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Trading Up: Trade Policy and Global Poverty

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Summary: The trade ministers of WTO-member countries will soon meet in Cancun, Mexico, to review progress in the current round of multilateral trade negotiations (named for Doha, Qatar, where it was launched in late 2001). There has been well-founded concern that Cancun could mark the collapse of the Doha Round, largely because industrial countries have been unprepared to grant enough liberalization in their highly protected agricultural markets to encourage developing countries to participate by liberalizing their markets for manufactures. Other contentious issues include the balance between humanitarianism and market incentive for research and development in the area of pharmaceutical patent rights. If all parties can agree to move ahead, the Doha Round holds major potential for reducing global protection and, thereby, global poverty. At the $2-per-day threshold, 2.9 billion people remain poor today—almost half the world. Used effectively, trade policy can be a major instrument for reducing this number. Global trade liberalization could substantially reduce global poverty in five important ways outlined in the box below. This policy brief is a preview of the analysis and recommendations in *Trade Policy and Global Poverty,* by William R. Cline, available later this year.

Trade ministers have an opportunity at the Fifth WTO Ministerial in Cancun to deliver on Doha commitments to enhance developing-country prospects for poverty reduction. Global trade liberalization could be a positive force for reducing global poverty in five important ways:

1. Liberalization of agricultural markets is the single most important way that the Doha round could reduce global poverty. When all forms of protection are consolidated into a single tariff equivalent, agricultural protection against developing countries amounts to 34 percent in the United States, 100 percent in the EU, 230 percent in Japan, and 65 percent in Canada. Free trade in agriculture would reduce global poverty by an estimated 200 million people, or about 7 percent.

2. Free trade boosts global income and unskilled wages in developing countries. Global free trade would boost world income by about $230 billion annually, with about $140 billion in gains for industrial countries and $90 billion for developing countries. In developing countries, real wages of unskilled labor would rise by an estimated 5 percent as a result.

3. Increasing trade spurs productivity, which in turn supports long-term increases in per capita income. Productivity gains in developing countries would lift an estimated additional 200 million people out of poverty in the long term.

4. Increased trade opportunities induce investment, which also generates long-term increases in per capita income. Capital investment effects could conservatively reduce the number living in poverty by an additional 300 million people.

5. Agreements on preferential access for developing countries have helped and should be expanded. Immediate free access for imports from the poorest countries—the Least Developed Countries, sub-Saharan African countries, and the Highly Indebted Poor Countries—into markets of industrial countries would accelerate poverty reduction. Seventy percent of the combined population of these countries lives in poverty, giving imports from these countries a higher "poverty intensity" than those from other countries.

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Open markets increase growth and reduce poverty

Most of the demonstrators at Seattle in 1999 thought that globalization causes poverty; most of those who will demonstrate at Cancun probably still think so. Increasingly, however, such key NGOs as Oxfam have recognized that new market opportunities from trade liberalization by industrial countries could instead be a major force for reducing poverty in developing nations. They have correctly concluded that done right, globalization reduces rather than increases poverty.

Classical economic theory says that global trade liberalization should help the world's poor. Poverty will only be reduced effectively through economic growth, and trade opportunities are key to growth. Open trade provides economies of scale for countries too small to achieve them domestically. Open trade stimulates economic growth through the diffusion of new technology and through competitive pressure that reduces the monopoly power of domestic firms that are thereby pressed to innovate rather than keep prices high to consumers (including the poor). Developing countries tend to have abundant unskilled labor and scarce capital and skilled labor. Basic trade theory says that in such countries, global trade liberalization will boost demand for exports of goods that intensively use unskilled labor, and as a consequence will boost unskilled wages relative to skilled wages and capital earnings.

The fact is that trade liberalization is a major area of unfinished business in the fight against global poverty. Recent empirical work supports this. First, the number of poor is sensitive to growth. In many Asian countries, each percentage point of additional GDP per capita reduces the number of poor by 3 percent or more. In Africa, where almost everyone is poor, and in Latin America, where the rich obtain a larger share of income, the response is more muted but still in the range of 1–2 percent poverty reduction for each percentage increase in per capita income. Second, research shows that trade is good for growth, and therefore good for the poor. The research is almost unanimous in finding that countries that obtain higher trade relative to GDP achieve higher productivity. There is more dispute about whether and by how much developing countries' own protection needs to be reduced further to spur growth, but all parties in this debate agree that developing countries will be better off if they have better access to industrial-country markets.

Agriculture matters most

One of my key findings is that liberalization of agricultural markets is the single most important way in which Doha could reduce global poverty. Three-fourths of the world's poor live in rural areas. They would benefit from increased export opportunities in world markets. The present combination of high agricultural tariffs and major subsidies in industrial countries has the effect of reducing agricultural prices on the world market by artificially limiting demand and boosting supply. Complete liberalization would raise world agricultural prices by perhaps 10 percent. The poor farmers globally would gain directly, and their gains would far outweigh the losses of the less numerous urban poor. I estimate that under reasonable assumptions **free trade in agriculture would reduce global poverty by 200 million, or about 7 percent.** (See Box 1 for estimations of poverty reduction in select countries associated with agricultural trade liberalization.)

The smoking-gun evidence of agricultural protection is not hard to find. The Uruguay Round of multilateral negotiations did away with agricultural quotas but left in their place "tariff-rate quotas" that kick in at prohibitive tariff rates once threshold import volumes are reached. Domestic farm subsidies of about $50 billion annually in the EU, $25 billion in Japan, and $20 billion in the United States expand domestic output, reducing imports by the same amount as equivalent tariffs of about 20 percent in both the EU and the United States and 10 percent in Japan.[1] I have estimated that when tariffs, tariff-rate quotas, and subsidies are all consolidated into a single tariff equivalent, **agricultural protection against developing countries amounts to 34 percent in the United States, 100 percent in the EU, 230 percent in Japan, and 65 percent in Canada.** This protection is simply inconsistent with a willingness to help the world's poor, especially when it is considered that the bulk of the subsidies and excess profits are received by large, often corporate, farmers in industrial countries rather than families considered poor by industrial-country standards. For example, the top recipient farm corporation in California received $1.8 million in subsidies in 2001, and even the 100th largest recipient obtained $430,000 in subsidies.[2]

Free trade and higher world prices in world agriculture would have an adverse impact on poor countries that are large net importers of food, and this effect should be taken into account in the design of official assistance policies.

Box 1: The Impact of Global Agricultural Liberalization on Poverty in Selected Countries

Millions of rural poor could be lifted out of poverty by a modest increase in world agricultural prices. Such an increase allows developing-country farmers to get better prices for their crops. Eliminating agricultural subsidies and protection in the United States, Europe, and Japan will decrease their production, raising prices on the world market and increasing the market for developing-country producers. Agricultural liberalization will affect different countries differently and the urban poor will have to pay more for food—but overall, 200 million people could be lifted out of poverty.

Country	% of poor in rural areas	% of GDP from agriculture	Change in poverty	
			Percent	Millions of People
Argentina	13.5	5	5.4	0.3
Bangladesh	94.0	25	-11.8	-12.0
China	88.9	16	-10.6	-72.1
Colombia	74.9	14	-9.0	-1.1
Guatemala	73.6	23	-9.9	-0.7
India	70.5	25	-6.8	-59.2
Indonesia	72.3	17	-7.1	-9.9
Kenya	83.8	2	-14.8	-2.8
Malawi	95.0	42	-15.2	-1.3
Mexico	31.9	4	2.0	0.8
Pakistan	72.5	26	-8.9	-10.4
Tanzania	88.3	45	-12.0	-2.4
Turkey	30.7	16	2.2	0.3
Venezuela	15.9	5	5.5	0.5
Vietnam	90.1	24	-15.1	-6.3

Fortunately, this impact should be limited. A calculation based on a leading international trade and protection data set (GTAP5) shows that only about one-sixth of the world's poor live in countries or regions that are net importers of food, and even in this group the net food trade deficit per capita tends to be relatively small ($5 annually—or 0.7 percent of poverty-line income—in Bangladesh, $8 in Pakistan, $12 in Mexico), although the levels are higher in the Middle East and North Africa (about $75) and Eastern Europe and the former Soviet Union (about $40).[3] Moreover, even within net food-importing countries, higher agricultural prices will tend to shift income from the urban to the rural sector, where the poor tend to be concentrated. In contrast, the most important countries and regions for global poverty tend to have at least modest food-trade surpluses (China, India, Indonesia, sub-Saharan Africa, and most of Latin America).

Free trade boosts overall welfare and unskilled wages in developing countries

Evaluating the effect of multilateral trade liberalization on global poverty is complex, in view of the numerous direct and indirect effects that must be taken into account. For example, reducing the tariff on textile fabric will affect the cost of the input used by producers of apparel. Similarly, production profiles after liberalization have to take into account how "factor prices" (wages, land prices, interest rates) will have changed.

That said, dividing trade into 22 product groups and the world into 30 countries or regions, and applying a leading model[4] to 1997–98 (GTAP5) data, I estimate that **global free trade would boost world economic welfare by about $230 billion annually,** with about $140 billion in gains for industrial countries and $90 billion for developing countries. For developing countries, the median estimate is that **real wages of unskilled workers would rise by 5 percent as a result.**[5] After applying each country's responsiveness of poverty to changes in income for the poor (noted earlier), a conservative estimate based on these "static" effects is that the result would be a reduction in global poverty by about 115 million. In a long-term "steady state" version of the model, allowing for increased capital investment in response to the new trade opportunities, the reduction in the number of poor could be as high as about 750 million, although this would require large investments, amounting to an expansion of the original capital stock by about 40 percent of developing-country GDP.

Tests with this model confirm that **agriculture is the most important sector to liberalize,** accounting for nearly 60 percent of welfare gains for industrial countries and over 50 percent for developing countries. **Textiles and apparel are also crucial,** accounting for another 12 and 8 percent of gains respectively. The latter result should ease concerns of those who fear developing countries could lose out in textile-apparel liberalization because of the loss of "quota rents." Alternative tests also show that developing countries do better to participate in global trade liberalization than to keep their own protection unchanged while industrial countries dismantle theirs. One reason is that developing countries are major customers of each other, and they tend to face higher tariffs on manufactured goods in each other's markets than they do in industrial-country markets. In the model database, developing countries currently carry out 36 percent of their trade with each other.

Increasing trade spurs productivity and induces investment, reducing poverty

The "dynamic" gains from global free trade, and the corresponding poverty reduction, could be even larger. Many argue that greater economic integration boosts productivity growth, which in turn raises income and reduces poverty. There is a rapidly growing literature on the statistical relationship between the extent of a country's trade with other nations and its growth rate and/or level of income per capita. From this literature I have synthesized the following central parameter: a 1-percent rise in the ratio of trade (exports plus imports) to GDP has been associated with a rise of about 0.5 percent in the level of long-term per capita GDP, of which the bulk comes in the form of increased overall ("total factor") productivity rather than higher capital per worker.[6]

This estimate may be combined with the earlier model estimate of the impact of trade liberalization on the level of trade. Global free trade would boost the level of international trade for developing countries by an estimated 3 percent, weighting by existing trade shares, and by over 5 percent weighting by shares in global poverty. Increases in trade are above average for a number of countries with large poverty populations (including China, India, and especially Bangladesh and Pakistan).

Combining the percent increase in trade with the parameter for long-term productivity response to such an increase, setting the latter conservatively at 0.4 to reflect pure productivity gains instead of increases requiring additional capital, and then applying the results to the individual countries' poverty base yields an estimate of 200 million as the long-term reduction in the number of poor from increased productivity associated with free trade. This can be added to the number of poor lifted out of poverty by static free trade gains (115–200 million, as discussed).

As noted earlier, the trade liberalization model captures a second important dynamic effect: increased capital investment in response to new trade opportunities. After further taking account of these "steady state" effects by conservatively incorporating only half of their additional gains, I estimate that over the long term (10–20 years), **free trade would lift out of poverty an estimated 650 million people globally.** By 2015 this would reduce the global number in poverty by about one-third from the baseline without trade liberalization.

An early harvest: free market access for poor nations

There is an important parallel track of trade opportunity that could substantially enhance the prospects of reducing global poverty. Any multilateral trade agreement is likely to phase in liberalization over time. Immediate free access for imports from the poorest countries—the Least

Developed Countries (LDCs), sub-Saharan African (SSA) countries, and the Highly Indebted Poor Countries (HIPCs)—into markets of industrial countries would accelerate the poverty reduction impact. These groupings account for 64 countries with a combined population of 1 billion, of whom 715 million live in poverty.

The "poverty intensity" of industrial-country imports from these countries is 64 percent on a head count basis and 45 percent on an income share basis. The "poverty intensity" of imports from a group of countries may be estimated by weighting imports from each country either by the "head count" fraction of households in poverty or by the fraction of income received by the poor in the country. Where income is unequally distributed, the income share measure will tend to be considerably lower than the head count measure. The maximum possible poverty intensity would be 100 percent on both measures for a country where the entire population is poor and all income goes to the poor. So in this case, weighting by industrial-country imports, these countries have an average of 64 percent head count poverty incidence and an average of 45 percent of total income in the country going to the poor. In contrast, industrial-country imports from developing countries more generally have a poverty intensity of just 32 percent on a head count basis and only 8 percent on an income share basis. **If industrial countries are to use the trade instrument in a more focused way to reduce global poverty, granting special market access to these low-income country groupings is a relatively efficient way to do so.**

Preferential access for developing countries has tended to develop a bad reputation because of the meager effects of the Generalized System of Preferences regimes, which typically cut off a country's special access when its exports into the market reach a threshold reflecting competitive capacity, and which also typically exclude sensitive sectors such as textiles, apparel, and important agricultural goods. There is evidence, however, that the more recent preferential regimes that are more intensively focused on poor countries have succeeded in boosting their exports. Statistical tests in my forthcoming study suggest that after controlling for other influences, countries have achieved extra export growth of as much as 7–8 percent annually from being members of the US Caribbean Basin Initiative or the EU's Lome-Cotonou arrangement, and of about 2 percent annually for Andean Trade Preference Act members. There are some signs that the recent Africa Growth and Opportunity Act (AGOA) is similarly spurring exports from sub-Saharan Africa to the United States.

At Cancun and in the next phase of the Doha Round, industrial countries could provide an "early harvest" for what is supposed to be the "development round" by committing to prompt extension of free market access to the LDCs, HIPCs, and SSA. This would include eliminating the "carve-out" impediments in existing arrangements (e.g., accelerating inclusion of key agricultural goods in the Everything But Arms and liberalizing textile-apparel rules of origin in AGOA). An important start would be for the United States to substantially extend the life span, and liberalize the conditions, of the African Growth and Opportunity Act regime, and to further invigorate it by granting a 10-year exemption from US corporate tax for firms making direct investments in sub-Saharan Africa.[7]

Meaningful preferential initiatives for poor countries should not be discouraged on grounds that they would divert trade from other developing countries, simply because the magnitudes are too small to worry about. In particular, the LDCs, HIPCs, and SSA countries combined represent only about 6 percent of total imports from developing countries for the United States, 8 percent for the EU, and 4 percent for Japan. Nor should the argument that their new-found preferences would soon erode from general Doha liberalization serve to block such initiatives. Immediate implementation of free access for poor countries would give them an important head start on the broader liberalization timetable.

Delivering on Doha's promise

Near-term collapse of the Doha Round appears to have been averted by a mid-August 2003 agreement between the United States and the European Union providing for a greater commitment to liberalizing agriculture. The most concrete provision is apparently a ceiling for subsidies at 5 percent of agricultural sector output. The extent of the commitment to removing agricultural tariff-rate quotas and phasing down agricultural tariffs is unclear, however, and developing-country spokespersons have tended to react skeptically to the proposal. At the same time, the US and EU have also made proposals calling for relatively deep reductions in tariffs on manufactured goods. It is not unduly difficult for them to suggest such reductions, considering that—at least outside of textiles and apparel—their average manufacturing tariffs are already low at about 2 percent for the United

States and 3 percent for the EU. So far, then, the deal offered by industrial countries appears to give up relatively little in the key area of agriculture and to ask for rather a lot in the way of cuts in tariffs on manufactures by developing countries (not to mention other requests, including the tightening of patent and investment rules).

If unwillingness to go much further on agriculture, or any of a number of other contentious issues in the Doha Round, were to cause the round to fail, numerous countries would likely pursue individual Free Trade Agreements (FTAs). This more balkanized version of global integration would be a poor second best to multilateral liberalization. FTAs would tend to involve prolonged periods of sequential negotiations with a queue of individual countries, and would tend toward more lopsided bargaining power between the big industrial-country side of the FTA (the US or EU, for example) and the aspiring developing-country partner (such as Chile or Morocco). One of the advantages of multilateral negotiations for developing countries is precisely that by negotiating together rather than singly, they can better neutralize the monopoly bargaining power of a large industrial country that is to some extent unavoidable in separate FTAs.

Ultimately the Doha bargain will need to include:

- more forceful liberalization of agriculture and agricultural subsidies
- a deep cut in remaining manufacturing goods tariffs (including on textiles and apparel)
- avoidance of any rollback on the commitment to phase out the Multi-Fiber Arrangement quotas by 2005
- a commitment by at least the more advanced developing countries to adopt cuts in their own tariff and non-tariff barriers, even if over a longer phase-in period (and/or with higher terminal tariffs) than for industrial countries

Ideally it would also include an early harvest of free market access for the lowest-income countries, as outlined. It should be possible for World Trade Organization members once again to accomplish a major successful liberalization of global trade, as they have done in past rounds, even though at times during the course of negotiations the chances of agreement have seemed bleak. If the Doha Round can be completed in a fashion that lives up to its designation as the Development Round, a major opportunity for spurring global growth and reducing global poverty will have been seized. Hundreds of millions of people in developing countries could be lifted out of poverty by a decisive move toward global free trade. Much hard work remains to be done in the negotiations, however, before this potential can begin to be realized.

Notes

1 The often cited OECD figure of about $350 billion includes far more than subsides, in particular the effect of tariffs and tariff-rate quotas in boosting prices that domestic consumers must pay.

2 Environmental Working Group (www.ewg.org).

3 The Global Trade, Assistance, and Production database maintained at Purdue University (www.gtap.org).

4 The computable general equilibrium model is that prepared by Glenn Harrison, Thomas Rutherford, and David Tarr (see *Economic Journal,* no. 107, 1997).

5 Unskilled real wages would also rise in the United States and the EU (by about 1 percent) and other industrial countries. This result suggests that the overall welfare gains from free trade more than offset any relative erosion for this "scarce factor" in industrial countries.

6 A great deal of careful statistical work has gone into ensuring that the measurements properly take account of the direction of causation. Higher incomes may also boost relative demand for imports.

7 See William R. Cline, "Trading Up: Strengthening AGOA's Development Potential," CGD Brief, vol. 2, issue 3, June 2003 (Washington, DC: Center for Global Development).

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