DFID Department for International Development

trade matters
eliminating world poverty

BACKGROUND briefing

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Trade and Poverty

"In recent decades, it is those countries which have seized the opportunity offered by more open world markets to increase exports and attract inward investment that have made the greatest strides in reducing poverty."

Speech by Clare Short, Ministerial Roundtable on Trade and Least Developed Countries, London, 19 March 2001.

Introduction

The world is becoming more connected; goods and services are crossing national borders with increased ease, creating a single global market. The UK Government White Paper *Eliminating Poverty: Making Globalisation Work for the Poor* sets out how the wealth being created by globalisation could lift millions out of poverty.

This briefing paper considers a key element of globalisation – reduction in barriers to international trade[1]. If properly managed this liberalisation can increase and create incomes for the poor, and provide more resources to tackle poverty.

This paper is in three sections: **a.** traces the effect of liberalisation measures on households and individual income levels; **b.** considers how policy choices can ensure that trade reforms have maximum poverty-reducing impact; and **c.** draws together some conclusions.

1 Throughout this paper 'liberalisation' and 'trade reform' are used interchangeably and taken to mean reductions of restrictions placed upon trade between countries.

Total developing country gains from a 50% cut in tariffs, by both developed and developing countries, would be in the order of $150 billion – around three times current aid flows

A. Economic approaches[2]

Economists assess the impact of trade reform on poverty by tracing the link from economy-wide liberalisation to changes in the living standards of individual households. Key to this model is the concept that liberalisation, mainly through reducing tariffs, leads to changes in the prices of traded goods[3]. As shown in the diagram below, these changes affect poverty levels along three pathways:

- **prices,**
- **enterprise** and
- **government revenue.**

2 Model is based on Chapter 4, Neil McCulloch, L Alan Winters, and Xavier Cirera (2001), Trade Liberalisation and Poverty: A Handbook, CEPR/DFID.

3 This paper considers a tariff as a simple percentage tax on traded goods.

Some one in five of the world's population live in extreme poverty. Governments worldwide have agreed to work together to halve the proportion of people living in extreme poverty by 2015, and to other targets including universal primary education and improved healthcare. The British Government is strongly committed to these targets.

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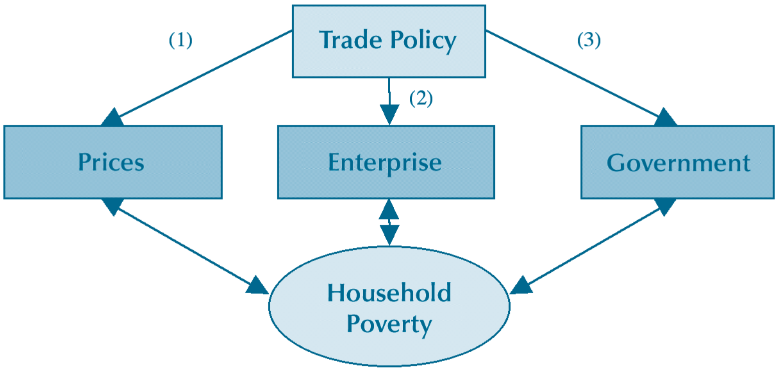
Analytical model of the pathways to poverty reduction



Household poverty is affected by price changes, enterprises and government revenues that alter as a result of changing trade policy.

1. Price changes

Trade liberalisation may affect the price of goods consumed and produced by the poor. However, changes in tariffs do not always result in price changes for individuals, but may be absorbed elsewhere in the system by measures such as increased domestic sales taxes.

Where price changes do exist, reduction of poverty is dependant not only on the size of these price changes, but also on the products to which they relate and the distribution of consumption and production. Falling prices benefit consumers, and rising prices benefit producers. The rate at which poverty is reduced depends on the ability of household members to adjust their consumption and production in appropriate directions in response to the price change. Some social/gender groups may be affected more than others if they are associated with products that change prices, relative to those that do not.

2. Enterprises

Price changes may alter production patterns. Rising prices give incentives to increase production, whilst falling prices do the reverse.

Where production increases, this may lead to an increase in wages and/or levels of employment. The extent of poverty reduction thus depends on the level of initial wages and the magnitude of the increase relative to the poverty line.

The response by firms to liberalisation can have beneficial effects on gender inequalities. Evidence shows that growth in the manufacturing sector has led to proportionately more women becoming employed. They earn more than they would from other forms of employment, although still less than a man doing the same job[4]. However, concerns have been expressed that such employment may also place increased demands on women's time.

Supply responses by firms to changing prices is crucial. There can often be barriers in place preventing firms from expanding or being established; new impediments to trade might also be created. Lack of access to credit and missing insurance markets are good examples. There is a clear need for policies that reduce these obstacles and encourage growth of exports. These are considered more fully below.

In India, liberalisation during the 1990s led to

4 Senapaty (2000), Trade, Gender and Employment Issues, ISST

an increase in the rate of growth of employment in the formal sector, but a large decline in employment in the informal sector. Because formal wages were well above the poverty line, the increase in formal employment is likely to have yielded a net reduction in poverty[5]. Another study based on survey data collected in 2001, shows that households in Kenya that became involved in export horticulture had higher incomes than those that did not, particularly in rural areas[6].

Emerging research on supply responses has used 'value-chain analysis'[7]. This starts with the premise that international trade is increasingly taking place along global supply networks or value chains. Dominant developed country supermarkets are able to dictate standards, quality, production criteria and employment conditions that suppliers need to meet.

Enterprises wishing to benefit from trade reform often depend on gaining access to these chains. Value-chain models aim to understand in what ways small producers and informal economy workers are included or excluded from global trade networks and what consequences this may have for poverty.

A recent study of the South African fruit industry has indicated that the growing dependence on value chains might be increasing insecurity and vulnerability of workers' livelihoods through the increased use of seasonal and contract labour[8].

3. Taxes and spending

Trade liberalisation has the potential to reduce government revenue if the amount collected from tariffs falls once these are lowered. This could limit spending on social services or increase levels of government debt. If this is so, some believe it may increase poverty. There are at least three reasons why these fears are probably unfounded.

First, tariff revenues may not automatically fall in the first instance. This is because part of the initial trade reform process may be the replacement of non-tariff barriers[9] with revenue generating tariffs (which are considered to be less trade-distorting and more transparent). Moreover, there is potential for total tariff revenue to rise as tariff rates fall, as a result of increased levels of imports.

Second, although revenues may eventually fall as liberalisation continues, it is not inevitable that spending on the poor must also fall. Ultimately the way in which government revenue is distributed is a domestic policy decision[10].

Finally, the fact that a government knows in advance that revenue from trade taxes may eventually fall, gives it time to widen its revenue base by improving or introducing new methods of revenue collection.

Household & livelihood impacts[11]

It is important to consider the effects of liberalisation on intra-household income distribution, and on wider definitions of poverty, to avoid trade policy having unintended consequences. It has been frequently argued that the costs of poverty fall disproportionately on women, children and the elderly, with most research in this area focusing on gender imbalances.

Although total household incomes may

5 CUTS/DFID (1999), Liberalisation and poverty: Is there a virtuous circle? (www.cuts.org)

6 Neil McCulloch and Masako Ota, Export Horticulture and Poverty in Kenya, IDS, 2002

7 For further information of these approaches see www.gapresearch.org

8 Stephanie Barientos et al (2002), The Global Value Chain and Changing Employment Relations in South African Fruit, IDS

9 These are primarily quotas, which set a limit on the amount of a good that can be traded.

10 Winters (1999), Trade Liberalisation and Poverty, CEPR/DFID

11 A recently commissioned paper by DFID explores these and other approaches to trade and poverty in some detail: Barrientos, S and N Kanji (2002), Trade Liberalisation, Poverty and Livelihoods: Understanding the Linkages

increase as a result of liberalisation, it does not necessarily follow that both men and women will be impacted upon equally. Every society tends to have distinctive gender roles, often involving men and women in different economic activities and different types of power, authority and decision making. The impact of liberalisation on gender differences and gender imbalance depends on how the changes affect men's and women's activities and their access to resources.

Increased female employment/income (and specifically greater regularity of income) can increase women's influence in household decisions[12]. It can also shift societal perceptions of women by increasing their autonomy. However, women might also encounter increased societal tensions from taking employment outside of traditional norms.

Research on Bangladesh suggests that during the last decade liberalisation led to a larger increase in employment in the manufacturing sector for women than for men. Women's wage rates increased both absolutely and relative to those of men. However, women's participation in other areas, namely leisure and domestic activities, fell. This might imply that women's livelihoods, and those of their children and dependants, did not necessarily improve[13].

Many analysts now take the view that poverty reduction measures should target wider definitions of poverty, incorporating the views of poor people themselves. Focusing solely on income as a measure of poverty may miss vital realities. For example, a rise in income may be less of a priority to a poor household than an increase in the security of its livelihood and/or a decrease in its vulnerability.

'Sustainable Livelihoods'[14] is a useful tool for analysing these issues. It considers peoples' livelihoods in the context of an assets/vulnerabilities approach. Increased trade, seen above as desirable, may actually entail costs in such things as food security or resource depletion. These need to be taken into account when judging overall impacts and designing domestic policy. For particular groups of poor people and individuals within them, the capacity to take advantage of new livelihood opportunities offered by liberalisation may depend on a number of non-economic factors, particularly social capital, ethnicity and physical isolation.

Economic growth[15]

The above model considers the impact trade can have on household income. However, trade may also have a permanent effect on the rate at which incomes change – an economic growth effect. Such growth offers an additional source of poverty reduction which is potentially large.

Measuring the growth effect from trade is problematic. Not only is it hard to define degrees of liberalisation but trade reform is rarely applied in isolation from other policies making calculations particularly difficult. Nevertheless, the weight of recent evidence suggests liberalising is an important element explaining growth performance.

Several channels from reform to growth have been identified. These include diffusion of modern technology that is embodied in traded goods/services. Access to larger markets which makes the use of such knowledge more efficient, is also important. So too is further innovation encouraged by the prospect of greater rewards from global demand.

Recent data also suggests that, on average,

12 World Bank (1985) cited in Susan Joekes (1999), A gender-analytical perspective on trade and sustainable development, IDS

13 Marzia Fontana and Adrian Wood (2000), Modelling the Effects on Women, at Work and at Home, World Development, Vol. 28:7

14 For further information see Sustainable Livelihoods Current Thinking Practice, DFID (www.dfid.gov.uk)

15 This section draws from the following studies:
Andrew Berg and Anne Krueger (2002), Trade, Growth and Poverty, ABCDE Conference
David Greenaway, Wyn Morgan and Peter Wright (2002), Trade liberalisation and growth in developing countries, Journal of Development Economics, Vol. 67 pp. 229-44

growth resulting from liberalisation does increase the incomes of the poorest and is not wholly captured by the better-off.

B. Choices: costs, policy and integrating reform[16]

1. Costs

Because households and firms cannot always adjust instantly to new opportunities, trade liberalisation has the potential to create short-term losers. This should not be a reason to halt reform: rejecting liberalisation because it adversely affected any individual poor person would be a recipe for long-term stagnation, ultimately increasing poverty. Rather, the identification of possible hardship should stimulate the search for policies to facilitate the necessary structural adjustments and reduce risks to vulnerable people.

Adjustment costs often generate public resentment. This presents governments with political, social and managerial challenges that can jeopardise reform efforts. Opposition from potential losers does not often reflect the interests of the poor. Those with the most to lose are not necessarily the poorest, nor do they always represent the majority. They may be politically powerful and better placed to articulate their interests. Meanwhile, the potential winners from trade liberalisation may be the poorest and in the majority but also diffuse and politically weak. Their views therefore remain unheard.

Recent evidence suggests that adjustment costs are actually quite small in relation to the overall benefits of liberalisation[17]. And in some contexts displaced workers have quickly found new jobs, mainly in emerging labour-intensive industries.

2. Policy

Potential losses from trade liberalisation can be minimised through carefully planned policies. Three methods are examined:

- **modifying reform,**
- **compensation** or
- **complementing reform.**

Modifying reform

The most effective way of amending the reform process is to sequence trade liberalisation. This could mean that reductions in tariffs are phased in over time, or quota restrictions lifted gradually. This ensures the economy is not hit by a large one-off shock, and as a result total adjustment costs may be lowered. Credibility of the government's commitment to the final goal is critical to encourage firms and households to begin adjustment in the interim period before reforms are completed.

Compensation

In the short run there may be scope for compensating the losers from trade reform. Such policies must be approached with caution: there are both moral and technical concerns. Morally, it is hard to argue that those hurt by trade reform should take precedence over others affected by different shocks. Technically, it is costly and time consuming to identify those hurt by trade. Finally, these measures are open to abuse.

It is therefore generally agreed that any compensation should come in the form of an economy-wide safety net that does not distort market forces or lead to welfare dependence. This can include relocation assistance and temporary income/food support. For example, Bangladesh's Food For Education (FFE) and the

16 This section draws from work by L Alan Winters (2001), particularly: Trade Policies for Poverty Alleviation in Developing Countries, SAIPS Conference Papers

17 Matusz, S. and D. Tarr (2002). "Adjusting to Trade Policy Reform."

Vulnerable Group Development (VGD) card system provided crucial help to those affected by liberalisation at a critical time[18].

Complementary Policy

Complementary policies, implemented before and/or during liberalisation, are designed to ease adjustment strains and help people avoid poverty.

Such policies can come in many forms; the following brief list concentrates on the most relevant:

- **companion policies** – dynamic economies will need more than just international changes in tariff rates if they are to succeed. Liberalisation should be accompanied by domestic policy changes such as functioning private markets and macroeconomic stability
- **supporting infrastructure** – potential opportunities for exploiting increased access to markets are often wasted due to a lack of critical infrastructure (e.g. roads, ports, customs procedures)
- **building credit markets** – to take advantage of new opportunities, traders will often need to have access to credit. Access to these markets by the poor is restricted, often more so for women
- **supporting the market as an institution –** developing countries often suffer from multiple market failures. Governments could encourage the formulation of networks, enforce market regulations and guarantee property rights
- **increasing labour mobility** – the demand for workers does not always coincide with their location. Developing countries may also suffer from cultural and skill segmentation impeding movement of labour
- **removing legal restrictions** – a comprehensive response to trade reform often requires new businesses. There are often barriers facing entrepreneurs in establishing firms
- **providing training** – new firms may need new skills and workers may lack the funds or means to access training
- **addressing gender imbalances** – the possibility that liberalisation may lead to competing demands being placed on women's time, reinforces the need for gender sensitive policies. Specific policies can include improved water collection, food processing and the availability of market substitutes for household services, such as childcare[19].

With limited funds available for these policies, liberalisation should be accompanied by an impact analysis (social, economic and institutional) to identify those people most likely to be prevented from taking advantage of new opportunities, in each particular country.

Examples of compensatory policies are found in Zambia, run by the United Nations Industrial Development Organisation (UNIDO). This project promotes new linkages between small-scale manufacturers and large-scale activity via industrial subcontracting in the leather and footwear industries, bringing informal producers into the formal sector[20].

3. Integrating trade

When a decision to liberalise is taken, the benefits for the poor will be maximised when reform forms part of a comprehensive development strategy that is owned by the developing country government.

The UK Government supports the Integrated

18 CUTS/DFID (1999)

19 Senapaty (2000)

20 CUTS (1999)

Framework (IF)[21] which aims to mainstream trade issues into a country's national development strategy, such as a Poverty Reduction Strategy Paper (PRSP). The IF is a collaborative effort by six agencies: World Bank, International Monetary Fund (IMF), United Nations Development Programme (UNDP), United Nations Conference on Trade and Poverty (UNCTAD), International Trade Centre (ITC) and the World Trade Organisation (WTO). The IF conducts diagnostic studies to determine and prioritise technical assistance and capacity building needs which then form the basis of a coordinated donor response.

C. Conclusion

Trade is a means to an end. It has the potential to lift millions from poverty. This aim will only be realised if both developed and developing country governments are committed to incorporating trade into a holistic set of domestic and international policies based on best practice and tailored to individual circumstances.

Potential gains from trade liberalisation are not automatic or guaranteed. Reform must be pro-poor and carefully implemented in parallel with complementary policies that ensure new opportunities are maximised for everyone and risks are minimised, particularly for the poorest.

The prospects for achieving a real development round are promising; the WTO is currently negotiating a new round based on the agenda set at Doha. The 5th Ministerial in Cancun in September 2003 will consider progress to date and negotiate an agenda for the next two years. The challenge for developed and developing country governments will be to achieve a WTO mandate for an agenda that is developmental and pro-poor.

Development assistance also has a key role to play in helping countries to achieve the benefits of increased trade and investment through building their capacity to trade and participate effectively in the WTO. The UK Government remains committed to these goals.

21 Further details at if.wto.org

This background briefing forms part of the Trade Matters series. A summary of DFID's policies on trade and development is contained in the **Why Trade Matters** booklet. To obtain further publications in this series, please visit our website at www.dfid.gov.uk or contact the Public Enquiry Point (address details on page 1).

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