Trade and the Less Developed Countries: Why Aren't Increased Trade and Liberalisation Helping The Poorest?

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Introduction

The problems posed by the disparity in incomes and standards of living across the world has brought much attention to the study of development in the past forty years. Much of this research has been based on the theoretical predictions of the Ricardo and Heckscher-Ohlin models and the extensions developed by other international economists[1] . Both models predict that increased trade between two countries will benefit both and that the fewer restrictions of trade (i.e. increased liberalisation) will increase the level of trade. However, as do all economic models, the HO and Ricardo models of international trade base their theory on assumptions that do not hold, at least perfectly, in the real world. The relaxation of these assumptions predicts some of the disparities between the original model and the data, but not all. In the 1980's the finding of intra-industry trade prompted theorists to construct models where the assumption of perfect competition is relaxed. However, there are still many areas in which theory has no full answer to the problems of underdevelopment and the failure of trade to benefit the less developed countries (LDCs).

Theoretical Background

Despite the obvious flaws in the current theory of international trade, it is still useful in predicting some of the variation between countries and can serve as a point of departure. The two main trade theories of the past two centuries are those of Ricardian comparative advantage and Heckscher-Ohlin (HO) factor proportions. The former predicts that all countries have a comparative advantage in some goods, defined by the relative price or production costs of two goods, wine and cloth in Ricardo's original theory. Thus even countries with no *absolute* advantage in production may have a *comparative* advantage, which causes trade and benefits both countries because with (free) trade, each country has the opportunity to buy more goods than they would have under autarky. In the HO model, trade is caused by factor endowment differences. Countries with large relative endowments of capital (high capital to labour ratios) will export capital-intensive goods while those with relatively more labour will export labour-

[1] One of the most influential theorists who have developed and proved some of the results of the Heckscer-Ohlin (HO) Model is Paul Samuelson (1948, 1949; Stolper and Samuelson, 1941; Dornbrush *et al*., 1980). His early work in the field was developing a mathematical proof of factor price equalisation predicted by the HO model (with the given assumptions).

intensive goods. For the same reason as in the Ricardo model, trade will occur and will be beneficial; that is, through trade, consumers in each country will be able to purchase goods for less. The HO model predicts, with perfect competition, free trade, equal technologies, and no transport costs, that factor prices will equalise in the long run. It is clear to all that this has not, and most likely will not occur. However, many empirical studies have focused on disproving the HO model. Edward Leamer (1994) comments that this is the wrong approach. Instead of trying to disprove the theory based on testing its (unbelievable) predictions, we should be testing the extent to which trade has led to factor price *convergence*, rather than equalisation. Beginning from here, I believe, will provide more evidence that trade can generate growth and convergence of living standards (under the right conditions) than by taking the unrealistic HO prediction literally and trying to disprove it. The next section will present some data and commentary on why trade has not done much to help the LDCs.

Back to Reality

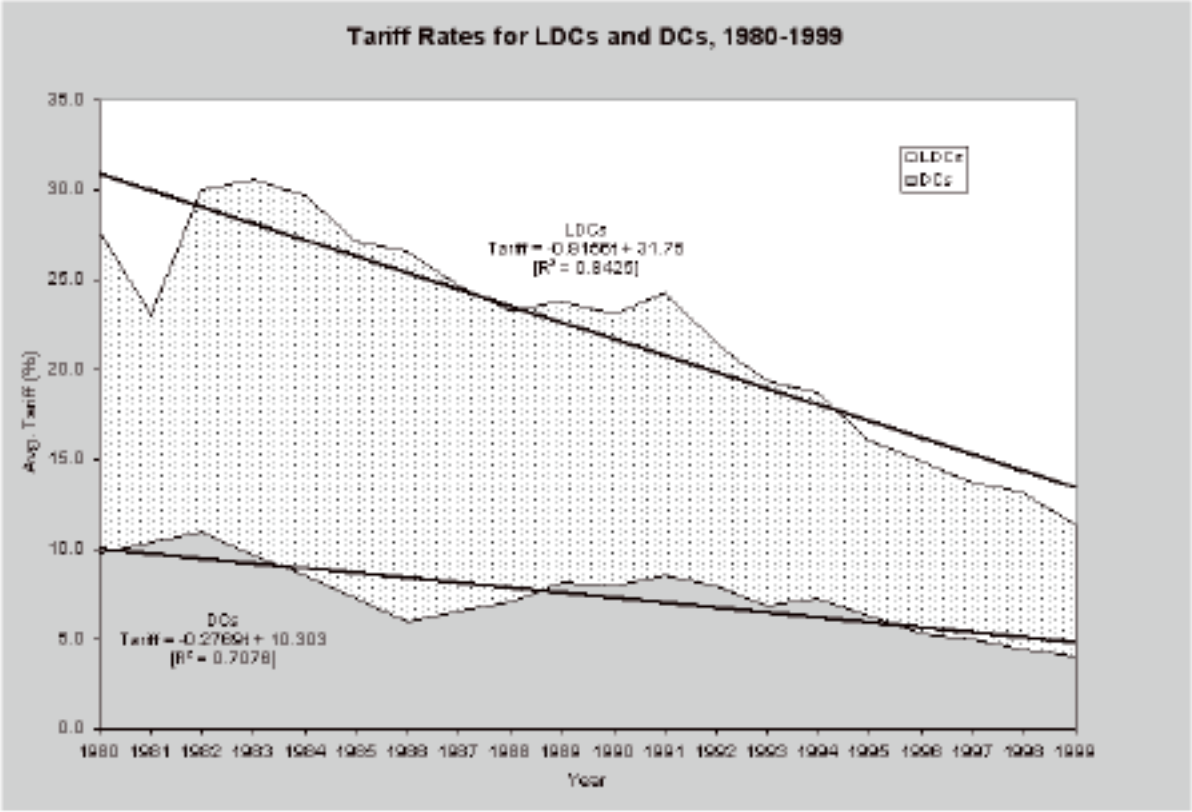
However nice the theoretical predictions are, they are somewhat restrictive and their assumptions are almost always violated in the real world. However, it is still useful to have them as a framework for the analysis of the data. The primary subjects of study relating to the effect of trade on development are the effects of trade on inequality and poverty, the effects of regional trade areas (RTAs) on the welfare of the world, the countries within the RTAs and the countries excluded from these RTAs, the effect of trade on agriculture and the issue of technology.

Regional Trading Areas: Who Wins and at Whose Expense?

Jumping back once again to the theory for a moment, Andriamananjara (1999) develops a game theoretic approach to the problem of whether regional integration is a step towards or away from global free trade. In general, he finds that left to their own devices, the introduction of RTAs will not lead to free trade. This is a result of the diminishing returns to expansion of the RTAs at some point. At this point, the costs of opening up the market to another member is higher than the benefit from preferential access to that market. However, with sufficient multilateral agreements and the co-operation with international organisations (such as the World Trade

Organisation (WTO)), RTAs can produce more optimal results. What is needed for this is that the RTAs must have open membership policies and must reduce external tariffs when the internal ones are abolished. As the data show, however, this is not often the case in practice, suggesting a larger role for the WTO in the future.

Table 1



Source: Own calculations from World Bank data.

Many studies have focused on finding evidence of the impact of RTAs on both the members and the rest of the world (ROW). Soloaga and Winters (1999) use a revised gravity model to separate the effect of the RTA from the country specific effect on trade. They do not find evidence that the formation of a RTA leads to increased intra-group trade. In the case of the EU and EFTA, they find some evidence suggesting that these RTAs cause trade diversion, the switch away from the efficient (external) producers to less efficient (internal) producers. This suggests that the policies of the EU and EFTA are closing parts of their markets to outside countries. Auboin and Laird (1998) find that most EU trade is intra-EU or with other developed countries. The most protected industries are textiles, steel, electrical goods and agriculture, precisely the goods for which the LDCs tend to export the most. As Table 1 shows, the tariff rates of DCs is lower than

that of LDCs, but has remained stable over the past twenty years. The LDC tariff rates have decreased almost completely monotonically over the same period and while still higher than the DCs, much of the difference is due to the use of non-tariff barriers (NTBs) by the DCs[2].

Accounting for these, the effective rate of protection might be higher in DCs than LDCs. The trend in recent years has been for the LDCs to open their markets, while at the same time, DCs exploit various loopholes in the General Agreement on Tariffs and Trade (GATT) to continue to use NTBs to protect their domestic industries. When asked to comment on whether the high barriers to trade imposed by DCs on exports from LDCs has reduced the gains from liberalisation of trade policy in the LDCs, Laird (formerly of the WTO, now at UNCTAD) gave a strong "yes". Further compounding these problems is the tendency for countries in RTAs in Africa and Latin America to specialise in similar goods, limiting their opportunities for intra-regional trade and further increasing their dependence on trade with the DCs from which they have been largely cut off. For an analysis of Africa's regionalism, see Yeats (1998). Foroutan (1998) finds that within RTAs, particularly those with the U.S. and the EU, a high degree of openness is required. However, as has been demonstrated many times, the U.S. and the EU open their economies much less readily. Overall, trade *should* be bringing the LDCs much more trade than it is and much of the blame for this falls on the DCs for refusing to lower NTBs.

Agriculture in the Less Developed Countries

One of the keys to improving the standards of living in the LDCs is increasing the role agriculture plays as a percentage of the value of output produced in developing economies. In the current state, LDCs implicitly and explicitly discriminate against agriculture within their own markets. This occurs through subsidies or other protection of industries. While promoting industrialisation is essential for LDCs to become developed, it is foolish to try to accomplish that by ignoring the importance of agriculture. In the industrialised countries, there is a common theme of high tariffs and NTBs against agricultural imports from the developing nations. The

[2] See Table 2 in the Appendix for the data on NTBs.

effective rates of protection against imports of agriculture are 40% for the EU[3] and 20% for the United States both before and after the Uruguay Round Agreements (URA). After the URA, the U.S. lowered barriers on wheat and the EU lowered barriers on meat, but only by about 10%. Still protected as much or more were rice, coarse grains, sugar, meat, oilseeds and dairy in the U.S. and wheat, rice, coarse grains, sugar, oilseeds and dairy in the EU (Ingco, 1997). In a recent paper, Hoekman and Anderson (1999) suggest the following changes to improve the performance of agriculture in LDCs:

> "From an economic perspective the main gains will come from market access liberalization: reducing agricultural protection (tariffs) in the industrialized countries to the levels applied to manufactures, and reducing the anti-agriculture bias in developing countries induced by protectionist policies in manufacturing and services" (18).

When *both* of these policies are introduced, LDCs will have a significantly greater chance of improving the welfare of their people.

Technology

The impact of technology is one of concern for many. The newer the machine, the higher the embedded technology and the lower the labour requirement to operate it. However, many LDCs do not have the skilled labour for operating these new machines at full efficiency. In addition, it may be more beneficial to use older (more labour-intensive) machines to increase employment. This decision is socially beneficial through the increased employment as well as more beneficial to firms because of the low price of labour relative to capital. But the LDCs have done the opposite; importing old machines is prohibited or highly taxed in many LDCs. Navaretti, Soloaga and Takecs (1998) develop a theoretical model and present empirical evidence for the proposition that older technology is beneficial because of the employment gains and lack of skilled labour. They suggest that the best course for LDCs to take is one in which they reduce or eliminate the taxes on the importation of old (used) machinery. However, this will not be enough because as technology progresses ever more rapidly, the LDCs will fall technologically further

[3] The EU's Common Agricultural Policy (CAP) is a major problem for LDCs because of its high levels of protection and subsidy of agricultural production. The excess product produced is often dumped in LDCs markets, driving down the domestic price and hurting farmers far poorer than those it helps within the EU. An abandonment or large reform of CAP should be a significant policy change for the EU. Similar accusations have been levelled at the U.S., but the U.S. policy is less immediate because of the differences in scale and the possible outcomes of CAP with EU enlargement.

and further behind the DCs. Navaretti, Soloaga and Takecs state that there are strong complementarities between providing incentives to using old machinery and developing a good investment climate and increasing the level of technical education among the working population. This policy will result in higher employment now and a technological convergence with the efficiency of cutting-edge technology in the future. These results are applicable not only to domestic firms, but also MNCs and other sources of FDI.

Trade and Poverty: Is The Gap Shrinking?

When analysing the impact of trade it is important not only to consider the aggregate effects but also to study those affecting the distribution of gains and poverty. Trade theory provides little in the way of a guide to how the gains will be distributed. For example, in the HO model, while the country as a whole may gain, the specific impact of the gains from trade on each sector is uncertain and is different for capital and labour. In the context of the LDCs, the primary impact on poverty will be affected through increasing the gains to labour where the bulk of those living in poverty make their income. Hoekman *et al.* (2001) assert that "in developing economies, trade liberalization should favor labor since exports will typically be labor intensive" (5). They also suggest that a social safety net for the poor is highly complementary to trade liberalisation. Without the former, the adjustment costs, while they may be small and present only in the short-run, can have the most impact on the poorest. Furthermore, because the poor are predominantly in agriculture and the urban informal sector, trade liberalisation will help them in the long-run through a decrease in the anti-agriculture bias[4] and the creation of jobs in the formal sector[5], which are most likely to be more reliable and longer-term than jobs in the informal sector. It seems to be consensus among most of the relevant papers that poverty does not simply mean a lack of access to the basic physical needs. It also includes access to education, health care, etc. In the short-run, the needs of the poor may suffer from trade reform unless there is an adequate policy framework such as the above mentioned social safety net. However, it is also much agreed upon that without sustained increases in trade, there will be little chance of sustained increases in national wealth and a reduction of (absolute) poverty[6]. These results suggest that increased trade

[4] See the section on agriculture.

[5] However, in a study on the link between trade and employment in Latin America and the Caribbean, Márquez and Pagés-Serra (1998) found a very small *negative* effect of trade on employment.

[6] The ignored case is increased equality to a low standard of living so that everyone is equally poor. In that situation, the relative poverty level is nil, but it is not a desirable outcome.

is a necessary but not sufficient condition for growth and poverty reductions in LDCs. It is up to the governments of the LDCs and the international agencies that advise them to formulate sound policies that will protect the poor in the short-run and allow them to flourish (or at least sustain themselves) in the long-run.

Conclusion

This paper has aimed at showing the positive impacts of trade liberalisation with respects to the LDCs. It has also tried to address some of the concerns about the sufficient conditions for improving the lives of the majority of the human population of the world who live below or slightly above the poverty line. There is still much more done to formulate appropriate policies for reducing poverty, increasing free trade by lowering the tariffs and NTBs of the DCs, and giving the appropriate technology to the LDCs without allowing them to fall far behind the DCs' technological frontier. Despite these limitations, freer trade is better for the LDCs. Many of the gains have not been seen because of the DCs stubbornness in accepting the full spirit of the GATT and WTO. Out of 140 members of the WTO, around 100 are LDCs. These countries have the power to help themselves with the international legal framework that the WTO provides. They can do it, but its not going to be a quick process.

Appendix

Table 2: Change in Non-Tariff Measures in LDCs, 1989-1998

	Core NTMs	Licensing	Imp. Monitoring
Median (All)	-9.8	-13.5	0.0
Max (All)	14.6	2.0	0.0
Min (All)	-44.9	-49.0	-100.0
Mean (All)	-14.0	-16.4	-7.4
Mean (Asia)	-15.3	-17.0	-2.6
Mean (Africa)	-15.3	-18.0	0.0
ean (Latin Am.)	-11.0	-14.4	-20.0

Note: Non-tariff Measures (NTMs) is caculated as frequency ratio in % of all HS 2-digit product categories. Core NTMs include licensing, prohibitions, quotas and administered pricing. The values are the change in NTM between the periods 1989-94 and 1995-98.

Source: Own calculations using World Bank PRWP No. 2214 data.

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