

Comments on:

“Trade Liberalization and Poverty in Asia: Issues and Policy Options”(by R S. Rajan)
Arvind Virmani¹

1 Introduction

The paper starts by defining globalisation and giving three factors that have aided it. I am in full agreement with the first point relating to advances in ICT and the third point relating to the shift in perceptions about the role of government and market incentives. The second point, in my view needs modification. It is widely assumed that the shift in perception (mentioned in the third point) first took place within the multilateral development institutions like the World Bank and then spread to others.² There was however another factor underlying the development of institutions such as WTO and the nature of their agenda, that is not mentioned. This was the perception in the USA and other developed countries in the mid-eighties of a strategic trade threat from Japan. Though the initial paranoia has long since waned, the idea that one or more large countries might make terms of trade gains at the cost of other large countries has not disappeared. The quest for strategic advantage through trade liberalisation in other large or potentially large economies has motivated several large countries’ push for global economic liberalisation directly or through multilateral institutions. The extent to which these institutions have succumbed to this agenda has varied, with a welcome return in the last few years to a re-emphasis on the policy distortions in the rich countries that harm the poor ones.

The paper quite correctly asks us to distinguish “Globophobia” from the genuine social concerns that may underlie it. In doing so one must be careful to distinguish between the concerns of the middle class in developed countries from those of the poor in developing countries. In the early stages of anti-globalisation protests, the latter were too often used as a cloak for the former. This too is gradually beginning to change. We must remember that the income of the average low-income person in country is ten times the per capita income of the average person in a poor country. Though the concerns of the middle class wage earner in a high-income country may be genuine, these are fundamentally different from the concerns of a poor person in a poor country. To take an extreme example the same word “environment” evokes concerns about global warming and extinction of species in one and of getting enough water, often muddy sometime black, for drinking and washing in the other.³

2 Finance and Capital Flows

¹ Adviser, Planning Commission, Government of India. The views expressed herein are the views of the author and do not necessarily reflect the views or policies of the Asian Development Bank (ADB) or its Board of Directors or the governments they represent. ADB makes no representation concerning and does not guarantee the source originality, accuracy, completeness, or reliability of any statement, information, data, finding, advice, opinion, or views presented.

² I was personally witness to this transformation during the eighties, while observing from the vantage point of the policy research department.

³ In one personal encounter with a highly principled and socially conscious individual at a seminar in Europe this point evoked polite abuse reminiscent of the word “male chauvinist pig” used by anti-Vietnam war protestors in a bygone era.

The paper then distinguishes between three aspects of globalisation, capital, labour and products. On the first, he concludes that, “there is limited evidence to suggest that globalisation of finance and capital flows (other than FDI) has had a discernible positive impact on growth.” About two decades ago a World Bank staff paper argued that the nature of credit markets in developing countries was quite different from those in the developed countries because of severe information problems.⁴ The Latin crisis of the eighties and the Asian crises have brought these points home with a vengeance. The experience of macroeconomic management in India viewed in the background of, persuades us that the effects of liberalisation of short-term debt flows (bank deposits and loans of one year maturity or less) may be quite different from those of other capital flows (medium & long term debt and equity).⁵ Further these effects can be quite different in a fixed rate regime and a floating rate regime. We believe that liberalisation of short term capital flows in a fixed rate regime is likely to increase the probability of financial crisis, while the increase in risk is minimal in a managed but market sensitive floating rate regime. Thus the potential benefits of liberalisation will be visible in the latter while they are likely to be overwhelmed by the negative effects of crises in the former.

3 Migration

The paper makes the telling point that greater mobility of unskilled labour across national boundaries would undoubtedly reduce world poverty. I would however, differ somewhat on a few points made about the movement of skilled labour from developing to developed countries. First the issue of subsidies to higher education. There is no justification for providing education subsidies to the rich and middle class as is often done. The solution to this problem is not to tax or restrict emigration but to phase out these subsidies. Well targeted subsidies to the meritorious poor can on the other hand be theoretically justified. In practice we find that the pricing of higher education is so low that even the relatively poor in rural areas are willing to pay much higher fees for schooling than they have to pay for publicly provided higher education. Attaining some semblance of balance through a rise in college fees coupled with means cum merit scholarships and government guaranteed loans must take priority over schemes to tax poor emigrants.⁶

In the mid-eighties a member of the Indian Planning commission made the point that, “Brain drain is better than Brain down the drain.” This pithy and memorable phrase hides some serious points that seem to be often missed in the literature. This followed a decade in which the issue of “Educated unemployment” had caught the popular. Stories about youngsters with undergraduate degrees having to work as peons and taxi drivers were legion.⁷ The simple point is that the issue of migration can-not viewed in isolation from domestic supply-demand balances in the home country. Push factors have often be much more important than pull factors in the emigration of skilled labour, and to force such people to waste their education is difficult to justify in a democratic country. A recent paper by Stark and Wang (2002) suggests that the possibility of migration may raise the private demand for education

⁴ Virmani (1982).

⁵ See for example Virmani, 2001.

⁶ Virmani (1999).

⁷ During the mid-nineties my peon had a BA degree. I am glad to report however that by 1996 he had passed a recruitment test and became a clerk in the government.

and thus increase the demand for education and consequently the supply of educated individuals.

I am also sceptical about the calculation of fiscal losses from migration of skilled people. The use of a full employment model, that attributes the full marginal product of a migrating individual as a loss, though it may be justified for upper middle-income countries, vastly overstates the loss to low income countries. One of the stylised features of a low income Asian economy is underemployed labour. Thus a marginally lower skilled person will replace the skilled migrant and so on down the ladder of skills, with the last person being an under-employed unskilled individual whose marginal product is much less than the minimum wage in the organised sector. The real loss to the low-income country is likely to lie somewhere between the marginal product of this unskilled person and that of the migrating person. In the case of middle income countries even if such estimates of short-term losses from skilled labour migration are valid, the reverse flow of emigrants into South Korea and Taiwan suggests that the long term benefits may still outweigh the costs.

4 Growth and Poverty

We turn now to the main focus of the paper the globalisation of trade or trade liberalisation and its effects on growth, poverty and income distribution. This section of the paper starts with the statement that, though “growth is a necessary condition for a sustained reduction in poverty,” it is “by no means a sufficient condition for poverty reduction.” In the context of Indian growth and poverty reduction, a recent paper made the following assertion:⁸ “The development lessons from the Asian high growth economies, including India (in recent decades) and Japan (in earlier ones), are that growth is necessary for development and poverty removal. A number of commentators have however, raised the issue of whether growth is also ‘sufficient’? Our answer is yes and no: Yes, high growth, sustained over a period of three or four decades, is ‘sufficient’ to eliminate poverty. No, in that high growth cannot be sustained over four decades without development of and change in government, market and social institutions.”

Even in an oligarchy (with or without democratic trappings) adverse changes in income distribution can be suppressed for a couple of decades, but not for ever. A sustained and substantial worsening of the income distribution in a given country will eventually reduce its growth rate. In a truly democratic country (i.e. one in which the interests of the poor are represented) adverse changes in the income distribution do not go unnoticed for long and affect the growth rate much sooner. Therefore areas of very slow growth (relative to the average) have to receive special attention if high growth is to be sustained. From this perspective, the “complementary policies” referred to in the paper are policies necessary to sustain high growth over long periods.

5 Trade and Growth

The paper brings out the distinction between trade outcomes and trade policies and also mentions Quantitative restrictions (QRs) and tariffs as examples of the latter. From the perspective of a operational policy advise this distinction is essential and needs to be explored further. In a brilliant paper, Roberts and Neary showed several

⁸ Virmani (2001).

decades ago that the effect of QRs went beyond the usual one implied by equivalent tax calculations. In comparison with such an equivalent tariff QRs have the effect of reducing the elasticity of substitution in the economy. Thus QRs are much more damaging to the economy than tariffs as they reduce its flexibility in responding to exogenous changes (tastes, technology) and shocks. Another effect of QRs in the form of import bans is to remove the “threat of competition” in a way that even a (currently) prohibitive tariff cannot do. The long-term effects of this on the incentives for improvement and innovation can be very damaging and were I believe one of the factors in the hollowing of the USSR. On an empirical plane our experience of removal of QRs in India supports the conclusions of the study of Choksi et al that there are clear benefits to the economy from removing QRs (even when they are replaced by tariffs).

In the case of tariffs the few studies that have attempted to measure the effect of tariffs on growth have focussed on average tariff rates based on the customs revenue and import data. This ratio is invariant to the nominal exchange rate. The most enlightening study on the effect of tariffs (measured by the average customs collection rate) on growth is by Clemens and Williams (2001). They show that tariff reduction in the post-war period increased growth in contrast to the opposite effect in the pre-war and inter-war period. In the pre-war period global tariffs were high and low tariff countries that raised their rates vis-à-vis high tariff trading partners benefited with higher growth. In the post-war period high tariff countries brought their tariffs down to the lower global rates of their trading partners and benefited from higher growth. This result supports the assumption that underlay our tariff reduction advise in India, that as long as Indian tariff rates were higher than those of ASEAN countries (and consequently also higher than those of our major trading partners the USA & W. Europe) we would unambiguously benefit from tariff reductions.

In practical tax reform we have to focus on reductions of the (simple or weighted) average customs tariff rate. The effect of a specific tariff reduction is critically dependent on the nature of the exchange rate regime: The effect of a given reduction on import demand is less in a market determined exchange rate, because nominal depreciation will partly offset the effect of the reduction of the nominal tariff. In a fixed rate regime, the effect on exports will also be absent and the consequent speeding up of reserve depletion will inevitably require further policy changes in future.⁹ Tariff reductions are therefore likely to have a greater positive impact on growth if the exchange rate is flexible than if it is fixed. This suggests that both average tariffs (calculated from statutory rates) and exchange rates (when fixed/exogenous) should be included as right hand side variables when estimating the effect of tariffs on growth in low-income countries. The lack of clear-cut results when using averages calculated from disaggregated tariff rates may be due to misspecification.

When considering reforms in the structure of tariffs we find the distinction between Consumer goods, Capital goods and Intermediate goods to be extremely important particularly with regard to phasing decisions. In sequencing QR elimination and tariff reductions our order of priority has been Intermediate & capital goods followed by Capital goods.¹⁰ Virtually all literature reviews of the effects of Trade on Growth ignore this distinction. Prof Rajan’s paper refers to Romer (1994) and indicates that it focuses on the inputs into production. In general, however, it is

⁹ This may take a long time if reserves were initially accumulating.

¹⁰ See for example Virmani (2001a).

not very clear from the several 'literature reviews' that I have read, whether specific theoretical results apply only to consumer goods or they encompass capital and intermediate goods. Srinivasan (1996) shows that reductions in tariffs on capital goods imports can raise investment and growth permanently. Similarly, a higher tariff on (and consequently increased protection to) an intermediate good inevitably reduces the effective protection to (i.e. dis-protects) user industries. This raises further demands from one or more users. In our experience the result of such propagation of distortions is highly unpredictable and random and bears little relationship to theoretical justifications that have been pointed out in this and other surveys of the literature. Clearly rent seeking, rent creation and corruption plays a role in the evolution of such structures. This leads us to the conclusion that a uniform tariff on intermediate and capital goods is to be preferred in the absence of strong reasons to the contrary Virmani (2002).

The conclusion of Rodrik (2000b) that both growth and larger trade are caused by the quality of institutions, can be re-interpreted by us as follows. Institutions that delivered better governance, minimised rent seeking, rent creation and corruption and therefore minimised tariff distortions and consequently the negative effects of protection policies. The policy conclusion can however be quite different from ours (i.e. uniform tariffs); namely that without institutional reform tariff reductions are pointless as they will have little effect on trade and growth.

The issue of sequencing trade reforms and other macroeconomic reforms, raised in the paper is also very important. In this context we need to distinguish between extreme situations such as that in the middle of a crisis or hyperinflation and normal range of variation in economic situation. In the case of the former, it is quite clear that macroeconomic stabilisation must take priority over tariff liberalisation. Even here there is an exception. If the level of protection is extreme compared to global averages, even simultaneous action on the true fronts can be quite beneficial, given the confidence that the trade balance will respond in the expected direction to nominal exchange rate changes. In a normal range of economic situations our experience suggests that there is no absolute pre-requisite. Once there is a reasonably clear target for different policy variables, priority in phasing should be given to those policy distortions that differ most from the desirable. The best (phasing) should not, however, become the enemy of the good (phasing): Trade or other reforms cannot and should not, in our view, be held hostage to the most distorted policy (e.g. fiscal deficits, power price controls) if political considerations do not allow faster reform in the latter. This approach has resulted in India's external liberalisation being one of the most demonstrably successful of all reforms (which included tax reform, infrastructure policy).¹¹

6 Trade and Poverty

6.1 Isolation

The inverse of Globalisation can be termed "Isolation." Not so long ago there was a consensus that Isolation was bad for a country and its growth. Small island economies and landlocked countries were thought of particularly vulnerable on this count. Committees and commissions were set up to review the problems of such

¹¹ Virmani (2001a).

countries and suggest solutions. Isolation is a problem not just for such economies, but also for regions within such economies. Remote and hilly areas within countries have long been recognised as extreme cases of isolation. The question of balanced regional development has received varying amounts of attention in medium-large economies. More recently the role of geography in economic development has received increased attention.

The forces of isolation within countries are as if not more important than the forces of globalisation across countries in determining the relationship between growth & equity in developing countries. Information, communication & transport need not develop at the same pace within a country as between countries. Indeed several authors have noted that the capital city and/or coastal cities of many countries are better connected with the outside world than their own interior towns. The possibility of deterioration in transport and other ICT facilities is more common within countries than between countries. The counterpart of globalisation on an international scale is economic integration at national level. As in the former we have to look at the evolution of internal trade and the flows of capital and labour within the country to determine the extent to which national integration is overcoming regional isolation.

6.2 National Integration

The global ICT revolution also provides an insight into the potential reasons why different regions and groups within a (medium-large) country may grow at different rates and vice-a-versa. Just as improvement in Information, communication and transport has facilitated global integration, lack of such progress (and in some cases even a worsening due to deteriorating governance) can lead to the worsening of inequality within medium/large countries. By the nature of economic underdevelopment the level of ICT within the country may in fact be worse than between the country (or its port/major city) and other countries. In most growing economies industry is the leading sector in growth and urbanisation is centred around such growing industry. Thus the ICT linkages between the urban and rural areas (particularly the hilly and remote areas) are critical to the spread of growth impulses. Though there may not be tariff/quantitative barriers to trade, tax and other policies can have similar distorting effect. Policies that promote such linkages such as Road connectivity and efficient/lowest cost telecommunication will promote growth, poverty reduction and stability in the income distribution.

Information and knowledge transfer is not however merely a matter of physical connectivity. Some level of education is necessary for a person to search for, understand and utilise relevant knowledge for productive purposes. Thus rural education is essential to promotion of the ICT revolution within a country. Public policies must therefore focus on such policies not only in a general (average) way, but ensure that rural areas and isolated groups get cost effective education. This promotes both internal and external convergence in growth.

6.3 Rural-Urban Differences

If we agree with the conclusions of Prof Rajan's paper (as I do) that global mobility of unskilled labour would be good for the poor, than the same must be true within a country. With few obvious barriers to internal labour mobility in most countries, it is a puzzle why urban rural differences in poverty persist within a country for decades. Some times as in China there may be explicit restrictions on the movement of people between rural and urban areas and from slow to fast growing

regions. Social divisions, ethnic, religious, caste and language differences undoubtedly play a role. We often find a concentration of migrants from a particular village or region working in specific economic clusters and areas. This suggests that the only means of information transfer are through social networks. Virmani (1999) therefore identified information externalities as a possible cause of low mobility and proposed the building of the comprehensive information network to match job opportunities with available man power. This would be particularly relevant for unskilled and uneducated labour in poor rural areas. It was purposed that such a network should be a part of broader labour reforms that allow legal & procedural flexibility in organized sector employment, improve the incentive for work and help to reduce the segmentation between formal and informal sectors.

Given the lack of information with potential migrants factors such as droughts and floods and a progressive deterioration in job opportunities seem to push the poor out of informationally isolated areas and force them to look for earning opportunities. In India over the past decade it has been observed that the unskilled labour from Bihar, one of the poorest states, have migrated to all parts of the country from J&K in north to extreme south. The division of families, with able bodied males migrating, requires greater care in design and implementation of consumption/ income surveys to take account of remittances, if erroneous conclusions are to be avoided. I would also suggest that there is a need for much greater research for labour mobility, its causes and consequences.

6.4 Internal Trade

Trade between rural and urban areas requires communication and transport facilities. The more primitive the facility the greater the probability that long entrenched traders earn rents at the cost of rural producers. This applies with even greater force to remote isolated and hilly areas. Adequate ICT infrastructure is essential for promoting competition and equitable growth. I would hypothesize that the slow growth of such infra structure, perhaps even a deterioration in the quality of existing links, is one reason for an increase in inequality over the past decade or so. The solution is to improve to the policy environment for the growth of telecom, ensure the governments supply the most critical of public goods such roads and highways. Laws, rules and regulations that hinder the storage, transport and processing of agricultural goods and reduce competition, can cause harm to rural growth and poverty reduction.

6.5 Capital Flows

Data on domestic investment and capital flows within the country is seldom readily available. The credit-deposit ratio of banks across regions does however give an idea of the direction of such flows. This ratio is negatively correlated to growth, with the ratio being less than one in relatively slow growing regions. This means that capital is flowing out of such regions either because of lack of profitable investment opportunities or because of informational problems in identifying such opportunities. In addition to the problems we have discussed above an additional problem is poor or deteriorating governance. Regions that fail to provide the most basic of public goods, personal and physical security are unlikely to attract investment from other regions much less from foreign sources. Uniform labour standards and minimum wages across regions also counter the natural tendency for the more labour intensive industry to be attracted to the poorer regions where unskilled wages are inherently low. Poor

governance also imposes considerable transaction costs on industry and trade thus biasing the system against such regions. Non-government organisations can play an important role in the delivery of quasi-public goods like basic education and health services when the quality of governance is poor.

6.6 Uncertainty and Shocks

One of the negative effects of globalisation is the introduction of new and unknown risks into. Individuals in a country have learned how to deal with domestic shocks over centuries, while institutions have evolved over the decades to help them cope with these shocks (e.g. drought, floods). Globalisation coupled with sudden opening of the economy can open the country and its people to new types of shocks that they are not prepared to deal with. This problem is more acute in the rural and agricultural sectors. To give one (artificial) example lifting of QRs coupled with moderate tariffs may result in some good (10 digit level say) being imported in large quantities at a fraction of the prevailing price due to newly discovered markets. If the good is a manufactured product, both the entrepreneur has a fair chance of moving on to another manufactured product. a small region growing a very specialised crop can hat the suddenly results in a large inflow

7 References

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