, institutional diversity. Countries must have the right to protect their institutional and social arrangements.

The centrality of trade liberalisation in a country's development strategy has also been questioned by NIE followers and they argue that trade liberalisation can divert financial resources and political capital from more urgent and deserving developmental goals. Integration into the world economy is associated with costly institutional reforms. Finger (2001) estimates that it would cost a typical developing country US\$ 150 million to implement requirements under a WTO accession agreement. He goes on to argue that the

vast majority of developing countries would be better off spending this money on other activities with more attractive rates of return.

In sum, NIE followers believe that the degree to which trade reform contributes to the construction of a high-quality institutional environment is more important than a liberal trade regime *per se* or adherence to WTO rules.

(ii) Growth and Poverty

Impact of growth on poverty:

The relationship between growth, income inequality, and poverty has been one of the central points of discussion in the development literature. There has been tremendous emphasis placed on the probable trade-offs between growth and income inequality. The relationship between growth and income inequality was proposed to resemble an inverted U curve; that is, income inequality increases in the initial phases of development, then declines as growth continues. This view was derived from the path-breaking work of Kuznets (1955) who investigated a time series of inequality indicators for England, Germany, and the United States.

There are some mechanisms that may generate the famous Kuznets curve. One widely cited mechanism is the transfer of labour from a sector with low productivity and low inequality to another sector with higher productivity and higher inequality as in the model proposed by the seminal work of Lewis (1954). The result would hold if the inequality between the sectors was substantially greater than the inequality within them. Aghion and Bolton (1997) propose another mechanism with trickle-down effects of capital accumulation. In their work, the increased wealth of the rich implies more funds available for investment by the poor, and the accumulated wealth of the rich trickles down to the poor through borrowing and lending in the capital market. In the presence of imperfect capital markets, their model can generate a Kuznets curve.

The Kuznets hypothesis has been exposed to a large number of tests over the past four decades. Recent studies using data from developing countries generally refute the inverted-U relationship between the level of income and level of income inequality. Deininger and Squire (1998) provide the most comprehensive test so far of this hypothesis with a data set of relatively good quality and comparable data for several points of time for individual countries. They conclude that “our data provide little support for an inverted-U relationship between levels of income and inequality, when tested on a country-by-country basis, with no support for the existence of a Kuznets curve in about 90 per cent of the countries investigated.” (Deininger and Squire 1998:573). In another empirical study, Ravallion and Chen (1997) conclude that growth seems to reduce inequality in the transitional economies of Eastern Europe and Central Asia. However, their work and other empirical studies shows that the pattern of income distribution in developing countries has been fairly stable over a long period of time (Dollar and Kraay, 2001a and Deininger and Squire, 1998).

Still, the empirical evidence about the relationship between income inequality and economic performance is fairly mixed and the outcome far from being settled. While Benabou (1996) reports that the vast majority of the empirical studies up to 1995 on this relationship reach the conclusion that there is a negative correlation between inequality and growth, Forbes (2000) employs a new and better quality data set and finds a positive and significant relationship between inequality and growth. However, the difference in empirical studies can be in part attributed to econometric differences, in the econometric approach and the choice of variables.

A clear distinction should be made, however, between income inequality (or relative poverty) and absolute poverty. Available data provide overwhelming evidence that economic growth contributes to reductions in absolute poverty, not only in empirical studies investigating individual countries but also in cross-country studies. Ravallion and Chen (1997) claim that there is a statistically significant negative relationship between absolute poverty and growth. In a study of 92 countries spanning four decades, Dollar and Kraay (2001b) find that the average incomes of the poorest one-fifth of society rise in

proportion to average incomes. They were unable to isolate any factors that account for this empirical regularity, illustrating how little is known about the relationship. Unlike the trade-growth nexus, however, the relationship between growth and absolute poverty reduction does not generate significant debate among economists and policy makers, although there is some dispute about the rate of economic growth at which absolute poverty begins to fall.

It should be noted that it is possible that growth can be biased against the poor so that with a sufficiently large increase in income inequality, the outcome can be a rise in absolute poverty. This behaviour was observed in the Philippines over the period between 1988 and 1991 (Ahuja *et al.* 1997:47). Import-substitution trade policies that favour capital-intensive industries rather than labour-intensive industries and forms of exploitation of natural resources that generate benefits concentrated in a small part of the population could have such an impact.

(iii) Trade Policies, Growth and Poverty Reduction

The prolonged debate surrounding the impact of trade policy on growth has been reflected in the trade strategies and development strategies implemented by developing countries. While the vast majority of developing countries relied on trade barriers to implement so-called import-substituting industrialisation (ISI) during the three decades after World War II, many of them have since undertaken trade reform to various degrees, and we have witnessed a comprehensive shift from import-substituting industrialisation to export-oriented industrialisation. This section summarises the arguments for and against these two development strategies. A brief survey of the empirical studies investigating the relationship between trade policies, growth and poverty is also provided.

Import-substitution strategies: After World War II, protectionism became dominant and for several decades import substitution industrialisation was adopted in the majority of developing countries. This protectionist development policy had its origins in the writings of Prebisch (1950) and Singer (1950).

The arguments for ISI were based on two premises. First, it was argued that there is a secular deterioration in the international relative prices of the principal exports of developing countries, primary commodities. In the absence of industrialisation in developing economies, this trend would lead to a widening of the gap between rich and poor countries. Second, the manufacturing sector requires temporary assistance in the form of protection until the 'infant industries' become grown-up and can compete with their counterparts in the industrialised economies.

Export-oriented industrialisation: At the heart of export-oriented industrialisation is trade liberalisation. Trade liberalisation implies the removal or reduction of incentives for ISI.

Krueger (1998) summarised the main arguments of export promotion advocates against ISI as follows:

- Developing countries in general have comparative advantage in labour-intensive industries and import capital-intensive goods and services. Protection of import-competing industries means that developing economies have to substitute domestically-produced, capital-intensive goods at higher costs for imported ones. Higher prices for investment goods imply a lower level of real investment for the same nominal investment expenditure, and hence results in a lower rate of growth.
- Protection in developing countries will allocate resources away from exports towards import-substituting sectors and hence aggravate the foreign exchange shortage. The authorities have to move to ever more restrictive import licensing and exchange control and this vicious cycle eventually leads to the adoption of stabilisation programs. The resulting stop-go pattern of economic activity can have a negative impact on growth, as argued by Diaz-Alejandro (1978).
- Low income per capita implies that markets in developing economies are relatively small, and protection of these markets can result in either concentrated market power or fragmented industries with too many small firms with size below minimum efficient size. In either case, domestic consumers have to pay a higher price than for

imports. If firms enjoy abnormal monopoly profits, they have an incentive to establish a strong lobbying force against the dismantling of trade barriers.

- One important consequence of an import-substitution regime is the tendency for the corruption of bureaucrats having control over import licensing and collection of customs duties.

Empirical studies/evidence: The evolution of trade policies as an important component of development strategies in developing countries over the last five decades provides rich material for empirical studies examining the trade-growth nexus. There is a large body of literature on this topic with various approaches, methodologies, and different levels of sophistication.

Given the above-mentioned debate about the role of trade liberalisation in theory and policy making, it can be predicted that the ambiguity is also present in empirical findings. While the majority of studies claim that there is a positive (either direct or indirect) correlation between openness and growth, some studies conclude that there is little systematic evidence of a relationship between the trade regime and growth, while others conclude that there is a negative impact of trade liberalisation on growth. Moreover, there has been debate about the approaches taken by the various studies.

Attempts to relate trade policy variables to economic performance and growth have proliferated from the pioneer influential studies of Little *et al.* (1970) and Balassa (1971). Broadly speaking, empirical studies have employed cross-country, time series or general equilibrium approaches in examining the link between trade orientation and economic growth. Recent empirical studies have resorted to more creative strategies including constructing a wide range of measures of openness (Dollar 1992; Sachs and Warner 1995; and Edwards 1998) and comparing convergence among groups of liberalising and non-liberalising countries (Ben-David 1993). The majority of these studies share the common finding that openness is associated with more rapid growth.

Yet these studies are subject to criticism and debate. One common shortcoming of these studies, as argued in Rodriguez and Rodrik (1999), has to do with the kinds of indicators of openness used. It is argued that the “trade policy” measures used tend to capture more than just trade policy and are likely to be correlated with other sources of poor economic performance.

Another possible shortcoming is that the models used for estimation omit plausible control variables. Policies correlated with growth (trade openness, macro-economic stability, small government consumption, rule of law, etc.) are all highly correlated among themselves. Hence, when all of these policies are included in regression analyses, it can be difficult to identify the separate effects of different policies.

Most of the cross-country studies do not treat the causality between trade and growth adequately. Edwards (1993) claims that many papers of the 1980s are characterised by a lack of care in dealing with issues related to endogeneity and measurement errors. Rodrik (2001) also emphasises that openness might be an outcome, rather than a prerequisite of growth.

Greenway *et al.* (2002) argue that dynamic misspecification is a further limitation of these empirical studies. By modifying the commonly used specification to capture the dynamic effects of trade liberalisation, they find that the impact of an opening trade regime on growth is non-monotonic. In fact, it resembles a J-curve; that is, there is initially a decline in economic performance following trade liberalisation before growth takes off.

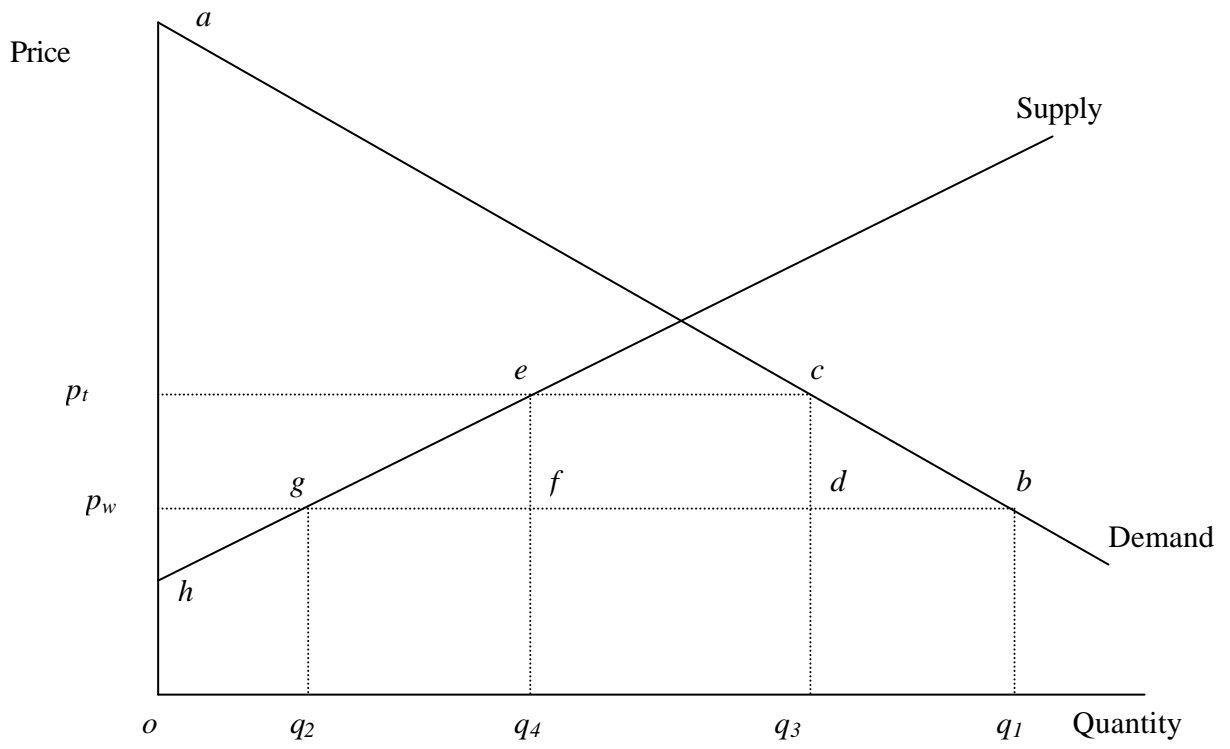
It should be noted that, to date, little attention has been paid to micro-level analysis of the impact of lowering trade barriers on economic performance of firms. A few studies (for instance, Bernard and Jensen 1995, Clerides *et al.* 1998) claim that there is little systematic evidence that firms derive technological or other benefits from exporting *per se*. The commonly observed pattern is that efficient producers tend to self-select into export markets. In other words, productivity seems to determine exports, not *vice versa*.

Only very recently have there been attempts to link trade liberalisation directly with reductions in absolute poverty. Dollar and Draay (2001a) is the most well-known study which found that trade liberalisation leads to faster growth and poverty reduction in poor countries. However, these findings have been subject to the range of criticism mentioned above, such as criticism of the indicators of trade openness used, questions over the direction of causality, and correlation of measures of trade openness with other policy variables that affect growth.

Appendix 2.

The Political Economy of Trade Reform

Protection of industries creates vested interests that will resist the removal of the trade barriers. The debate between the gainers and losers from trade reform is very lopsided, which makes it one of the most difficult forms of economic reform to implement. Rodrik (1994) has argued that it is so difficult to gain public support for trade reform because the income redistribution involved is so large relative to the efficiency gains. As illustrated in the diagram below, tariffs and non-tariff barriers cause large income transfers from consumers to producers and the government. If the world price is p_w , in the absence of protection oq_1 would be demanded and the quantity oq_1-oq_2 would be imported. When p_t is the world price plus the tariff, the reduced amount oq_3 is demanded and oq_3-oq_4 is imported. Domestic production increases from oq_2 to oq_4 because domestic prices increase to p_t . There is a loss of consumer surplus measured as abp_w-acp_t . With the use of the tariff, this loss of consumer surplus involves the area $cdfe$ going to the government as tariff revenue and producer surplus (or “economic rent”) increasing from hgp_w to hep_t . The efficiency losses are the triangles cdb , which is the consumer “deadweight loss” due to consumers having to shift income from other goods and services due to the higher price, and the triangle gef is the producer “deadweight loss” due to the protected producers being able to bid resources away from other economic activities.



If a non-tariff barrier such as an import quota is used instead of the tariff, the consumers' loss is the same but the producers and importers gain all the income transfer unless the quotas are auctioned. In this case the import quota is set at oq_3-oq_4 , which raises the domestic price to p_t . If there is no auctioning of the import quotas, the importers gain an economic "rent" of $cdfe$. If the quotas are auctioned, this rent is shifted to the government.

Rodrik's point is that the transfers of income from producers and the government or importers to consumers as the result of a tariff cut are very large in comparison to the efficiency gains that the community would realise. Moreover, the losses experienced by the producers, importers and government are immediate, while the benefits to society are delayed because it takes time for new industries to be established in response to the lower costs of resources and lower cost of imports. Further, those experiencing the devaluation of assets and the job losses are often concentrated geographically and hence electorally, while those benefiting from the trade reform (consumers and other producers) are spread throughout the economy. Producers who gain may not even be in existence at the time. Because the losers are clearly identifiable and usually electorally concentrated while the gainers from trade reform are not clearly identified and the gains are not large for any individual, the costs and benefits of lobbying for and against trade reform are very lopsided. Consumers find it difficult and costly (relative to their individual gain) to lobby in favour of trade reform. Moreover, there is a free-rider problem in the sense that individual consumers would prefer that other consumers lobby as they will gain if the reforms are implemented. If all individuals act in this way, no lobbying takes place. In poor countries where poverty is concentrated in rural areas, the consumer benefits from trade liberalisation do not flow down to the poor because they largely rely on subsistence⁶, while trade liberalisation imposes losses on the relatively high-paid and influential people in protected industries.

⁶ However, the rural poor will usually benefit from any devaluation of the exchange rate due to the reduction in protection, as this will increase the prices they receive for exports of farm products.

The time lag between trade reform and the creation of new industries and jobs will be longer and the response smaller the poorer is the investment climate. The lag length and response time will be adversely affected by factors such as the credibility of the government's policies, the flexibility of the labour market, law and order problems, property rights to land, and credit availability. The longer the time lag between the losses suffered by the industries losing protection and the establishment of new industries and jobs, the greater the likelihood of resistance to the reforms and 'backsliding'.

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