Trade Policy, Growth and Poverty in Asian Developing Countries

Edited by
Kishor Sharma

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Developing countries have seen waves of reforms since the mid-1970s, primarily to sustain growth and alleviate poverty. However, there has been mixed experience. With the exception of East Asia, poverty remains a major development challenge in developing countries. Doubts that liberalisation serves the interest of the poor countries remain very strong among the policy makers in low- and middle-income developing countries. The view that liberalisation benefits the rich and that the poor are left out as globalisation proceeds is increasingly heard in public forums in both developed and developing countries.

Kishor Sharma has brought together some of the world's leading experts to shed light on this debate. The book presents a comprehensive analysis of the link between policy liberalisation, growth and poverty in 11 Asian developing countries (Bangladesh, China, India, Indonesia, Korea, Malaysia, Nepal, Pakistan, Taiwan, Thailand and Vietnam), which constitute a large portion of the world's population. Some of these countries, particularly East Asian countries, have made remarkable achievements in alleviating poverty and inequity, while in South Asia it remains a major development challenge. By examining both the success and failure stories from the same region, this book provides some useful development lessons to policy makers and planners.

Trade Policy, Growth and Poverty in Asian Developing Countries documents a comprehensive survey and analysis of the link between trade, growth, poverty and inequity. This volume should be of considerable interest to students of development economics and policy makers in Asia and other developing countries.

Kishor Sharma is a Senior Lecturer in Economics in the School of Management at Charles Sturt University, Wagga Wagga, New South Wales, Australia. He has worked for the Nepal Industrial Development Corporation (1982–6) in Kathmandu and the UNV Program (1987–91) in Apia, Samoa. He is the author of two research monographs and has published several articles on trade and development issues in Asia.

Routledge studies in development economics

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Preface

The idea for this volume was conceived during the course of a research mission for the United Nations Industrial Development Organisation (UNIDO) to Kathmandu in late 2001. During our two-week mission my research counterpart, Chandra Athukorala (ANU), and I had extensive discussions on growth and poverty in Nepal. By this time poverty and inequality had reached its peak in Nepal (in fact the highest in South Asia) and, as a consequence, the country was going through a civil war. The law and order situation in the country was so precarious that the Government was forced to declare a State of Emergency (November 2001). This was necessary mainly to protect public life, infrastructure and private property, as multinational companies and big business houses were vulnerable to attacks by the left-wing ('Maoist') activists. The view that market-oriented policy reforms, initiated since the mid-1980s, have further marginalised the poor was extensively voiced in the mass media and the policy circles in Nepal. This debate, and our attempts to delineate the rhetoric and reality of policy reforms in Nepal in relation to the nexus of employment and equity, convinced me of the need to look more closely at the experiences of other countries in the region from a comparative perspective.

Although the success stories of newly industrialised countries (NIEs) suggest that the market-oriented policy has helped reduce poverty and inequality, the policy makers in low- and middle-income countries are still hesitant to draw qualified policy inferences from the experiences of these countries. In fact, doubts that liberalisation reduces poverty and inequality, based on the more recent experiences of other developing countries, remain very strong among the policy makers. Also, frequent demonstrations by non-governmental organisations (NGOs) and critics of globalisers have made it difficult for the governments in many low- and middle-income countries to introduce further reforms particularly in the areas of labour market and privatisation.

Clearly, the debate over market-oriented policy reforms and poverty still remained unresolved. This book aims to help resolve the key issues of the debate through a fresh look at the comparative experiences of Asian developing countries. Asia is an interesting region to examine the issue at hand because it has both success and failure cases. For instance, East Asia has substantially reduced poverty and inequality through market-oriented reforms while in South Asia it

remains a major development challenge. Often the half-hearted nature of policy reform is blamed for the poor poverty outcome in South Asia.

All chapters included in this volume are written by leading academics and policy makers. Given the time and resource constraints, however, the case studies presented in this volume are limited to twelve developing countries from East and South Asia. I hope the volume will provide some useful development lessons to students of development economics and policy makers in Asia and other developing countries.

My greatest debt in compiling this volume is to the contributing authors and this would not have been possible without their commitment and cooperation. I am indebted to Chandra Athukorala who encouraged me to commission this project and guided me throughout the project. I also take this opportunity to thank Routledge's reviewers for their very constructive suggestions, and Edward Oczkowski, Gamini Herath, Neil Karunaratne and Prema Thapa for reviewing some of the chapters included in the volume. Last, but not least, my special thanks go to Beverley Loughton for her excellent word processing skills.

Kishor Sharma

Part I
Overview

1 Trade policy, growth and poverty

The issues

Kishor Sharma

In most developing countries eradication of mass poverty has been the major development policy objective throughout the post-war era. In the 1950s and 1960s economic growth through capital accumulation was seen as a means of alleviating poverty. This policy emphasis led to huge capital-intensive investment, particularly in urban areas. However, growth brought about by capital accumulation, which was mainly centred in urban areas, failed to eradicate mass poverty, particularly in rural areas.[1] By the early 1970s, it was increasingly realised that capital accumulation was not enough, and that health and education were equally important in eradicating widespread poverty. This view was strongly articulated in a number of empirical studies, which argued that improvements in health and education were important not only in their own right but also to promote growth in income of the poor.[2] This led to a change in donor priorities. In 1973, Robert S. McNamara (then the World Bank's President), in a speech to the Board of Governors in Nairobi, stressed a need for donors' priorities to move away from capital-intensive infrastructural lending of the 1960s towards rural development designed to benefit the poor. However, under a planned development strategy, in the absence of incentives for efficient utilisation of resources across activities, these investments failed to generate sustainable growth and alleviate poverty.[3] The inability of the planned development strategy in meeting the basic needs of the people came under severe attack by the late 1970s, which gave way to a wide range of policy reforms including trade liberalisation.[4] It is now widely believed that it is not only the rate of investment but also the incentives for its efficient utilisation which are important for sustaining growth and alleviating poverty (Easterly 2001; Srinivasan 2001).

Many developing countries have been able to reduce poverty and inequality through market-oriented economic policy reforms. This is particularly the case in East Asia, although the debate over the role of state in economic growth and poverty alleviation is by no means resolved. As Winters (Chapter 2) points out, the association of trade liberalisation in East and Southeast Asia with poverty alleviation is not sufficient to say that this was the direct outcome of liberalisation; too much else was going on. Likewise, the mixed experience from Latin America since 1980 is not sufficient to prove the opposite. This leaves us with the unresolved debate over the role of state in sustaining growth and alleviating poverty. Two competing policy prescriptions are often suggested to achieve growth and alleviate poverty and inequity.

The mainstream economists (liberalisers) argue that market-oriented reforms are crucial for sustaining growth and alleviating poverty in developing countries.[5] This follows from the fact that the developing countries have an abundant supply of unskilled labour, and that they have a comparative advantage in goods and services that use unskilled labour intensively. Hence, an exogenous shift in policy, which increases the demand for unskilled labour, will alleviate poverty by increasing the real income of the poor and increasing the growth rate.[6] A more rapid growth means more revenue, which will enable the government to spend more on poverty alleviation programs and increase the access of the poor to basic services. However, the ability of second generation liberalisers to increase their exports of labour-intensive products is limited mainly due to low supply-side elasticities and restricted access to the rich countries' markets, particularly for textile, clothing and agricultural products. The supply-side elasticity is very low due to fragmentation of the local product and factor markets, as well as low levels of physical infrastructure and human capital. Also, the rich countries have not completely given up their protectionist sentiment, leading to slow growth in exports of labour-intensive products, which are important for alleviating poverty in developing countries.[7] However, it does not mean that poor countries should retaliate by imposing trade and investment restrictions. In fact, the post-war development experience has shown that such restrictions by the poor countries can have significant negative consequences for their own development objectives (Bhagwati 2002: 24).[8]

Reducing poverty is a global objective and poor countries alone cannot achieve this goal without commitments from rich countries. These commitments should include improving market access, ending subsidised agricultural over-production and granting financial and technical assistance for developing productive and supply capacities. But, the access to the rich countries' markets is limited and foreign aid has, in fact, declined despite a growing need for such assistance, at least in the short-term, following an outward-oriented strategy. In real per capita terms, net official development assistance (ODA) disbursements to the poor countries dropped by 46 per cent between 1990 and 2000 (UNCTAD 2002). This drop in ODA appears to have significantly reduced infrastructure investment particularly in rural areas and has made poverty alleviation a difficult task in many least developed countries (LDCs). With regard to improved market access, the rich countries need to play a fair game. The poor countries need the complete dismantling of trade barriers in developed countries on a most-favoured-nation (MFN) basis rather than grants of preferences such as Generalised System of Preferences (GSP). Although incentives like GSP sounds attractive and generous, it has done little for the poor countries as Bhagwati (2002: 26) correctly points:

> The eligible products often excluded those on which poor countries had pinned their hopes of increasing exports … Preferences were also often dropped for commodities when they began to be successfully exported … Rule of origin served to curb exports.

It is quite possible that market-oriented reforms could worsen welfare and increase poverty in the short term. For example, market-oriented reforms may increase the prices of goods and services that the poor consume[9] without significantly increasing their returns if the labour market is distorted. In fact, overall employment and the real income of the poor can even fall if there are hiring and firing regulations designed to protect the interest of labour. These regulations can even encourage the use of capital-intensive technology in labour abundant countries, leading to a rise rather than a fall in poverty. Also, if labour market training programs are not efficient poverty can increase. It is precisely such situations that the critics of policy liberalisation (also known as revisionists) are looking for.[10]

The revisionists, therefore, argue that the growth objective under a market-oriented policy should be combined with cushioning measures to protect the vulnerable groups in society.[11] For instance, trade liberalisation might increase the prices of basic necessities that dominate the consumption basket of the poor. If the prices of goods that the poor consume increase faster than their wages then the poor would be losers from an exogenous shift in policy.[12] This could be temporary and may be associated with labour market rigidity as discussed above. Hence, revisionists argue for the provision of safety nets to protect the vulnerable groups in society. These include food-for-work schemes and lower prices for food grains for the urban poor. Unfortunately, these measures often slow down economic growth without achieving the re-distributive objective. For example, attempts to keep market prices for grains lower to help the urban poor hurt the poor most by turning the terms of trade against the poor producers. This reduces incentives for increasing agricultural production and productivity. Evidence from several developing countries suggests that measures designed to help the poor failed to achieve the welfare objective and are often counterproductive. Very often, these measures are so bad that agricultural output declines, inflation surges and the black market becomes the major income generating activity for the non-farming population, leading to an increase rather than a decrease in poverty and inequality (Lipton and Ravallion 1995).

In recent years, even international institutions like the World Bank have embraced the revisionists' view by arguing that combating poverty requires not only economic growth but also 'security' and 'empowerment' (*The Economist*, 23 September 2000: 97). This view is also popular among some economists (Rodrik 1995; 1999; Dollar and Kraay 2000b). Dollar and Kraay (2000b: 4) have argued:

> [There is little doubt] that some poor households are hurt in the short run by trade liberalisation. It is thus important to complement open trade policies with effective social protection measures such as unemployment insurance and food-for-work schemes. To the extent that trade openness raises national income, it strengthens the fiscal ability of a society to provide these safety nets.

In the context of these two competing policy prescriptions, policy-makers in developing countries need to ask whether the revenue generated from the openness is to be spent in developing basic infrastructure – which is very poor in developing countries – or in financing the safety nets. A wise policy-maker will choose the former.

It should not be forgotten that improving agricultural productivity is a key to poverty alleviation in developing countries where a large majority of the workforce relies on agriculture.[13] Agricultural productivity improvement comes through a number of channels including provision of rural–urban road networks and irrigation facilities, access to basic health services, better technology and markets. It is now widely accepted that for sustaining growth and alleviating poverty, investment policy has to be pro-rural and labour intensive. Pro-rural investment is likely to contribute to agricultural growth and benefit the poor in two ways. First, most poor are net food buyers. Second, their ability to buy basic necessities depends primarily on income generated from agriculture (Timmer 1991; Lipton and Ravallion 1995).

In recent years, concerns about the high incidence of poverty in developing countries have led to a rethinking of international development cooperation. The new approach aims to halve the incidence of poverty by 2015. To achieve this goal, countries are encouraged to design their own poverty reduction strategies papers (PRSPs) and donors are selectively focusing aid to those countries that have good poverty reduction strategies, good governance and are committed to policy reforms. However, these papers, like the structural adjustment programmes (SAPs) implemented in the 1990s, have limited focus in developing productive and supply capacities in the poor countries, which are crucial for pro-poor growth. Since the SAPs failed to make a significant dent in poverty in LDCs, there is a danger that the PRSP approach can fall into the same trap, in the absence of a strong focus on infrastructure development particularly in rural areas.[14] In fact, the incident of poverty in LDCs that undertook enhanced structural adjustment facility rose from 51 per cent before the implementation of the programme to 52 per cent in the three years after and 53 per cent in the next three years. Given the rising population, the number of people living in extreme poverty increased sharply under these programmes (UNCTAD 2002: 24).

Despite growing disagreement over the role of market-oriented reforms in alleviating poverty, case studies examining the experience of a large number of developing countries are extremely limited. At the same time, there is an increasing tendency to establish the link between openness, growth performance and poverty alleviation through cross-country comparison, without looking at the role of institutions, infrastructure network, social sector policy and other natural obstacles to growth (such as civil unrest, natural disasters, etc). The most comprehensive cross-country study to date is by Dollar and Kraay (2000a), which pools together data for eighty countries covering four decades. They find that openness enhances growth and thereby reduces poverty and income inequality. However, as is well known, a major problem with cross-country studies is that they ignore the country-specific features and assume that structural

parameters are constant across the country in the sample (Srinivasan and Bhagwati 1999). This makes the findings from such studies highly questionable as developing countries differ not only in their development priorities but also in size, resource endowment, quality of institutions and the level of infrastructure and human capital. Also, cross-country studies provide only a partial picture of the effects of market-oriented policy on the poor because the same reform may have different effects in different countries, hence 'average' results can provide only a rough guide to the impact of reform on the poor. Thus, case studies of individual countries would, provide a better insight into the link between policy reforms, growth and poverty, taking into account each country's structural features, the level of physical and human capital as well as institutions. In this context, this book gathers the experience of Asian developing countries – the continent, which provides shelter for about 50 per cent of the world's poor (Table 1.1).

Given the time and resource constraints we limit our case studies to eleven countries from different socio-economic backgrounds, all of which have gone through the liberalisation reforms in different points in time. But, as discussed below, the nature and extent of reforms vary substantially between countries. Some of these countries (particularly Korea, Taiwan, China, Malaysia, Vietnam and Thailand) have made notable achievements in alleviating poverty and inequality while others, particularly the South Asian countries, lag behind. Investigating the success and failure stories from the same region can offer important insights for comparative policy analysis. Also, limiting the analysis to a single continent has the advantage of being able to control some of the continent-specific features (e.g. history, culture and ecological environment) that would have to be considered if countries are taken from different continents (Timmer 1991).

Asia is an interesting continent to examine the issue at hand.[15] Within Asia, East Asian countries have embraced a comprehensive reform package. They liberalised their goods and factor markets, and paid adequate attention to the shortcomings of markets, institutions and infrastructure. Land reform was also a part of their reform agenda, which allowed the poor to increase their income by increasing agricultural productivity. As shown in Table 1.2, except for Indonesia and Thailand, agricultural productivity almost doubled in the East Asian countries during the 1975–81 to 1996–8 periods.

With the higher GDP growth and a lower population growth, East Asian countries were able to increase the per capita income and thereby reduce poverty and inequality (Tables 1.2 and 1.4). Their progress against poverty was not explicitly linked to implementing targeted poverty reduction programmes as revisionists propose. Instead, their success in reducing poverty depended on an outward-oriented strategy and sound macroeconomic policies.[16]

Countries in South Asia, by contrast, liberalised foreign trade regimes but maintained control in factor markets mainly to protect the interests of the minority. Despite more than a decade of reforms, governments in many South Asian countries still maintain control over labour market and supplies of basic

Table 1.1 Income poverty by region, selected years, 1987–98

Region	Population covered by at least one survey (%)	People living on less than US$1 a day (millions)					Share of population living on less than US$1 a day (%)				
		1987	1990	1993	1996	1998[a]	1987	1990	1993	1996	1998[a]
East Asia and Pacific	90.8	417.5	452.4	431.9	265.1	278.3	26.6	27.6	25.2	14.9	15.3
excluding China	71.1	114.1	92.0	83.5	55.1	65.1	23.9	18.5	15.9	10.0	11.3
Europe and Central Asia	81.7	1.1	7.1	18.3	23.8	24.0	0.2	1.6	4.0	5.1	5.1
Latin America and the Caribbean	88.0	63.7	73.8	70.8	76.0	78.2	15.3	16.8	15.3	15.6	15.6
Middle East and North Africa	52.5	9.3	5.7	5.0	5.0	5.5	4.3	2.4	1.9	1.8	1.9
South Asia	97.9	474.4	495.1	505.1	531.7	522.0	44.9	44.0	42.4	42.3	40.0
Sub-Saharan Africa	72.9	217.2	242.3	273.3	289.0	290.9	46.6	47.7	49.7	48.5	46.3
Total	88.1	1,183.2	1,276.4	1,304.3	1,190.6	1,198.9	28.3	29.0	28.1	24.5	24.0
Excluding China	84.2	879.8	955.9	955.9	980.5	985.7	28.5	28.1	27.7	27.0	26.2

Source: World Bank 2000.

Notes
The poverty line is $1.08 a day at 1993 PPP. Poverty estimates are based on income or consumption data from the countries in each region for which at least one survey was available during 1985–8.
a Preliminary.

Table 1.2 Growth in population and GDP, and agricultural productivity in selected Asian developing countries and selected regions, 1979–99

Economy and region	Population growth		GDP growth		Agricultural productivity (1995 dollars)	
	1980–90	1990–9	1980–90	1990–9	1979–81	1996–8
East Asia						
China	1.5	1.1	10.1	10.7	161	307
Korea, Rep.	1.2	1.0	9.4	5.7	3,800	11,657
Taipei, China	—	—	—	—	—	—
Indonesia	1.8	1.7	6.1	4.7	610	749
Malaysia	2.8	2.5	5.3	6.3	3,275	6,061
Thailand	1.7	1.2	7.6	4.7	634	932
Vietnam	2.1	1.8	4.6	8.1	—	203
South Asia						
Bangladesh	2.4	1.6	4.3	4.8	212	276
India	2.1	1.8	5.8	6.1	275	406
Nepal	2.6	2.4	4.6	4.8	162	189
Pakistan	2.7	2.5	6.3	4.0	394	626
Regions						
East Asia and Pacific	1.6	1.3	8.0	7.4	—	—
Latin America and Caribbean	2.0	1.7	1.7	3.4	—	—
South-Asia	2.2	1.9	5.7	5.7	265	356
Sub-Saharan Africa	2.9	2.6	1.7	2.4	418	379
World	1.7	1.0	3.2	2.5	—	—

Source: World Bank 2000.

utilities (namely water, electricity and telecommunications). Also, despite the dominant role of agriculture, land reform has not been a part of the reform agenda. In brief, the nature of policy reforms in South Asia is half-hearted. While trade and investment regime has been liberalised, regulations in the labour market have discouraged employment-intensive investment and contributed to poor productivity in the absence of flexibility. As is well known, liberalisation demands efficient institutions and infrastructure facilities. However, even after liberalisation, South Asian countries have paid very little attention to addressing these bottlenecks as evidenced by the stagnant share of gross domestic investment in GDP.[17] There is no doubt that the lower level of infrastructural investment has failed to create synergy between rural and urban areas and contributed to poor agricultural productivity in South Asia in comparison with East Asia (Table 1.3). Since agriculture is the backbone of these economies employing over 70 per cent of the workforce and contributing about 50 per cent to GDP,[18] without significant improvement in agricultural productivity the real income of the poor, in particular those who live in the rural areas, are destined to remain low.

Table 1.3 Gross domestic investment in selected Asian developing countries and selected regions, 1961–96 (percentage of GDP)

Economy and region	1961–70	1971–80	1981–90	1991–6	1961–96
East Asia					
China	14.0	20.3	21.0	22.7[a]	25.8[b]
Korea, Rep.	20.0	28.9	30.9	37.4	29.3
Taipei, China	17.1	26.4	23.2	—	22.2
Indonesia	10.4	22.4	27.5	29.0	22.6
Malaysia	19.9	26.3	30.8	38.9	29.0
Thailand	21.5	26.2	30.7	41.1	29.0
Vietnam	—	—	—	—	—
South Asia					
Bangladesh	16.4	13.9	19.7	19.4	17.3
India	16.1	19.6	22.6	23.0	20.3
Nepal	5.5	13.1	19.4	22.8	15.2
Pakistan	17.91	16.3	18.7	19.4	18.1
Regions					
East Asia and Pacific	19.1	28.6	31.8	36.7	29.1
Latin America and Caribbean	20.4	23.5	20.3	20.6	21.2
South-Asia	16.2	18.6	21.9	22.3	19.8
Sub-Saharan Africa	16.8	21.1	17.5	16.7	18.0
World	24.3	25.31	23.2	22.25	23.8

Source: Penn World Data; World Bank 2000.

Notes
a 1991 and 1992 only.
b From 1961 to 1992.
— Not available.

Asia represents the largest landmass on the planet. India and China – the world's two largest populated countries – alone accommodate about 38 per cent of Asia's population. Within the region, there are countries that are rich in natural resources and those that are poor. A large majority of the countries are underdeveloped or developing (Asian Development Bank 2000). These countries have achieved rapid economic growth in the post-war period, but poverty still remains very high in the region. According to the World Bank, the percentage of people living on less than US$ 1 per day has declined in the Asia-Pacific region from 75 per cent in 1987 to about 67 per cent by the end of the 1990s. This decline in income poverty was directly attributable to superior growth performance in East Asia. In contrast, the number of people living in poverty in South Asia has not changed appreciably. It is one of the poorest regions in the world partly due to high population growth and partly due to unsustainable growth. Unsustainable growth is attributed to a number of factors including the inability to integrate with the rest of the world, civil wars, natural disasters, etc. The incidence of poverty in South Asia, at 40 per cent is much higher than the 15 per cent recorded in East Asia. Both income and non-income

Table 1.4 Income poverty in selected Asian developing countries

Economy	International poverty line % of population below US$1 per day				National poverty line % of population below the poverty line				
	1975	1985	1995	1998	1965	1970	1975	1985	1996
East Asia									
China	—	—	—	18.5	—	—	—	—	6.0
Korea, Rep.	—	—	2.0	—	41.1	23.0	14.6[a]	5.0[b]	9.6
Taipei, China	—	—	—	—	47.0	30.0	23.0	3.0	—
Indonesia	64.3	32.2	11.4	15.2	—	58.0	40.0[a]	28.0[b]	11.3
Malaysia	17.4	10.8	<1.0	—	—	49.0	43.9	24.0	8.2[d]
Thailand	8.1	10.0	<1.0	<2.0	57.0[e]	39.0[f]	32.0[a]	26.0[g]	11.4
Vietnam	—	—	—	—	—	—	—	—	50.9
South Asia									
Bangladesh	—	—	29.1	—	—	—	73.0[h]	52.0[g]	35.6
India	—	—	47.0[i]	44.2[d]	—	52.0[c]	51.0[j]	45.0[b]	35.0[i]
Nepal	—	—	37.7	—	—	—	—	—	42.0
Pakistan	—	—	31.0	—	—	—	43.0	25.0	22.0[k]

Sources: World Bank 2000; Quibria 2002.

Notes
a 1976 d 1997 g 1986 j 1978
b 1984 e 1962 h 1973 k 1993
c 1972 f 1968 i 1994 — Not available

measures of poverty are alarming in South Asian countries, although the latter shows some improvements over the years (Tables 1.4 and 1.5).

   Although income measures of poverty are widely used (percentage of population below the certain income say less than US$1) they do not capture all aspects of poverty, particularly the value of public services.[19] It is quite possible for public services to deteriorate and yet income measures of poverty may not show a decline in poverty (Kanbur 2001). For example, the quality of public health and education systems might have fallen over the years, hurting the poor more than before but this may not be captured by the income measures at least in the short run. Hence, focusing solely on income measures of poverty fails to provide other useful information needed for eliminating poverty. We know that welfare, especially individual welfare, is not uniquely determined by income alone (Kanbur 2001).

   In this book we gathered both income and non-income measures of poverty, although in some countries data may not be available. Author(s) were asked to examine how liberalisation might have influenced poverty (and or equity) in different groups and in different parts within the country. Although it is now widely believed that countries that have made a significant progress in reducing poverty are the countries which are more open to trade and investment, have a high level of physical and human capital, and sound macroeconomic policies, each contributor to this book was asked to test these provisional hypotheses.

Table 1.5 Indicators of some non-monetary measures of poverty in selected Asian developing countries and selected regions, selected years

Economy and region	Life expectancy at birth (years)		Infant mortality rate (per 1,000 live births)		Adult illiteracy rate % of (people age 15+)		Access to improved water source (% of population with access)		Access to sanitation (% of population with access)	
	1967	1997	1967	1997	1970	1995	1982–5	1990–6	1982–5	1990–6
East Asia										
China	62.0[a]	69.8	85.0[a]	38.0	—	17.0[b]	—	90.0	—	21.0
Korea, Rep.	57.7	72.3	58.0	9.0	13.2	3.1	83.0	83.0	100.0	100.0
Taipei, China	64.0[c]	74.8[d]	24.0[e]	6.4[d]	46.0[c]	5.6	—	—	—	—
Indonesia	46.0	65.1	124.0	47.0	43.7	16.3	39.0	62.0	30.0	51.0
Malaysia	59.4	71.7	50.0	11.0	41.7	15.6	71.0	89.0	75.0	94.0
Thailand	56.7	68.8	84.0	33.4	19.7	5.8	66.0	89.0	47.0	96.0
Vietnam	48.9[a]	67.4	112.0	32.0	—	7.0[b]	—	36.0	—	21.0
South Asia										
Bangladesh	43.3	58.1	140.0	75.0	75.9	61.9	40.0	84.0	4.0	35.0
India	48.0	63.1	145.0	71.0[d]	66.9	46.7	54.0	81.0	8.0	16.0
Nepal	41.0	57.4	175.0	79.0	83.9	64.1	24.0	44.0	1.0	6.0
Pakistan	47.8	61.7	145.0	95.0	79.3	58.8	38.0	60.0	16.0	30.0
Regions										
East Asia and Pacific	57.1	68.1	88.8	36.3	44.2	17.4	—	84.0	—	29.0
Latin America and Caribbean	59.3	69.6	90.5	31.6	26.2	13.3	72.0	—	46.0	—
South-Asia	47.5	62.2	145.1	76.6	68.5	49.0	52.0	77.0	7.0	16.0
Sub-Saharan Africa	43.0	50.7	143.1	92.1	71.8	44.1	—	—	—	—
World	57.5	66.73	104.77	55.22	45.1	26.5	—	—	—	—

Sources: World Bank 2000; Quibria 2002; UNDP 1999.

Notes

a 1970; b 1998; c 1960; d 1995; e 1970; — Not available.

This volume is organised into four parts. Part I presents an overview of the link between trade and poverty. Part II documents the lessons from East Asian developing countries, while the experience of South Asian countries are presented in Part III. The final part, Part IV, summarises development lessons, based on the case studies of the twelve Asian developing countries.

The introductory chapter, sets the scene for the book. It presents the issues and analyses the policy prescriptions that both the mainstream and the revisionists propose. The chapter then discusses the key socio-economic features of East and South Asian developing countries and summarises some basic economic and social data. Finally, the chapter sheds light on the role of state in sustaining growth and alleviating poverty.

In Chapter 2, L. Alan Winters analyses the link between trade and poverty in a fascinating manner. He discusses a number of possible channels through which trade liberalisation might affect poverty. The starting point of the analysis is the so-called 'farm household' – a household that produces goods or services as well as sells its labour and consumes. An increase in the price of something the household sells (labour and goods) increases its real income and reduces poverty. In the opposite situation poverty rises. Winters then argues that trade reform can both create and destroy markets and that the existence of markets is essential for trade liberalisation to have a beneficial impact on the poor.

He convincingly demonstrates that trade policy reform is likely to have major effects on employment and wages that are essential for poverty reduction. If liberalisation boosts the demand for labour by increasing the demand for labour-intensive products then either or both wages or employment will increase. However, Winters argues that whether liberalisation reduces poverty depends on whether the poor are strongly represented in the type of labour for which demand has risen. If the poor are mostly unskilled, while it is the semi-skilled labour that receives the boost, poverty will be unaffected – or, indeed, worsened as unskilled wages fall. It also depends on where the wage rate is relative to the poverty line. If wages are pushed up from subsistence to higher levels, or if the sectors expanding their employment offer above poverty-line wages, then poverty will be alleviated. Since most developing countries are relatively abundant in unskilled labour, trade liberalisation will usually boost the demand for labour and help reduce poverty.

Finally, Winters argues that sustaining economic growth is a key to poverty alleviation and that there is little reason to fear that growth induced by freer trade will hurt the poor in the long run. However, he notes that:

> Since the gains from trade rely largely on adjusting a country's output bundle, there is a possibility that in the short-term people will suffer temporary adverse shocks. In this situation appropriate safety measures to protect people from extreme poverty as well as complementary policies to help firms and individuals realise their productive potential are desirable.

Chapters 3–9 (Part II) present the East Asian experience. In Chapter 3, Xin Meng examines the consequences of market reforms on unemployment, poverty

and income inequality in urban China which has become one of the most important social and economic problems in the country since the mid-1990s. She finds that less educated, middle-aged women and those who worked in loss-making firms are the losers from the economic restructuring. Meng also finds that not all households with unemployed individuals suffered from significant income losses. Households with one unemployed member seem to have done relatively well compared to households with more than one unemployed member in terms of per capita household income. Finally, Meng suggests that the government should try to eliminate the possibility of multiple household members facing unemployment simultaneously. Also, tax incentives and preferential lending arrangements to these households to set up their own business might ease the rising unemployment.

In Chapter 4, Kelly Bird and Chris Manning discuss growth and poverty outcomes of trade and investment reforms in Indonesia. They argue that economic reforms that transformed the economy and labour market in the 1980s were extraordinarily successful in reducing poverty through employment intensive growth. Despite widespread perception that the poor did not benefit from economic reforms due to rent seeking and cronyism during the later years of the Soeharto regime, achievements of the reforms were pro-poor. While the economic reforms facilitated employment growth, and hence poverty declined, economic growth has not recovered its pre-financial crisis momentum. Bird and Manning argue that populist agendas, paradoxically, pose a potential threat to the creation of a more equitable distribution of income in a more democratic, yet fragmented, political system.

In Chapter 5, Oliver Morrissey and Dirk Willem te Velde analyse the role of trade and investment liberalisation in reducing inequity in Korea. Since Korea has a relatively low level of poverty – about 2 per cent of the population below the international poverty lines in 1995 (see Table 1.4) – their focus is mainly on income inequality. The authors argue that income inequality is low in Korea by world standards – closer to the level observed in OECD countries – and that wage inequality has been declining since the late 1980s. This is in part explained by the tendency of foreign direct investment (FDI) to increase wages of skilled and unskilled workers equally. Morrissey and Te Velde conclude that despite a severe economic downturn after the financial crisis in 1997, Korea did not shift towards protectionist policies. Instead, Korea liberalised its foreign investment regime further, particularly in the services sector, with active promotion of FDI. An active domestic policy of skill upgrading has prevented trade liberalisation from encouraging growing income differential among different skills.

Prem-Chandra Athukorala discusses how the employment-intensive growth brought about by the neutral incentive regime contributed to poverty alleviation in Malaysia in Chapter 6. He argues that, unlike many other developing countries, domestic price signals were never insulated from world market conditions, and resource costs arising from rent-seeking activities have always been minimal in Malaysia. Apart from a neutral incentive regime, a greater emphasis was also placed on infrastructure development and expansion of education. Also,

interventions in labour market were kept to a minimum. An outward-looking policy regime, coupled with political stability and ethnic harmony, enabled Malaysia to take full advantage of the new opportunities arising from integration with the global economy. Athukorala concludes the chapter with the argument that initial conditions and Malaysia's geographic location might also have helped the country to grow rapidly.

Pan-Long Tsai and Ching-Lung Tsay explore the link between trade policy, economic growth and poverty reduction in Taiwan in Chapter 7. They argue that economic growth in Taiwan has been based on small and medium enterprises (SMEs). Their island-wide presence and tendency to employ low-skilled, labour-intensive technology are particularly helpful in raising real income of the poor even in the backward, poor rural areas. Although the export processing zones (EPZs) have been quite successful in attracting foreign investment and earning foreign exchange, Tsai and Tsay argue that their contribution to alleviation of poverty and inequality appears to be very low. This is attested to by the fact that the large majority of the workers employed in the zones are low-paid young females with relatively low human capital. Notwithstanding these job opportunities, the income made possible by the EPZs have certainly improved the livelihood of those in the bottom quintile.

Tsai and Tsay convincingly argue that while not a sufficient condition, economic growth is doubtless a necessary condition for poverty reduction. Based on Taiwan's experience they conclude that trade liberalisation can create a favourable environment for growth and the SME-based growth could be extremely effective in improving income distribution and reducing poverty.

Thailand's experience with openness and poverty alleviation is documented in Chapter 8 by Isra Sarntisart and Paitoon Wiboonchutikula. Their analysis suggests that export-led growth has been a key factor in reducing poverty in Thailand and that achievements in reducing poverty over the past four decades have been very impressive, although they rose marginally after the 1997 Financial Crises. While the Northeast has kept its record as the poorest region of the country, Bangkok and its vicinity have been well insulated from poverty because of the agglomeration of industrial and service sectors in the surrounding areas. Sarntisart and Wiboonchutikula argue that regional industrialisation has been very effective for poverty reduction in Thailand. In addition to this, high crop prices and currency depreciation also played an important role in reducing poverty. The authors conclude the chapter by arguing that openness is a key to employment creation and poverty reduction in Thailand. However, the proliferating non-tariff barriers (NTBs) namely, anti-dumping measures, standards and technicalities, regulations, trade-distorting subsidies, etc. in the developed countries could prevent the poor in Thailand from benefiting from the country's increasing openness. This issue is very crucial and has important implications not only for Thailand but also for other developing countries.

Vietnam's experience in poverty alleviation is documented by Pham Lan Huong and Vo Tri Thanh in Chapter 9. The broad-based growth brought about by reforms has significantly increased opportunities for the poor and reduced

poverty in the 1990s. There has been an unprecedented growth in output and export earnings, leading to a fall in both rural and urban poverty. However, income inequality appears to have increased between rural and urban areas. The authors argue that to sustain the current level of growth Vietnam has to introduce a deeper reform aimed at institutions, state-owned enterprises (SOEs), banking, and education and training system.

In Chapter 10, Peter Warr investigates the regional perspective on poverty reduction and sectoral growth strategy in Southeast Asia. His empirical analysis is based on time series data on the headcount measure of poverty incidence for Thailand, Indonesia, Malaysia and the Philippines over the period 1960–99, in aggregate and in both rural and urban areas. While Warr finds that poverty reduction was related to growth of agriculture and services but not to growth of industry, the southeast Asian countries have made remarkable progress through the employment-intensive industrialisation. He concludes that growth of industrial output was very weakly associated with increases in poverty, probably heavy protection of industry led to a capital intensive, import substitution industrialisation which did not serve the interests of the poorest groups.

The South Asian experience in poverty alleviation is documented in Chapters 11 through 14. In Chapter 11, Clem Tisdell and Mohammad Alauddin assess the impact of market-oriented reforms on poverty in Bangladesh. They argue that the market-oriented reforms – which began in the early 1980s and picked up momentum only in the early 1990s – had very little impact in alleviating poverty in Bangladesh. Tisdell and Alauddin note that throughout the reform period, income inequality has increased and there has not been a significant fall in the incidence of rural poverty in Bangladesh. It is even debatable whether there has been a significant reduction in the incidence of urban poverty in this period, particularly if both income and non-income measures of poverty are taken into account. In Chapter 11 Tisdell and Alauddin observe that:

> It seems that an economic miracle as a result of Bangladesh's reforms has yet to be realised. Proponents of the effectiveness of *laissez-faire* policies to reduce poverty could, however, argue that this is mainly because Bangladesh's reforms have not yet been in place for long enough or are not as yet, sufficiently far sweeping, for example, too may state enterprises remain. Or the following counterfactual argument could also be put forward, namely that without market reforms the incidence of poverty in Bangladesh would be far higher than it is now. These are all plausible possibilities. However, without adequate proof, these views have little scientific validities.

J. V. Meenakshi and Ranjan Ray document India's experience in trade liberalisation and poverty alleviation in Chapter 12. Although they find a decline in poverty and inequality in India in the 1990s, this has not been the case in several States, including some of the most populous ones. Meenakshi and Ray find that several backward regions and groups continue to experience high levels of poverty and relative deprivation even after the policy reforms. Their findings suggest that there exist distinctly disadvantaged social groups in the country – the

scheduled caste/scheduled tribe (SC/ST) and female-headed households, who continue to fare worse than other households. These disparities are highlighted when the distinct demographic composition of such households is taken into account. Indeed, in the case of female-headed households, it is only when their distinct demographic composition is taken into account, that they are worse off than other households becomes apparent in many States. The authors suggest that anti-poverty programmes should target these vulnerable households.

In Chapter 13, Binod Karmacharya and Kishor Sharma examine the growth and poverty outcomes of liberalisation in Nepal. Although Nepal's exports of labour-intensive manufactured goods – in particular readymade garments and carpets exports – have increased since the mid-1980s, it has made very little impact in sustaining growth and reducing poverty as their exports are mainly motivated by the export incentives namely GSP rather than the country's real comparative advantage. In the absence of reform in the factor market, trade liberalisation alone has failed to create an environment for SMEs, which are labour-intensive. Rural poverty appears to be high in the absence of a significant improvement in agricultural productivity, where about 80 per cent of the work-force is employed (see Table 1.2). Among South Asian countries, poverty remains very high in Nepal. Karmacharya and Sharma argue for a need to intro-duce labour and infrastructure sector reforms as well as implementation of complementary policies to enhance supply elasticities and to offset some of the adverse outcome that are due to the unsatisfactory initial circumstances.

Impact of liberalisation on growth, employment and poverty in Pakistan is examined by Tilat Anwar in Chapter 14. Like many South Asian countries, Pakistan has made attempts to integrate its economy with the global economy since the late 1980s. However, Anwer, notes that its achievement in accelerat-ing growth and creating job opportunities for the poor has been very limited partly due to its inability to attract labour-intensive investment and partly due to slow export growth. The author notes that the lowering of tariff rates led to con-siderable loss of revenue, leading to a fall in development expenditure which directly helps the poor. The government sought to restrain aggregate demand not only by granting wage increases below the inflation rate but also by freezing employment in the public sector. This together with higher unemployment did not significantly reduce poverty even after the liberalisation. Like many South Asian countries, Pakistan's reform is half-hearted as there have been very slow progress in privatisation and labour market reform.

The final chapter, Chapter 15, provides reflections on the issues. Kishor Sharma and Gamini Herath argue that the growth and poverty outcomes of pol-icy reforms depend on accompanied policies. Outward-oriented policy alone does not explain differences in poverty outcomes in East and South Asia. Several other factors must accompany the reform programme to make a significant dent on poverty. These factors include efficient markets, effective institutions, good governance, infrastructure and pro-rural investment. The authors argue that although some reforms can be politically very costly, for example reforms in labour market and land ownership, and privatisation of public enterprises, they must be

done to sustain growth and alleviate poverty. South Asia lagged behind in these areas, which may explain the poor poverty outcome.

While many chapters presented in this volume agree with the view that the rapid growth is a key to poverty alleviation, market-oriented policy reforms alone are not sufficient to achieve sustainable growth. The basic prerequisites namely efficient human and physical infrastructure, flexibility in factor markets and strong integration between rural and urban area are equally important for achieving growth with equity. As developing countries continue their reforms, the more evident it becomes that the success of policy reforms is dependent on the ability of the existing social, economic and institutional structures to exploit the benefits of openness. Learning from the experiences of others provides important insights and to this end the chapters in this book seek to make some small contribution.

Acknowledgements

Notes

1 Poverty is a multifaceted problem. Hence, its measurement should include both income (minimum level of subsistence income required) and non-income (such as infant mortality rate, life expectancy, literacy rate and access to basic sanitation facilities) indicators.
2 Some of the most influential studies are that of Adelman and Morris (1973) and Schultz (1981). These authors had also convincingly demonstrated a positive link between human capital, equitable growth and poverty alleviation.
3 A large number of studies undertaken under the auspicious of OECD and National Bureau of Economic Research have documented misallocation of resources in several developing countries. These are summarised in Little *et al.* (1970), Bhagwati and Desai (1970), Bhagwati and Srinivasan (1975) and Krueger (1983).
4 In this chapter the terms 'policy reforms', 'market-oriented policy reforms', 'openness', 'outward-oriented strategy' and 'trade liberalisation' are synonymously used.
5 Trade restrictions which favour capital-intensive industries can hurt the poor in two ways. First, such policy reduces the demand for labour and thereby reduce their returns. Second, bias in favour of capital-intensive industries increases the costs of their access to capital (Srinivasan 2001).
6 Not all developing countries have an abundant supply of unskilled labour. Such countries can benefit from trade liberalisation through increased access to goods at lower prices and improved efficiency.
7 The textile and clothing sector is protected under the multi-fibre arrangement (MFA) which began in 1961 as the Short-term Cotton Textile Arrangement. However, by 1974 it had several separate agreements restricting world trade in all textiles. Likewise, the agriculture sector is protected through the Farm Subsidies in the US and Europe. Both sectors are important in alleviating poverty in developing countries. According to Oxfam if Africa, East Asia, South Asia and Latin America were each to increase their share of world exports by 1 per cent, the resulting gains in income could lift 128 million people out of poverty.

8 There is some hope for the poor countries as developed countries have agreed to completely eliminate the Farm Subsidies by 2010 and phase out the MFA by 2005 under the Uruguay Round of trade negotiation completed in Marrakesh in 1995.

9 This can happen because of the removal of subsidies and devaluation of the currency.

10 Oxfam International is one of the critics of trade liberalisation. It is a confederation of twelve non-governmental organisations working together in more than eighty countries to find solutions to global poverty. Oxfam protests to any pressure from international organisations to force governments to liberalise or privatise basic services that are vital for the poor and demands for enhancing the quality of private sector investment and employment standards among other things.

11 Note that the mainstream economists also agree on the cushioning measures. The only difference between the revisionists and mainstream economists is that the latter advocate cushioning measures as a part of a broader reform strategy while the former emphasises on cushioning measures without realising the point that direct welfare measures cannot be sustained without long-term growth. I thank Prema-Chandra Athukorala for this point.

12 Critics have also argued that measures to achieve fiscal balance (as a part of market-oriented reforms) result in contraction of the infrastructure budget and social expenditure, making the access to basic services difficult for the poor.

13 This is because productivity improvement permits higher real wages for the poor and increases their access to basic necessities.

14 There is no doubt that the SAPs have had some positive macroeconomic effects in many developing countries, particularly in bringing inflation under control, reducing fiscal deficits and correcting overvalued exchange rates and thereby improving export performance, but made little contribution in alleviating poverty.

15 Asia generates about one-quarter of the world's GNP. It has about 18 per cent share in world's exports and contributes about 20 per cent to world manufacturing value added. Japan alone accounts for over 50 per cent share in Asia's economic activities (Asian Development Bank 2000).

16 Sound macroeconomic policies are essential to reduce poverty. In the absence of such policies both inflation and budget deficit rise which hurt the poor. Hence, a poverty reduction strategy should aim at reducing both. But note that to maintain the fiscal balance infrastructutral investment should not be cut as these investments increase access to basic services for the poor and hence help reduce poverty.

17 For example, in South Asia the gross domestic investment as a percentage of GDP did not increase much during 1991–6 period when compared with 1971–80. In the same period the East Asian countries significantly increased their investment.

18 This varies from country to country. In Nepal, over 80 per cent of the people are employed in agriculture and about 50 per cent of GDP come from this sector.

19 The incidence of poverty based on income measures has a number of problems, although there have been some improvements over the years. For example, production of home consumption is now included and regional price variation is largely captured. We will not go into this debate here as it is beyond the scope of this book.

2 Trade and poverty

Is there a connection?

L. Alan Winters

Openness and trade liberalisation are now seen almost universally as key components of the national policy cocktail required for economic growth and aggregate economic well-being. They are believed to have been central to the remarkable growth of industrial countries since the mid-twentieth century and to the examples of successful economic development since around 1970. The continued existence of widespread and abject poverty, on the other hand, represents perhaps the greatest failure of the contemporary global economy and the greatest challenge it faces as we enter the twenty-first century. This chapter discusses whether the two phenomena are connected. Specifically, it asks whether the process of trade liberalisation or the maintenance of a liberal trade regime could have caused the poverty that so disfigures modern life, or whether, in fact, it has contributed to its alleviation.

If trade liberalisation and poverty were both easily measured, and if there were many historical instances in which liberalisation could be identified as the main economic shock, it would be simple to derive simple empirical regularities linking the two. Unfortunately, none of these conditions is met, and so we are reduced to examining fragmentary evidence on small parts of the argument.[1] The key to interpreting this evidence in terms of the effects of trade on poverty, as well as to designing policies to alleviate any ill effects, is to understand the channels through which such effects might operate. That is, in the absence of clear empirical regularities, we need to develop a theory of how trade shocks might translate into poverty impacts in order to consider how plausible such links look in the light of what we do know about the way economies function; to identify the places in which it would be sensible to seek empirical evidence; and to help us to fit the jig-saw puzzle of fragmentary evidence into a single overall picture.

Tracing the links between trade and poverty is going to be a detailed and frustrating task, for much of what one wishes to know is simply unknown. As discussed in more detail below most of the links are very case-specific. Hence general answers of the sort 'liberalisation of type *a* will have poverty impacts of type *b*' are just not available. Poverty impacts will depend crucially on specifics such as why people are poor to start with, whether the country is well endowed with mineral wealth and what sort of infrastructure exists.

An important aspect of any analysis of poverty is the definition and measurement of the phenomenon itself. While recognising that there are many legitimate

approaches to this, I implicitly adopt here an absolute consumption – or, where necessary, absolute income – metric.[2] In choosing this definition, I am not denying the importance of other aspects based, for example, on human development or social exclusion. I believe, however, that the first step towards understanding the effects of international trade on poverty is to focus on the simplest, most directly impacted and easily observable dimension of the question. Besides, the different dimensions of poverty are at least fairly well correlated, so that conclusions about income-poverty will be a reasonable indicator of other aspects.

A second measurement issue is how to combine the individual poor into an index of poverty. The standard approach among poverty-scholars is to define a poverty line and then measure one of three statistics (Ferriera and Litchfield 1999). The first is the number of households (or people in households) that fall below the line, possibly expressed as a proportion of population. This is known as the head-count index: it pays no attention to the extent to which people fall below the poverty line, but essentially asks whether a policy pushes more people from below to above the line than vice versa. The second statistic sums the shortfall of actual incomes below the poverty line across all people or households below the line. It is concerned with the depth of poverty, but values an extra dollar of income equally whether it goes to someone far below the line or very close to it. The final measure sums the squares of the shortfalls and thus gives an individual greater weight in the final index the further they are below the poverty line.

Clearly selection of the poverty line is an important aspect of these measures. Again I do not want to enter this debate. The poverty line is not necessarily the same for all countries – each country will have its own views according to custom, expectation, etc. However, once we have to aggregate across countries – for example, to consider global effects or effects on subsets of developing countries – it becomes difficult to make the case for differences.

There are many reasons why people are poor, and even within broad groups there are huge differences in circumstances between individual households. Thus the effects of most shocks will differ across 'the poor', and a crucial part of any practical analysis must be to identify different interests within that group. A first step towards this is a poverty profile, including information on the consumption and production (including employment) activities of the poor. I do not labour the point about heterogeneity below, but in truth it is hard to over-estimate its importance. Implicitly nearly all the factors discussed will vary *across* the poor within a single country.

While poverty profiles are a necessary input into thinking about the links between trade and poverty, they should not lead us to believe that poverty is a static and unchanging state. There is, in fact, a fairly rapid turnover of families into and out of poverty, and the determinants of those transitions appear to be rather different from those turned up by studies of the static correlates of poverty (Baulch and McCulloch 1998). This is potentially an important insight for our purposes, for if trade affects the transition probabilities it could have significant effects on the stock of 'poor', while apparently having little to do with that stock directly. Understanding these transitions is also a crucial component in designing policy to mitigate any adverse trade or trade policy shocks. Unfortunately,

Figure 2.1 Trade policy and poverty: an analytical scheme.

this is not an issue on which I know of any current research; doing such work depends on first completing the more prosaic static analysis of trade and poverty that is the concern of this chapter.

As shown in Figure 2.1, I will explore the static effects of trade and trade policy on poverty via four broad groups of institutions: enterprises, distribution channels, government and households. These static effects are presented in a separate section below. In addition, I will discuss both longer-term dynamics – economic growth – and shorter-term dynamics – vulnerability to shocks and adjustment stresses.

None of the economic analyses for the individual institutions is very complex, but in each case I shall demonstrate the possibility of both pro- and anti-poor influences. Thus when I come to put them together, it will hardly be surprising that there are no general conclusions about whether trade liberalisation will increase or reduce poverty. I do, however, derive some results about the sort of circumstances under which the effects are likely to be benign and, with them, the makings of a view about how liberalisation can be designed to foster poverty alleviation. Thus the essay concludes with sections on policy implications and on key questions to ask about any trade reform. One of the inevitable conclusions from a taxonomy such as this is that the impacts of trade on poverty will differ across countries. Thus great care is needed in generalising from one country's experience to another, and policy positions for one country will be quite unsuitable for another.

The individual and the household

A basic view of the household

It is simplest to start with what economists refer to as the 'farm household' (Singh *et al.* 1986). This is not to be taken literally as referring only to people who work the land or the seas (although the rural poor account for the majority

of world poverty) but to any household which makes production as well as consumption and labour-supply decisions. By focusing on households I am consciously setting aside gender and intergenerational issues, but I will return to these very shortly.

In this simplest case, we can think of household welfare as depending on income and the prices of all goods and services that the household faces. The former must be measured as so-called 'full income' comprising (a) the value of the household's full complement of time – the maximum amount of time that could be spent working, perhaps twelve hours per person per day – valued at the prevailing wage rate, (b) transfers and other non-earned income such as remittances from family members outside the household, official transfers, goods and services in kind, and benefits from common resources and (c) the profits from household production.

This view defines all the variables that need to be assessed in order to calibrate the effects of an international trade policy shock on income or consumption poverty. Of course, the approach applies to all households and all shocks, but here I concentrate only on households for which poverty is an issue (i.e. those in poverty before or after the shock, or for whom the probabilities of being in poverty are materially changed) and on shocks emanating from trade policy.

The effect of a single small price change on household welfare depends on whether the household is a net supplier or net demander of the good or service in question: a price rise for something you sell makes you better off. To be more precise, to a first order of approximation, the effect of a very small price change on household welfare is proportionate to its net supply position expressed at current prices as a proportion of total expenditure.

For finite price changes the household's responses to the price change also influence the size of the welfare effect, but they will not reverse its sign. Thus, if the household has alternatives to purchasing a good whose price has risen, it can mitigate the cost of a price rise. Similarly, if it is able to switch towards an activity that has become more profitable, it can increase its gains beyond the first order amount.

Responsiveness is particularly important when one considers the vulnerability aspects of poverty. Policies which reduce households' ability to adjust to or cope with negative shocks could have major implications for the translation of trade shocks into actual poverty. Moreover, fear of the consequences of not being able to cope with negative shocks might induce households to rule out activities that would raise their average income significantly but run greater risks of very low income. Responsiveness is also important because it spreads shocks from the market in which the price change occurred to others, whose prices might not have been affected by trade policy at all. All these factors are considered below.

Generalising the household

The simplest view of the household just expounded is very useful for getting our thoughts in order, but it is not very realistic. Thus we should consider a number of potential generalisations before seeking to apply it in practise. Not all

will be feasible or relevant in every case, of course, but among the factors to be included are:

(a) Households can provide several forms of labour, so we need to consider their endowments of all these types of labour and the wages they command.
(b) By talking of the 'prevailing wage rate', I imply that there is one wage per class of labour and that it is exogenously given to the household. In particular, this implies that household members are indifferent between working on their own farm or outside it, and that the farm is indifferent between 'home' and 'outside' workers. It is as if the farm (or family business) supplies labour to the labour market and buys it back at the given wage. But this separability might not apply – for example, because there are different costs to monitoring family and non-family workers or because family workers incur transportation costs in reaching other employers. In these cases we need to separate 'home farm' and 'off-farm' activities, with the prices of the former varying according to the 'demand' for them (i.e. their productivity) and the supply of labour to carry them out once outside activities are allowed for.
(c) Once labour can undertake more than one activity, we need a way of allocating time across alternatives. If prices are exogenous the choice is easy – take the activity for which the wage is highest – whereas if 'home' prices are endogenous, time is allocated to equalise returns across activities (including leisure).

These three generalisations allow us to think about the well-documented phenomenon that poor households typically earn income in a large variety of different ways, and that the mix of these may change significantly with trade policy changes. Indeed, the ability to switch between activities is an important aspect of adjusting to potentially impoverishing shocks.

(d) Some activities – and possibly some sales and purchases – may be quantity-constrained. Most obviously, some external jobs may only be available for a fixed number of hours per day – for example, factory work or service activities such as transportation services. Particularly if trade policy flips some workers from positive to zero hours (or vice versa) – that is, if policy moves individuals in or out of work – it could have highly significant poverty impacts. The loss of a job is probably the common proximate cause of households descending rapidly into poverty.
(e) Finally, the set of factors of production owned by a household and their associated returns needs to be generalised to include land and other assets. While avoiding issues of long-run dynamics at this stage we need to recognise that such assets generate incomes and thus affect poverty. The unequal distribution of land is an important contributory factor to poverty, and while addressing it is not strictly a matter of trade policy, it clearly affects the outcomes of trade liberalisation if the latter affects the rate of return to land.

Genderising the household

A key extension of the approach above is to recognise the importance of intra-household distribution. It is frequently argued that the costs of poverty fall disproportionately on women, children and the elderly. Two approaches seem possible: either to work on the household and add some analytics for intra-household distribution, or to define welfare changes for individuals and add some analytics to describe inter-personal transfers. The former is probably the more straightforward route, and the fact that the majority of data and the bulk of interventions refer to households rather than individuals suggests that policy-makers and legislators see households as the fundamental unit.

The easiest approach is to assume that household activities for generating welfare can be treated quite independently of those for distributing it. The analysis above describes the former, and if the determinants of the distribution of welfare across individuals are not affected by trade policy, the welfare of each person in the household will vary in proportion to the whole in response to a trade policy shock. This would more or less remove gender and age from the analysis and would be very convenient.

Unfortunately, however, the separability just outlined is not plausible, so we need to delve more deeply into the structure of the system, linking up the generation and distribution of welfare. First, shares are likely to vary systematically with total welfare levels (Kanbur and Haddad 1994). Second, for such separability to be plausible we have to believe that transfers of goods and services within the household will be used to compensate individuals who, because of their (non-transferable) characteristics (especially their suitability for certain types of work), bear the brunt of adverse shocks. If subsistence requirements or culture preclude such transfers, the separate treatment of generation and distribution is no longer feasible and the effects of specific prices or factor shocks filter through to specific individuals.

The distinction made in many traditional societies between 'male' and 'female' crops or activities is an important link here. So too are the arguments that falling male wages and/or employment can reduce female welfare because females are obliged to increase their work outside the home, but receive little compensatory help with their traditional in-home activities. Clearly, the same effects could arise if the outside price of female labour rose – for example, because of improved export prospects for clothing. If pressure on female labour for cash crops reduces women's input to the family food crops, nutritional standards could also suffer: fieldwork described in Oxfam – IDS (1999) discovered some evidence of these kinds of problems in Southern Province, Zambia, see Winters (2000a) for a brief account.[3]

Unfortunately while the arguments of the previous paragraph seem very plausible, they are very case-specific. Gender and intergenerational issues must be taken seriously, and the consumption and incomes of individual household members may be important in assessing poverty. But no robust and general approach to predicting the effects or even to analysing them has emerged to date. Thus

other than noting that, along with the points in the previous subsection, the gender/intergenerational issues call for attention and flexibility in the application of the basic results, it is difficult to specify how to proceed.

Finally, of course, information on intra-household distribution is difficult to obtain. Since it is almost impossible to disaggregate consumption across household members, it is likely that the best approach to these issues will call on physical indicators, for example, health or nutritional status and time allocation data.

Price changes and the transmission of shocks

The direct effects of a price change: the distribution sector

I start by considering a change in the tariff facing a single good. Figure 2.2, summarises the way in which such shocks might work through to the variables determining household welfare in a target country. Schematically, for any household the figure comprises five columns of information. The elements concerning distribution lie in the middle of the figure where I trace the transmission of price shocks from world prices through to final consumers (in the rectangles), and briefly describe the factors influencing the extent to which shocks at one stage are passed through to the next.

Consider the transmission of price shocks in pure accounting terms. For an import, the world price of a good, the tariff it faces and the exchange rate combine to define the post-tariff border price. Once inside the country, the good faces domestic taxes, distribution from the port to major distribution centres, various regulations which may add costs or control its price and the possibility of compulsory procurement by the authorities. I refer loosely to the resulting price as the 'wholesale price'.

Figure 2.2 Trade policy and poverty: causal connections.

Source: Winters 2000b.

From the distribution centre the good is sent out to more local distribution points, and potentially faces more taxes and regulations. In addition at this point, cooperatives or other labour-managed enterprises may be involved. It is useful to distinguish these because their behaviour in the face of shocks could be significantly different from that of commercial firms. I term the resulting price the 'retail price', although of course market institutions may well not resemble retail outlets in the industrial economy sense. Finally, from the retail point, goods are distributed to households and individuals. Again cooperatives may be involved, plus, of course, inputs from the household itself. More significantly, the translation of price signals into economic welfare depends on the household's characteristics – its endowments of time, skills, land, etc. – technology and random shocks such as weather. The last two are important conceptually, because anything that increases the household's productive ability permits it to generate greater welfare at any given price vector.

A corresponding taxonomy can be constructed for export goods, starting at the bottom of the column. An export good is produced, put into local marketing channels, aggregated into national supply of the good and finally sold abroad. At each stage the institutions involved incur costs and add mark-ups, all of which enter the final price. If the export price of the good is given by the prevailing price on world markets, all such additions come off the farm-gate price that determines household welfare.

In determining the effects of world price or trade policy shocks on poor households it is vital to have a clear picture of these transmission channels and the behaviour of the agents and institutions comprising them. For example, sole buyers of export crops (i.e. those to whom sellers have no alternative) will respond differently to price shocks than will producers' marketing cooperatives. Regulations that fix market prices by fiat or by compensatory stock-piling can completely block the transmission of shocks to the household level.[4]

Even more important, all these various links must actually exist. If a trade liberalisation itself – or, more likely, the changes in domestic marketing arrangements that accompany it – lead to the disappearance of market institutions, households can become completely isolated from the market and suffer substantial income losses. This is most obvious in the case of markets on which to sell cash crops, but can also afflict purchased inputs and credit. If official marketing boards provided credit for inputs and against future outputs, whereas post-liberalisation private agents do not, no increase in output prices will benefit farmers unless alternative borrowing arrangements can be made.

The importance of transmission mechanisms is well illustrated by the contrasting experience of markets in Zambia and Zimbabwe during the 1990s (Oxfam – IDS 1999). In Zambia, the government abolished the official purchasing monopsony for maize; the activity became dominated by two private firms which possibly colluded to keep prices low and which abandoned purchasing altogether in remote areas. Even if the latter was justified economically in the aggregate, it still left remote farmers with a huge problem. This was exacerbated

by the difficulties of their re-entering subsistence agriculture, given that the necessary seed stocks and practical knowledge had declined strongly during the (subsidised) cash-crop period. In Zimbabwe, by contrast, three private buyers for cotton emerged after privatisation, including one owned by the farmers. Here the abolition of the government monopsony resulted in increased competition and prices and farm incomes rose appreciably. In a less extreme example Glewwe and Tray (1989) show how transport and storage costs attenuated price changes of potatoes following liberalisation in Peru.

The discussion above prompts three comments. First, and blindingly obvious, is that the effects of liberalisation depends on where you set off from. If an import ban plus government monopoly subsidises remote farmers, the first round effects of liberalisation will be to hurt those groups.[5] A second important example of this comes from Harrison and Hanson (1999). They suggest that Mexico's trade liberalisation in the 1980s has not boosted the wages of unskilled workers as many had expected precisely because its initial pattern of protection was designed to protect that group. In short, the analysis of the poverty impact of trade liberalisation can be no more general than is the pattern of trade restrictions across countries.

Second, usually many goods are liberalised at once, so that the effects on individual households will be the sums of many individual shocks. When some of the goods affected are inputs into the production of others, the net effect is quite complex and it is important to consider the balance of forces. For example, Zambian liberalisation raised the selling price of maize in the 1990s, but even where purchasing arrangements continued, input prices rose by more as subsidised deliveries were abolished; as a result, maize farming generated lower returns and output fell (Oxfam – IDS 1999).

Indirect effects and the domain of trade

Third, we need to know how the household will accommodate the price changes. This will first condition our view of how serious the shock is: an adverse shock may entail large losses of welfare if no alternative goods or activities exist, or relatively small losses if they do. Similarly positive shocks may deliver great benefits if households can switch their purchases or activities to take advantage of them.

An additional aspect of accommodating a shock is that the act of substituting one good or activity for another necessarily transmits the shock to other markets which may not have been directly affected by a trade reform. Thus it sets off a whole series of second-round effects. A critical consideration in assessing these effects is the domain over which the 'second-round' goods or services are traded, because this defines the range of agents whose behaviour will be altered as these markets come back into equilibrium. The trading domains are summarised on the far right of Figure 2.2.

The border price of a good that is traded internationally will be largely, if not entirely, determined by the world price. Hence putting aside any changes in the

various margins identified above, the prices of such goods will not change further as the market equilibrates to a shock. That is, there will be no 'second-round' price effects because, in effect, with a world market, all producers and consumers in the world will adjust their behaviour a tiny amount to absorb the changes in the target country.

For goods that are traded on a national market, but not internationally, the second-round quantity shocks will be spread over the whole of the national economy; this too will probably display sufficient elasticity to absorb them with rather small resulting price changes. While small, however, the price changes will be widespread and through this mechanism shocks could be spread from one region of the target country to another. If things are traded only locally – say, because of transportation difficulties or because they are services rather than goods – the trading domain is smaller still: the price adjustment will be larger than in the previous cases, but the impact more narrowly focused geographically.

Several authors argue that it is second-round effects that make agricultural liberalisation and productivity growth so effective at alleviating poverty.[6] Their demand spill-overs are heavily concentrated on employment-intensive and localised activities in which the poor have a large stake – for example, construction, personal servants and simple manufactures. These authors' work assumes that developing country rural economies have excess labour and can deliver extra output by taking on more workers without price increases. This, in turn, means that the increase in income has multiplier effects so that total income in the locality rises by more than the initial impact on the fortunate farmers. The basic insight, however, also generalises to our situation. As farmers spend their extra income the prices of local goods and services are driven up, increasing the incomes of those who produce them. Whichever model applies – with fixed or flexible prices – the policy conclusion remains that liberalising world trade in agricultural goods is likely to have strong pro-poor effects.

Positive shocks to the urban economy are also desirable, of course, but will usually result in more diffuse spill-overs – to a wider set of goods and more directly to imports. Imports still generate spill-over benefits – output in the export sector has to grow, because the imports have to be paid for. But if the factors used intensively in the export sector or in domestic sectors on which urban residents spend their income are not among the poorest, the spill-over from urban shocks will be less pro-poor. Of course, in the end the relative benefits of different second-round effects is a matter for detailed empirical investigation case by case.

Finally, there are two sets of goods for which explicit prices are not observed, but which nonetheless are important for assessing poverty impacts. First, subsistence activities and goods: of course, by definition these are not subject to direct trade shocks, but they will still be affected by spill-overs from goods that are. It is easiest to think of these spill-overs in terms of the ways in which inputs of labour and outputs of subsistence goods are impacted by changes in tradable goods' and services' prices. Recall as an example, the spill-overs to kitchen-gardening discussed above under the gender dimension of adjustment.

   The second set of goods for which we do not observe prices is those that are just not available. While conceptually simple to deal with in our schema – the price of a good is infinity when it is not available – changes in the set create complex measurement problems.[7] They may be important, however, even for the poor, as Booth *et al.* (1993) document in Tanzania. They may also be critical from a policy perspective, as, for example, when non-tariff measures or regulation exclude certain goods from the market. An interesting case-study is Gisselquist and Harun-ar-Rashid (1998) who discuss the restrictions on inputs into Bangladeshi agriculture and show how their relaxation greatly increased the availability of, for example, small tractors and water pumps to small farmers.

   Not only are prices affected by spill-overs and the trading domain, but the distribution chain may also be. Agents' and institutions' willingness and ability to pass price changes through will be partly determined by the domain of the market they serve. In practice the information required to predict second-round effects is very complex. In many cases, however, the shocks induced by trade policy changes will be sufficiently specific and/or small for us to ignore the second-round effects, and we can focus just on the direct impacts described in rectangles in Figure 2.2.

Enterprises: profits, wages and employment

Three elements of the enterprise sector

The left-hand side of Figure 2.2 – the elipses – describes a completely different and equally important link from trade to poverty – that arising through its effects on enterprises. 'Enterprises' includes any unit that produces and sells output and employs labour from outside its own immediate household. Thus as well as registered firms proper, it includes some of the informal sector and larger farms that employ workers part-time or full-time. The important distinction is that outputs are sold and inputs acquired through market transactions. Hence the link in the figure to border, wholesale and retail prices.

   The analysis of the enterprise sector requires three elements – demand, firms and factor markets. Demand for the output of home enterprises is determined by income (of which more later), and export, import and domestic prices. The trade prices are largely or wholly exogenous to the average developing country, but domestic prices are endogenous, even if market forces mean that they are actually constrained always to equal one of the others.[8] As noted above, domestic prices will be determined by interactions at several levels, but here we subsume this all into one term, and some goods will be non-traded internationally and so have only domestic prices.

   The demand for the domestic good must be matched by supply, which stems from the second element – firms. These divide their output between home and export markets according to relative prices, and determine total output according to those prices relative to costs. Costs, in turn, depend on factor prices (wages, returns, etc.) and factor input–output coefficients (i.e. the inputs necessary per unit of output), the latter of which depend on technology and

again on relative factor prices. If there are increasing returns to scale, input–output coefficients also depend on total output. In accordance with the analysis of households above, factors and their returns need to be disaggregated by type, including caste, gender and skill.

Given total output and the input–output coefficients, total factor demand is given, and this is confronted with total factor supply in the factor markets – the third element. These are equilibrated by movements in factor prices, with the result that employment and wages – the two variables of most relevance to poverty – are determined. Implicit in this view is that the distribution of assets and skills across households is given and that household welfare depends only on factor rewards and employment opportunities. Increasing asset stocks is an issue of economic growth, and perhaps public expenditure (for education and health), both of which we treat below. Redistributing them between households is a separate issue quite independent of international trade policy. The distribution of the employment of factors across sectors, however, is not given. The movement of factors between sectors plays a crucial role in the poverty impact of trade shocks.

The remainder of this section considers two different approaches to enterprise effects – one assuming fixed economy-wide levels of employment for each factor of production so that shocks are reflected only in factor prices (a 'trade theory' approach), and one assuming infinitely variable levels of total labour employment at a given fixed wage (a 'development theory' approach). It observes that neither polar view is wholly correct and that a critical variable for enterprises in the real world is the degree of substitutability in demand between their output and that available via imports.

'Trade theory' – inelastic factor supplies

Of course, all the processes described in the introduction to this section happen simultaneously, but the figure helps to explain some of the critical links. I start with traditional trade theory, in which total factor supplies are exogenously fixed, wages and returns are perfectly flexible and the domestic and foreign varieties of each good are identical.

Price changes, including those emanating from trade policy changes, affect the incentives for enterprises to produce particular goods and the technologies they use. The simplest and most elegant analysis of these incentives – the Stolper–Samuelson Theorem (among the most powerful and elegant pieces of economic analysis on any subject) – generates very powerful results indeed. It proves that, under particular conditions, an increase in the price of the good that is labour-intensive in production will increase the real wage and decrease the real returns to capital.[9]

Unfortunately, for all its elegance, the Stolper–Samuelson Theorem is not sufficient to answer questions of trade and poverty in the real world, and it must be supplemented by more heuristic but less specialised approaches. Its basic insight, however, applies under a very broad set of circumstances. An increase in the price of a good – exportable, importable or non-traded – will increase the

incentive to produce it. This will raise the returns to factors of production specific to that good – for example, labour with a specific skill, specialist capital equipment, brand image – and, assuming that some increase in output is feasible, will also generally affect the returns to non-specific, or mobile, factors. Typically, the returns to at least one such factor will increase and those to at least one other fall. Presuming that the poor have only their labour to sell, the focus for poverty studies is on wage rates – usually on unskilled labour and wages.

Broadly speaking, if the prices of unskilled-labour-intensive goods increase we would expect unskilled wages to increase. As these industries expand in response to their higher profitability, they absorb factors of production from other sectors. By definition, an unskilled-labour-intensive sector requires more unskilled labour per unit of other factors than do other sectors, and so this shift in the balance of production increases the net demand for unskilled labour and reduces it for other factors. If poor households depend largely on unskilled wage earners, poverty will be alleviated by the resulting wage increase (although, of course, head-count indices will vary only if the wage increase moves families from one side of the boundary to the other).

It is important to note that in the previous paragraph, the first-order effect is the total production effect, not any shift in factor proportions. It arises because the industry using relatively more unskilled labour increases its demand for *all* factors while other industries release all factors. It is the different compositions of these different sectors' preferred bundles of factors that matters, not any shifts within them.[10] A parallel analysis concerns technical progress. Increases in the general level of efficiency in an industry will reduce its price and/or increase its profitability. This will increase its level of output and thus generally increase demand for the factors that produce it.[11] Factors specific to that sector will benefit, as will mobile factors that are used intensively in the sector. This effect could be offset if technical progress is heavily biased against one factor or another (the factor saved loses out), but if progress is concentrated on only a few sectors it is generally more important to know which sectors and to know their factor intensities, than to know the factor-bias of the technical progress. If, on the other hand, technical progress is uniform across sectors, the composition effects largely cancel out and factor bias is the key to predicting the factor demand effects of technical progress.

In world terms developing countries are clearly labour-abundant, so that freer trade (whether generated by their own or by industrial countries' trade liberalisation) gravitates towards raising their wages in general. However, within developing countries it is not clear that the least-skilled workers, and thus the most likely to be poor, are the most intensively used factor in the production of tradable goods. Thus while, for example, the wages of workers with completed primary education may increase with trade liberalisation, those of illiterate workers may be left behind or even fall. One of the reasons that agricultural liberalisation is such an important goal for future trade policy is that for this sector we can be reasonably confident that low-skilled workers in rural areas – the majority group among the poor – will benefit through the production responses.

It is sometimes suggested – at least implicitly – that the factor intensity approach to the distributional effects of trade policy is refuted by the failure of Latin American liberalisation in the 1980s to alleviate poverty. Without denying the need for refinement in the argument, I believe that the alleged surprise arose more from faulty premises than from theoretical failure. Thus, as Wood (1997) argues, by the 1980s Latin America was not obviously the unskilled-labour abundant region of the world economy: both China's 'arrival' in world markets and Latin America's abundant natural resources suggest otherwise. Similarly the growth of outsourcing, for which Northern firms do not find it most efficient to seek the lowest-grade labour, suggests that Mexican exports are now intensive in labour that is relatively skilled by local standards – Feenstra and Hanson (1995). Finally, of course, it may take time for markets to clear. Thus while Chile's liberalisations (trade and otherwise) were associated with worsening inequality over the 1980s inequality measures have now returned to pre-reform levels – and at vastly higher average income levels and lower poverty levels (World Bank 1997; Ferriera and Litchfield 1999).

'Development theory' – infinitely elastic factor supplies

One exception to the rule that an increase in the demand for a factor increases its wage (real return) is if the factor is available in perfectly elastic supply, that is, if effectively any amount of the factor can be obtained at the prevailing wage. Then the wage (return) will be fixed exogenously – for example, by what the factor can earn elsewhere, which is assumed to be unaffected by the trade policy shock that we are considering – and the adjustment will take place in terms of employment.

First, suppose that labour is the elastically supplied factor. Most generally this will be because the formal sector can draw effectively infinite amounts of labour out of the informal sector or subsistence agriculture at the subsistence wage. This is the famous 'reserve army of labour' model propounded by Nobel Laureate W. Arthur Lewis (1954). Of course, if the formal wage is no more than the subsistence wage (as the model strictly implies), this transfer will have very little effect on poverty. Poverty will only be alleviated if the loss of labour in subsistence agriculture allows the workers remaining in that sector to increase their 'wage', either because the sector begins to run out of labour (the case of successful development) or because the workers had negative social product in that sector (e.g. overcrowding).

Another case where the supply of labour is effectively infinite is where the formal sector has an enforced minimum wage, at which lots of people are willing to work. In this case we can presume that as labour transfers to the formal sector it earns a higher wage and that, as a result, some poverty is alleviated. If trade liberalisation raises the value of the marginal product of labour in the formal sector, for example, by raising the price of an exportable output, it reduces the employment cost imposed by the minimum wage and alleviates poverty. If, on the other hand, trade reform reduces the value of the marginal product and thus reduces employment, it has adverse consequences. Box 2.1 summarises the alternative analytics of the labour market.

Box 2.1 Trade, poverty and the labour market – the simple analytics

The classic link between international trade and poverty in developing countries is via the labour market. If opening up to international trade allows a country to export more labour-intensive goods and replace local production of capital and skill-intensive goods by imports, it increases the demand for labour – typically in the formal sector. (Of course, if the country is not a labour-abundant one, or trade policy previously favoured labour very strongly, liberalisation may not boost labour demand.) If poverty is concentrated among people who are actually or potentially part of the labour market, increasing demand will help to alleviate poverty. But how, and whether, it does so depends significantly on how the labour market operates.

Consider two extreme assumptions. In Figure 2.3a, I assume that the supply of labour to the formal sector is completely fixed. When the demand for labour shifts out from DD to D′D′, employment can not increase and the market must be brought back to equilibrium by an increase in wages from w_0 to w_1. If some of the workers in this market were poor – or were part of poor families – the increase in wages has a direct and beneficial impact on poverty. This is the classic 'Stolper–Samuelson' result that appeared to work so strongly in East Asia over the 1970s and 1980s.

The second extreme is illustrated in Figure 2.3b, where the supply of labour is perfectly elastic at the prevailing wage. Now an increase in labour demand is accommodated by increasing employment to L_1, with no change in wages. The effect on poverty depends heavily on what the additional workers were doing before accepting these new jobs. If they were engaged in subsistence activities – agriculture, scavenging – and earning the equivalent of w_0 initially, there is no change in their situation. Only if

Figure 2.3 (a,b) Trade, poverty and labour market.

the switch into this labour market were so great as to significantly reduce labour supply to the subsistence sector and hence raise its 'wage' for everyone would be a poverty impact. This is no less than the case of successful development, through which whole economies are transformed over a period of decades. Trade liberalisation is an important part of the process, but it is not the only one.

The alternative and more common case is that the wage in the formal sector exceeds the subsistence wage – possibly because it grants access to social services. In this case the workers who transfer to that sector experience a direct wage increase which almost certainly alleviates poverty. This is the situation in the Zambian Copperbelt where each mining job is reported to support fourteen dependants (Oxfam – IDS 1999) and in India, where the formal sector manufacturing wages are substantially above the poverty line (CUTS 1999).

One possibility to consider is that trade reform could increase measured or perceived poverty even though it raises unskilled wages in the formal sector. Suppose, following Harris and Todaro (1970), that workers migrate from rural areas to urban areas until the subsistence wage and the expected wage in the city are brought into equality.[12] Then, if the subsistence wage is unaffected by a trade reform, any rise in the actual city wage that it induces must be balanced by a higher probability of unemployment in the city. Thus in expected value terms the trade reform would be beneficial (actually benefiting existing urban workers, who would receive a wage increase, and imposing no expected cost on migrants from the subsistence areas). However, if the urban poor are more readily measured or observed than the poor on rural subsistence farms, this could lead to the appearance of greater poverty.

In fact, neither of the polar extremes – of wholly fixed or wholly flexible labour supplies – is likely to be precisely true. Hence in practical assessments of the effects of trade shocks on poverty, determining the elasticity of labour supply and knowing why it is non-zero, is an important task.

A possible indicator of the relative importance of the sorts of effects just described comes from Consumer Unity Trust Society (CUTS) (1999). Using the years 1987/8 to 1990/1 to reflect pre-liberalisation performance and 1991/2 to 1994/5 post-liberalisation performance, CUTS finds formal manufacturing sector employment in India growing faster after liberalisation, and wages more slowly: employment at 3.8 and 9.4 per cent and wages at 8.1 and 7.0 per cent respectively. Similar results apply at the sectoral level. However, as Winters (2000a) observes, the success of the reserve army model in explaining the evolution of formal manufacturing in India is not really surprising: the sector accounts for only about 1.3 per cent of the Indian work-force!

A much more perplexing aspect of the Indian reform of 1991 is that it appears to have been associated with a significant *decline* in employment in informal

manufacturing, especially in labour intensive sectors. This decline outweighs the increase in formal employment and seems to have been concentrated in the rural areas. In Winters (2000a), I speculate that the most likely explanation – if, indeed, the data are to be believed – is that the real depreciation that accompanied liberalisation (which will have raised the prices of traded relative to non-traded goods) switched output from non-tradables to tradables and that the former are disproportionate users of the informal sector. If true, this reminds us that poverty impacts must consider the fate of the non-tradables sector as well as that of tradables.

From a poverty perspective, of course, the important question is what happened to those who lost their informal jobs. If they could move back into subsistence or other agriculture at approximately the same wage, not much happened to them in poverty terms, and the observed increase in formal jobs seems to offer a net gain. If, on the other hand, the loss of an informal job signals a descent (deeper) into poverty, the net effects of these changes is negative for poverty alleviation. Unfortunately, we just do not know the answers to these questions, although other data in CUTS (1999) shows that wages in the informal sector are quite often below poverty levels. Formal sector wages, on the other hand, seem to be uniformly substantially above poverty levels.

Capital might also be available in infinite supply – for example, say, from multinationals at the world rate of return. In this case the inflow of capital into the liberalised sector is likely to boost wages and/or employment, which will increase the welfare benefits and, if they exist, the poverty alleviation benefits, of a trade liberalisation. It is important to remember, however, that if capital inflows make for larger effects when sectors gain from liberalisation, they are equally likely to increase them in sectors that lose.

The latter is not to say, however, that capital mobility causes otherwise avoidable losses from trade liberalisation. When capital has been attracted into a country by distortionary policies – for example, tariff protection and tax holidays – the inflow could have been immiserising. Then, while the outflow resulting from the reform of these policies will impinge directly on workers in the affected sector, the overall welfare effects taking account of spill-overs to other sectors will be positive – and larger than if there had been no immiserising investment to undo. If the distorted sector was particularly crucial in addressing poverty, however, it might be that such liberalisation worsens poverty, at least in the short-run until the affected workers have found alternative jobs and/or the government has diverted some of the gains elsewhere in the economy into poverty alleviation policies in the stricken sectors.

Of course, if our target country does not face exogenously given prices for every good, developments in the enterprise sector will affect the prices faced by consumers and hence feed back into column 2 of Figure 2.2. For tradable goods this is probably not a major consideration because few developing countries have significant market power over the medium and long terms, but for non-tradables it will be important. Given weak infrastructure and trading institutions, many goods and services are effectively non-traded in the developing world; their

prices will be determined by the need to equate local supply and demand and by the influence on supply of endogenous changes in factor prices.

Differentiated products

An important distinction in the analysis of the enterprise sector is whether or not goods are homogeneous across foreign and domestic suppliers. Homogeneous goods must have the same prices, and so international trade defines the prices of both traded and domestic varieties. Trade prices essentially determine internal producer and consumer prices and analysis is straightforward. The alternative view is that goods are differentiated, so that each variety faces its own separate downward-sloping demand curve, with links between goods depending on the degree of substitutability between varieties. In this case the transmission of trade policy shocks to domestic prices is less direct, usually affecting more goods but by less than in the homogeneous goods case. This typically also attenuates the shock to factor prices, because, as more goods are affected, the net shifts in the relative demands for different factors are less extreme. The degree of substitutability between domestic varieties and those traded varieties that are affected by the trade reform becomes a critical parameter – the higher it is, the more the shock is focused on the related domestic varieties (Falvey 1999).

As I noted at the end of the preceding section, a trade reform will sometimes be sufficiently straightforward that it will not be necessary to trace all the connections mentioned here, but rather focus on just a very few of them. This can only be determined case-by-case, however.

Taxes and spending

The right-hand set of boxes in Figure 2.2 – the trapezoids – illustrates the third of the major static links between trade and poverty: via taxes and government spending. The common presumption is that falling revenues can squeeze social expenditures and hurt the poor, but, in fact, this is far from inevitable.

For most countries, the early stages of trade liberalisations in the 1980s to 1990s entailed converting quantitative restrictions and regulations into tariffs and reducing high tariff rates. Particularly when the latter was accompanied by a reduction in the scope of tariff exceptions and exemptions it was as likely to increase tariff revenue, as to reduce it (Hood 1998). Thus, in this first stage, concerns over revenues can be overstated, although, of course, the effective *increase* in taxation implied by reducing exemptions could raise prices. If these increases in prices impinge heavily on the poor, they could worsen poverty even if they increase economic welfare overall – particularly if the government is not efficient in spending the revenue it collects. On the whole, however, given that exemptions are mainly granted to the rich and influential, it is unlikely that their loss is anti-poor.

Eventually, however, trade liberalisation will reduce tariff rates so far that government revenue falls. This triggers the more common worry that the government, finding its revenue constrained, will curtail expenditure on social

and other poverty alleviating policies and/or levy new taxes on staple and other goods consumed heavily by the poor. Given the association between structural adjustment, stabilisation, liberalisation and poverty over the 1980s, these worries have some historical basis, but it would be mistaken to assume that the association is immutable. It is clear, however, that governments must display care and maintain a clear focus if they are to ensure that this indirect route does not have adverse effects on poverty. Experience in East Asia over the late 1990s suggests that pro-poor expenditure can be at least partially protected even in the face of far larger shocks than a trade reform.

A further question under this heading is whether trade liberalisation restricts a government's ability to manage spending and taxation in a way that impacts poverty. To start again at the less obvious end of the question, a trade liberalisation bound at the WTO makes the price-reducing effects of tariff cuts less reversible: it constrains the government's (and its successors') ability to manipulate policy in arbitrary ways. Given that such manipulation very often redistributes real income from the poor to the rich, and that uncertainty reduces the incentives to invest, the constraints are likely to be beneficial. Put more positively, WTO may allow governments to tie their own, or their successors', hands in ways that would otherwise be politically impossible.

Much more common is the fear that bindings and/or commitments at the WTO prevent governments from pursuing pro-poor interventions. For example, if price variability is a problem it has been argued that the ban on variable levies, which stabilise the domestic prices of internationally traded goods, could hurt the poor by subjecting them to greater uncertainty. It is sometimes argued that the Uruguay Round Agreement on Subsidies precludes production subsidies that could stimulate output and development.[13] Moreover, consumption subsidies – a more promising anti-poverty tool – were not affected by the Round. There is a slight danger that the Agreement on Agriculture could undermine food subsidy schemes. This occurs if countries' nominal subsidy requirements have increased above low base year levels of support, and if direct consumption subsidies can not be substituted for the production-based subsidies that the Agreement constrains. But again, few developing countries face such problems.

All these arguments are essentially specific examples of the analysis above: they are trade interventions whose direct effects can be traced via the distribution and enterprise sectors. In addition, however, they have systemic effects because they affect whole classes of policies. For example, even if some particular subsidies would be advantageous, given the difficulty of identifying these cases and preventing their capture by interest groups, a blanket ban may be advantageous. Alternatively if governments have established good reputations for using trade policy contingently to stabilise the real incomes of the poor, blanket bans may raise perceived uncertainty in sectors that have not, to date, been subject to intervention. Clearly making such determinations in practice is going to be very complex, and all one can do is plead that they be made on the basis of the evidence on, rather than the theoretical potential of, government performance.

Finally, some have argued that increased openness reduces governments' abilities to raise revenue because mobile factors can no longer be taxed so

readily (Rodrik 1997). If so, social and redistributive expenditure could be under threat. In its direct form this argument applies only to factors that can move locations in response to taxation (or other) incentives, so international trade policy is only indirectly relevant. For example, the general reduction in trade barriers since the mid-1980s has made it easier to 'cut up the value chain', which presumably fosters capital mobility.

On the trade side, increasing world competition makes it more costly for an individual country to tax exports in terms of both eroding the tax base and distorting production patterns. However, it is not clear that individual countries have ever had much scope for such taxes in manufactures, which is where trade barriers have come down most strongly in recent decades. An example where a country's own policy rather than world conditions (others' policies) matter would be if reducing tariffs on a good made it more difficult to tax local producers because they could more plausibly threaten to move off-shore and supply the market from abroad. In this case overall efficiency considerations would still mandate the tariff cut. However, if, for some reason, consumption of the good could not be taxed instead of production (and remember that the tariff cut will have reduced consumer prices, so there will be space for the former) there is a danger of governments losing revenue. Of course, as I noted above, falling revenue does not inevitably lead to declining poverty-alleviation.

An inability to tax capital is clearly a problem for governments intent on redistributive policies, and it clearly reduces the set of available options. It should not, however, be taken as precluding all possibilities. First, most countries collected only a small proportion of their revenues from capital taxation even when their economies were very closed. Second, in fact, many governments subsidise inward investment rather than fret about not being able to tax it. Third, there are other redistributive policies which are not vulnerable to this difficulty. For example, for tackling poverty, Bowles (1999) lists land reform, re-assigning property rights implicit in use of the commons, public-brokered risk sharing, greater accountability in the provision of public services, and removing or reducing discrimination. None of these is easy, but they certainly show that taxing capital is not the only route to helping the poor.

Shocks, risks and vulnerability

The static analysis that I have presented so far compares two perfectly stable scenarios, but, in reality, the real world is full of shocks. Thus we should ideally try to deal more directly with the effects of trade liberalisation on the *chances* of falling into poverty (or of emerging from it) in an uncertain world. We need also to recognise that economic actors' responses to these probabilities may, in turn, feed back onto the static effects just discussed.

The simplest analysis of risk supposes that both foreign and domestic economies are subject to independent random shocks. By increasing foreign exposure, trade liberalisation increases the weight of foreign relative to domestic shocks in the determination of domestic welfare.[14] The simple notion of risk spreading suggests that at low levels of trade, further trade liberalisation would

tend to reduce overall risk because it is very unlikely that both international and domestic conditions would both be very good or both be very bad together – that is, they would tend to off-set each other. However, if foreign shocks are much greater than domestic ones, risk could increase, and if foreign and domestic shocks were strongly positively correlated, the offsetting will be rather weak.

The most obvious application of the independent risks approach is if farmers produce a crop which a trade liberalisation transforms from a non-tradable into a tradable good. Postponing for now any consideration of price stabilisation policies, this change seems most likely to reduce overall variability since in addition to the risk spreading argument, most world markets are more stable than local ones because they already aggregate a lot of offsetting shocks. Another possibility, however, is that liberalisation leads farmers to switch from crop x (subsistence food, say) to crop y (cash crop). Their overall risk then switches from that for x to that for y, and thus could obviously increase. However, if this switch is made knowingly and has no spill-over effects beyond the farmers who make the decision, it is not obviously welfare worsening, for even if the risk increases, the returns might do so too. Thus, just as with the rural–urban migration example above, higher expected welfare might be associated with increasing observed poverty if farmers accept higher risk in order to reap higher returns but periodically suffer the bad luck that entails.

Of course, the switch from subsistence to cash crops may not be made knowingly (governments do not always convey information on risk accurately) and there may be important spill-overs. Oxfam – IDS (1999) report how, in rural Zambia, switches to maize as a cash crop apparently eliminated the knowledge and seed supplies required for subsistence varieties, preventing farmers from reverting to traditional methods when the cash crop market disappeared. Additionally, switches between crops may have serious implications for intra-household income distributions. If, for example, adult males receive the returns from cash crops but females and children bear the risks of failure in terms of nutrition or schooling, the decision to switch could worsen female and child poverty, and may even not be welfare enhancing for the household overall. The important point analytically, however, is that not every *ex post* descent into poverty is the result of an *ex ante* flawed trade liberalisation.

An alternative lens on the previous paragraph is the observation that the inability to bear the risks entailed in producing cash crops can explain the unwillingness to pursue higher average returns created by trade and hence may explain some apparently disappointing supply responses to trade reforms. If they face catastrophe if things go badly, the poor may not be able to afford to be entrepreneurial (Morduch 1994). The policy implication of this is to call for serious consideration of whether the inability to bear risk reflects distortions in, for example, asset ownership or in capital markets. Creating a guaranteed minimum level of real income through policies such as standing public employment schemes could increase the supply responses and income benefits of trade liberalisation significantly – more about this below.

One fear is that, because trade liberalisation (especially in the context of a WTO Round) alters the set of feasible policies, it affects the ability of

governments to operate price stabilisation policies. Thus, for example, if prior to liberalisation domestic food prices were stabilised by varying the restrictiveness of trade policy (e.g. variable levies, or by allowing imports only in periods of shortage), moving to a fixed tariff could increase domestic instability. Thus, for example, the Uruguay Round constraints on variable levies or on export subsidies could increase instability, and hence poverty, in certain economies even if they raise average incomes. It is not clear how important this possibility is, however: I know of no documented cases that it has actually occurred.[15]

Turning briefly to country-level data, there is a presumption that more open economies suffer more heavily from terms of trade shocks and that this, in turn, slows their development or worsens their welfare Rodrik (1998). The first part of this question has at least two elements. First, if openness encourages specialisation one would expect the net barter terms of trade (the ratio of import to export prices) to become more volatile with openness. In fact, this appears not to happen – see Lutz and Singer (1994), and also Easterly and Kraay (1999), who find that very small countries have no worse volatility than larger ones. Second, a given volatility in the terms of trade implies a greater volatility in national income the more open the economy, and we expect openness to increase with trade liberalisation (and also as country size falls). This second element does receive empirical support (Rodrik 1998; Easterly and Kraay 1999).

An important related question is whether more open and liberal economies generate larger or smaller domestic shocks; this could go either way. Krueger (1990b) argues that openness encourages better policy positions in general. Rodrik (1998), on the other hand, suggests that more open economies have greater volatility in total income, which suggests that the terms of trade element dominates the local shocks elements. However, income volatility does not necessarily imply greater consumption volatility, for open economies may be better able to smooth consumption (and investment and government spending) by importing. Thus, overall, trade liberalisation has somewhat ambiguous implications for macroeconomic stability.

The connection between trade liberalisation and risk and vulnerability is clearly very important and yet is very poorly researched. One can certainly find examples in which adverse shocks have led to some people falling into poverty that they may have plausibly avoided in the absence of reform, but such observations alone do not constitute a case against liberalisation. As well as the trade-offs between individuals that we noted above in the static results, we need to consider the trade-offs for any individual over time and between states of nature. It would be perfectly rational to voluntarily increase the *ex ante* risk of poverty in return for a sufficiently higher average income.

Economic growth, development and technology

Economic growth is the key to permanent poverty alleviation. It is also strongly related to contemporaneous reductions in poverty – see, for example, Bruno *et al.* (1996) or Roemer and Gugerty (1997). Unless growth seriously worsens income distribution the proportion of the population living in absolute poverty will fall

as average incomes increase. The balance of the evidence seems to be that although growth can be associated with growing inequality (or economic decline with narrowing inequality), the effects on poverty tend to be dominated by the advantageous direct effects of growth.[16] This effect also appears to generalise to the very poor (below US$ 1 per day) – Ravallion and Chen (1996) or Bruno, Ravallion and Squire (1996), although, at such very low levels of income, small shocks loom large, and Demery and Squire (1996) find hints of contrary evidence in Africa. In recent work, Dollar and Kraay (2000a) have found that the incomes of the poorest fifth of the population grew one-for-one with GDP per head in a sample of eighty countries over four decades. This was as true of growth induced by openness to trade as of that due to other stimuli. Possibly lying behind these results, but possibly independent of them, is that it is generally easier for the government to raise the resources for poverty alleviating policies if incomes are higher and/or growing.

Overall, therefore, if there is any truth in the claims that openness enhances growth, we might reasonably expect it to have beneficial effects on poverty through that route alone. Certainly we should require very strong case-specific information that a particular trade liberalisation seriously worsened income distribution before adopting the contrary view. On the other hand, it is well to note that 'neutral' growth has to be strong if it is to stabilise the *absolute* number of poor in an expanding society. Each year output growth has to keep pace with population growth and then to add some more to pull the incremental numbers of poor out of poverty. Thus relying on growth and the growth effects of trade liberalisation is probably not sufficient to address poverty problems over the medium term. Conscious policy is also required.

What about trade liberalisation and growth? Controversy rages. There is evidence that, even allowing for adjustment strains, liberalisation typically boosts growth in the relatively near term (Operations Evaluation Department 1992; Greenaway *et al.* 1998). Whether this reflects just a one-off improvement in efficiency or long-run increase in the latter's rate of growth is not clear, however. The former is still worth something, but it is the latter that really matters.

There is widespread belief that openness, fairly broadly defined, stimulates growth. Frankel and Romer (1999) is among the most recent and most convincing of studies advancing this view, although some of the other more commonly cited studies have received pretty rough treatment recently from Rodriguez and Rodrik (1999).[17] Moreover, from the perspective of this chapter it is important to note that these latter studies include open trade (the *result* of trade liberalisation) as only one of several indicators of openness and one which generally seems to weigh rather lightly in the overall result (Harrison 1996).

In part, I believe, the weakness of the empirical link between liberal trade and growth reflects the great difficulties of measuring trade stances once one comes inside the boundary of near autarchy: for example, tariffs need to be aggregated, quantitative restrictions assessed and then aggregated, and the degree of credibility level of enforcement measured (Winters 2000c). Overall, the fairest assessment of the evidence is that, despite the clear plausibility of such a link, open

trade alone has not yet been unambiguously and universally linked to subsequent economic growth. It has certainly not, however, been identified as a hindrance.

Moreover, trade liberalisation has a positive role as part of a package of measures promoting greater use of the market, more stable and less arbitrary policy intervention, stronger competition and macro economic stability. With the exception of the last, an open trade regime is probably essential to the long-run achievement of these stances, and it probably helps with the last as well (Krueger 1990b). Thus, taken as a whole, trade liberalisation is a major contributory factor in economic development.

Any link from openness to growth probably operates at least partly by enhancing technical progress: for example, by making new inputs, new technologies, or new management techniques available to local producers. Such flows could arise from trade – either imports or exports – or from direct flows of technology from abroad.

The evidence that access to imports enhances performance is quite strong,[18] while that which postulates a link from exporting to technology is, surprisingly to some, weaker. While macro studies and case-studies have suggested links, detailed and formal work based on enterprise data is doubtful: Bigsten *et al.* (1998) find links for Africa, while Kraay (1997) is ambiguous for China and Tybout and Westbrook (1995) find nothing for Latin America. Similarly it is quite difficult to prove that FDI boosts efficiency (Haddad and Harrison 1993). In both cases the problem is one of causation: efficiency and exporting are linked because efficient firms export, FDI and efficiency because investors choose efficient firms and sectors. While there is undoubtedly a connection between openness and the dynamism of an economy, it is more complex than economists sometimes choose to believe. Openness probably needs several concomitant policies or conditions before it will generate growth.

Of course technological flows need not depend just on trade or commercial transfers of know-how; they may arise autonomously or through direct interventions in research and development in favour of developing countries. An example of the latter is the green revolution, which produced and disseminated high-yield varieties of grain to many parts of the developing world. While most commentators hold the green revolution to have been a significant step forward in poverty alleviation, the mechanisms identified are quite complex. For example, non-farmers have sometimes been major beneficiaries via increased demand for purchased inputs where local industries existed to satisfy the demand for consumption goods and equipment (see Moseley 1999) or where demand for local services increased (see Mellor and Gavian 1999). Both are examples of significant intermarket spill-overs. Alternatively, income has been transferred from farmers to net buyers of food through policies that forced agricultural output to be domestically absorbed rather than exported. This was the case in India and many other South Asian countries.

A very sensitive issue in the area of openness and technology is trade related intellectual properties (TRIPs). The Uruguay Round TRIPs agreement certainly results in developing countries having to pay more for using certain technologies,

and in those cases will both reduce income and curtail the use of the technologies. On the other hand, the increased rewards may stimulate the flow of technology to developing countries, although, to date, firm evidence to that effect is lacking. The commercialisation of intellectual property may also bias it away from meeting the needs of the poor, since collectively they represent such a small market. Thus coterminus with the creation of intellectual property rights, serious attention should be paid to the older publicly funded sources of technology, and to ensuring that intellectual property rights do not shut off routes for the cost-effective development of crop technologies and health products for the poor. The critical examples of this are, perhaps, South Africa's difficulties in acquiring anti-AIDS cocktails at reasonable cost and the failure of pharmaceutical companies to work seriously on malaria.

It seems impossible at present to make convincing generalisations about how technology and trade liberalisation might interact in their effects on poverty. However, I would reiterate the argument that the sectoral composition and factor intensities of the affected sectors will be major factors in determining those effects, not whether in any particular industry, the technology is labour-using or labour-saving.

Growth does not appear explicitly in the analytical scheme of Figure 2.2, but it should not be forgotten on that account. Growth will affect relative prices as well as the incomes generated by the enterprise sector both in terms of average wages and rates of return and the number of people working in that sector. By generating greater demand, growth will assist governments to raise revenue. To the extent that growth is based on technological improvements it will affect the incomes generated by the enterprise sector as well as increase the output that farm households can generate at any given price level.

Short-term adjustment

Trade liberalisation is generally held to have long-run benefits, but it more or less requires adjustment in a country's output bundle to achieve them. If adjustment is costly, liberalisation could lead to periods of decline and/or poverty before things get better. For assessments of the overall economic benefits of liberalisation, the distinction between the social and private costs of adjustment is critical. The former are net losses to society, through, for example, higher unemployment. The latter are private costs that are counterparts to private gains elsewhere – for example, the loss of jobs that existed only by virtue of subsidy or distortion. For the purposes of poverty impact analysis, however, the distinction is less significant. Our question is just whether individuals or households slip temporarily into poverty as an economy adjusts to open trade, and what can be done to prevent this and help them if they do.

The most significant adjustment problem lies in factor markets, especially employment, and so I concentrate on that. There are two separate questions: how long do spells of unemployment/underemployment last and who suffers them? Note that it is the nature of adjustment or transition costs that they are

temporary. Permanent losses are strictly the business of previous sections, although, of course, in practice it requires great confidence in one's analytical and empirical tools to claim to be able to separate permanent from temporary job loss *ex ante*.

How long does unemployment last?

The key to answering this question lies in the speed of labour turnover and the flexibility of the labour market. Unfortunately, there is apparently very little research directly on labour turnover in developing countries (Matusz and Tarr 1998). The latter suggest that, in industrial countries (where liberalisation more frequently entails the contraction of a sector, not its demise), it is surprisingly rapid in most circumstances. If so, unemployment of displaced workers will be relatively short-lived. In some cases workers displaced from low-paid jobs not only found new jobs quickly, but at higher wages (Jacobsen 1978). In developing countries such benign effects are also a realistic possibility, although the evidence is based on aggregate employment data rather than surveys of workers. For example, Mauritius has successfully combined a limited trade liberalisation (in an Export Processing Zone) with poverty reduction – see, for example, Milner and Wright (1998), who identify increasing unskilled and female wages as exports boomed. Panama is another case: a strong liberalisation of trade in 1996/7 and of domestic regulations in previous years led to a decrease in unemployment (16.2 to 13.2 in one year) and to reduced poverty as informal sector wages rose and poor workers entered formal employment. Harrison and Revenga (1998) find manufacturing employment increasing almost immediately after half the liberalisations they study; the other half are mostly transitional economies in which much more than trade liberalisation was happening and in which the general retrenchment created a very unfavourable environment for trade-displaced workers.

   Life is not necessarily so rosy, however, even in 'regular' (i.e. non-transition) liberalisations. Workers may suffer long-lived and deep losses of income if they have previously enjoyed very high levels of protection or if they had built up strong firm-specific human capital. For example, Jacobson *et al.* (1993a, b) find that the US workers laid off after long job tenure earned 25 per cent below their pre-dismissal wages after five years. Rama and MacIsaac (1999) find that employees displaced from the Ecuadorian Central Bank in 1994 had regained on average only 55 per cent of their pre-dismissed salaries after fifteen months despite generally low unemployment levels.

   Where major reform is undertaken, it is frequently argued that things must get worse before they get better. Fiscal retrenchment is necessary immediately and the 'old ways of doing things' comprehensively dismantled in order to lend credibility to the claim that new ways will emerge. Under these circumstances it is hardly surprising that transitional unemployment occurs, and the key factor in its duration will be the institutional structures for new activity to grow. The latter include such things as the freedom to establish new firms, the ability to obtain

service by utility companies, the security of property rights and the existence of credit markets. They do *not* include policies to delay change by protecting employment and existing employers except, possibly, in the very short run. Such delays undermine the credibility of reform and hinder the development of new activities, as, for example, we saw in Poland over 1990–1 (Winters and Wang 1994) and India over the early 1990s (CUTS 1999).

The conclusion is, yet again, that it is difficult to generalise about how deep and how durable transition losses will be. One needs to know about the specific circumstances of the affected sectors. It does seem likely, however, that costs will be greater the more protected the sector originally was and the greater the shock. In particular, labour markets suffering very large shocks can become dysfunctional because even normal turn-over ceases as incumbents dare not resign for fear of not finding a new job. Thus major reforms – for example, transition – or concentrated reforms – for example, closing the only plant in a town – do seem more likely to generate transitional losses through unemployment than more diffuse reforms. On the other hand, it is precisely the sectors with highest protection or the economies with most widespread distortion that offer the greatest long-run returns to reform.

Transitional unemployment and poverty

Transitional unemployment (or declining rewards for skills) is unfortunate for anyone who suffers it, but it does not necessarily lead to poverty. Individuals who have lived beyond the reach of poverty for some time will generally have assets, or access to credit, with which to smooth consumption. Thus for such individuals it is only longer shocks that fall within the remit of this chapter. The poor, on the other hand, will have very few assets, and so will be unable to smooth over even short spells of unemployment. Hence, even switching from one unskilled informal sector job to another could cause severe hardship, especially if temporary stress led to permanent or semi-permanent consequences, such as losing one's place in the queue for rented housing or education services. This suggests that attention to transitional unemployment should mainly be focused on those who were poor or near-poor initially. This is not always the case in practice, for typically the middle class will be more articulate and more influential politically than the poor.

Trade and poverty: the policy implications

This chapter is primarily about the positive economics of trade policy and poverty (i.e. the facts, as we can best infer them), but ultimately these are of interest mainly because they inform the normative question of 'what should we do'. I conclude, therefore, with a brief discussion of some of the policy issues involved.

The discussion above suggests that trade liberalisation can have both positive and negative effects on poverty. If poverty alleviation is a major goal of national policy, it is important to think how international trade policy can be harnessed

to assist it. This section briefly considers some possible policy responses starting with trade policy and moving through to a broad set of what I call complementary policies. It does not deal with the trade-off between poverty and other goals, but it starts by re-iterating that even within the poverty arena trade-offs exist.

Judging policy

If one is to enter the debate, one needs a yardstick against which to judge policy. If that is to condemn any shock that causes even one individual suffer a reduction in income, it is unnecessary to carry out any analysis. Given the heterogeneity of households and that trade policy is strongly redistributive between people in the domestic economy, all policies will fail this test. Even the requirement that no household fall temporarily into poverty is likely to be too restrictive to permit any action in poor countries. The more utilitarian view that the number of households (or persons) in poverty should be reduced is more appropriate. Even this, however, needs to be mediated by attention to the depth of poverty and to the different ways in which different dimensions of poverty respond to shocks.

In practical circumstances, it is also important to recall that it is easier to identify losers from trade policy than potential gainers. The losers from reform are identifiable, concrete and personified as Krueger notes (1990a) whereas the gains are diffuse and appear merely prospective and theoretical. Only in a proportion of cases can one confidently identify the sectors that will gain (e.g. when large export taxes are removed), and even then, although one might identify capital or resource owners who stand to benefit, it is almost impossible *ex ante* to name the workers who will fill the new jobs and/or benefit from pay rises. Couple this with a natural tendency to place greater weight on (and hence to be more vocal about) declines in welfare than on equal increases, and it is easy to see how attitudes towards liberalisation policy are biased towards antipathy. Moreover it is usually the case that the poor are much less able to articulate their concerns than the middle and elite classes.

None of this should be construed as saying that all criticism of trade liberalisation is misguided and biased, but it is a warning that the volume of opinion is not a sufficient indicator of the true merits of a policy change. It also re-emphasises the importance of political leadership in explaining the relative merits of different policies, even difficult and subtle ones such as trade liberalisation!

Trade policy

Consider, first, how trade reform itself might be managed from a poverty perspective. One response to the fear that a trade liberalisation will cause poverty is 'don't do it', but this is not satisfactory. While it has proved hard to isolate the effects of liberal trade on economic growth empirically, there is widespread agreement that it has an important role to play. It not only brings advantages directly

but it is also important in the constellation of polices designed to ensure efficiency and competition in markets, and transparency and predictability in policy-making. Thus in the long run liberal trade assists poverty alleviation and should figure in the poverty-conscious government's armoury.

Another response is 'don't do it all: while everyone is in favour liberalisation in general, certain sectors or products should be exempt'. In fact, all countries have such exceptions – for example, agriculture in Europe, clothing in the USA – but that does not necessarily make them good economics. There undoubtedly are cases where an isolated intervention in trade would be benefi-cial to immediate economic welfare and/or to poverty alleviation. However, given the difficulties of identifying these cases, of preventing their capture by interest groups and of avoiding the systemic signal that lobbying for intervention pays, it is unlikely to be beneficial overall to try to pursue them. Thus while one does not need to progress all the way to free-trade to reap the benefits of liberal-ism, the case for planning a series of exceptions is not strong. One needs very strong evidence of the efficacy of such interventions, and this is, on the whole, missing. Simply appealing to the experience of East Asia is not persuasive. It is not beyond dispute that their trade interventions were important or beneficial,[19] and it is far from certain that other countries have the policy-making institutions to be able to replicate East Asian policy stances effectively.

A third response is 'don't do it now'. This is a more useful response in some circumstances. For example, trade reform in the midst of recession seems likely to suffer more, and more durable, transitional unemployment than reform in a boom; where investment is necessary to allow the production of export-quality goods, time may be desirable to permit it to occur. There is, however, a world of difference between committing to policies with long adjustment periods and postponing liberalisation because 'the time is not ripe'. The key is credibility that reform will actually occur. Adjustment costs may be lower if adjustment can be spread somewhat through time, but they are probably enlarged if adjustment is resisted in the hope that the threat of liberalisation will go away. It is notable that some trade reforms have been accelerated once they have been launched – for example, implementation of free trade in the EEC, of the Kennedy Round tariff cuts, and of the tariff cuts planned in the Association of South East Asian Nations (ASEAN) Free Trade Agreement – usually at the behest of the private sector. This presumably reflects the fact that, once it is accepted that reform will occur, business is keen to adjust rapidly.

Thus sequencing a major trade liberalisation is probably desirable – just as, say, the Uruguay Round permitted long adjustment periods. This should not merely entail postponing the largest adjustments longest, however, but should pay atten-tion to the different adjustment needs of different sectors and to the interactions between different parts of the package. For example, if the inputs and outputs of a particular sector are liberalised at very different rates, the sector could face either negative incentives for production during the transition (if tariffs on the output fall faster than those on inputs) or excessively positive ones. Whatever the transition period, credible commitment to the final goal is important, for

without it neither current nor potential production activities will look desirable and there will be a diversion of effort into lobbying.

Specific compensatory policies

If trade liberalisation causes poverty among certain sections of society, a natural response is to ask whether society can not offset the effect directly. Despite their theoretical attractions for economists, governments are not generally attracted to simple budgetary transfers because of their cost, their transparency (and the transparency of their abuse) and the appearance that they do little to cure 'the problem' that the individuals face. Rather assistance is usually offered, if at all, in terms such as retraining, relocation assistance and temporary income support. In fact, while they probably do have a contribution to make, even these approaches face severe difficulties. Official retraining has mixed success under any circumstances; worse, there are problems in separating those cases where trade is to blame from those where it is not.[20] Thus unless one is willing to underwrite almost any adjustment, identification of cases is a major difficulty.

Making a general commitment to compensate individuals for adverse shocks is most unattractive, however. It has potentially huge cost and it shifts private risk to the public sector, with all the attendant problems of people taking on extra risk precisely because they keep any gains while the government gets the losses. It is not the role of the state, nor is it feasible, to absorb every negative shock that might afflict individuals. On the other hand it is difficult to make a moral case as to why trade shocks warrant adjustment assistance while other do not.

A further complication is giving compensation in a way that encourages rather than discourages adjustment. European agricultural policy is essentially designed to protect farmers from the consequences of their declining competitiveness in food production, and yet it has the effect of rewarding current not ex-farmers. Compensation is no longer so strongly related to farmers' current output, but because it is paid only to those who keep their farms it has the effect of supporting farming as an activity.

In cases where trade liberalisation leads to the loss of jobs, government can insist on, and perhaps help to finance, redundancy payments. These can help some people to avoid poverty, but is not guaranteed to do so as shown by the so-called 'new poor' in Zimbabwe who failed to use their money productively and ended up among the poor (Oxfam – IDS 1999). Moreover, redundancy payments typically reward past service not current need and so are not particularly well targeted for poverty purposes.

General compensatory policies

These policies – often referred to as safety nets – are designed to alleviate poverty from any source directly. They replace the problem of identifying the shock with one of identifying the poor. Ideally, countries should already have such

programmes in place. Indeed, a major part of their effect arises from their mere existence rather than their use: they facilitate adjustment by assuring the poor that there is a minimum (albeit barely acceptable) below which they will not be allowed to fall. If trade-adjusting countries do already have these schemes, they have the advantages over tailor-made schemes of automaticity, immediacy and a degree of 'road-testing'. Sensibly constructed, safety-nets need not entail huge expenditure. There is rather little chance of people using them by choice if the thresholds are set low enough; and, since relieving poverty is more or less universally recognised as a responsibility of the state, there is little argument about the legitimacy of such interventions.

Targeting is a major problem for safety nets, because the middle classes are often better able to access them than are the poor. Moreover, a major trade shock could put severe financial pressure on them. However, Ravallion (1999) offers some useful thoughts on setting them up. Workfare is a good start, provided that the wage is low enough, that there is little or no administrative discretion in its application, and that the tasks set are seen to be of communal interest. In fact, Ravallion suggests that local communities select the projects to be undertaken under workfare and that the richer ones should also be asked to co-finance them. Workfare needs supplementing, however, by schemes to provide food to people such as the elderly and infirm who cannot work, and for children – for example, food-for-education schemes. These supplementary schemes may be tripped on and off according to need, but should have a permanent infrastructure and sensitive and quick triggers. Expenditure on safety nets is almost by definition counter-cyclical, and so it will need firm commitment by government to ensure that the money does not dry up in times of greatest need.

Safety nets can not be the only response to the threat of increasing poverty from trade liberalisation, but, they are an important part of it. They can generally be better targeted than other polices and they are not very distortionary of market forces. If countries do not have them already, they should consider setting them up as part of the context for a trade reform that may create short-term poverty. They should not, however, be trade-shock specific.

Complementary policies

Complementary policies are those which would be useful to have in place or to implement simultaneously with a trade liberalisation. They are not directly compensatory, but are rather designed to ease the adjustment strains and help households avoid poverty by allowing them a greater degree of economic viability. Strictly, these policies include very general prescriptions for addressing poverty, such as the distribution of productive assets, adequate education and health provision, and the encouragement of civil society and participation and voice among the poor. However, I restrict this brief discussion to those that refer rather specifically to reaping the benefits and avoiding the costs of trade liberalisation.

The critical issue in the poverty impacts of trade liberalisation is the functioning of markets. A trade liberalisation needs to be preceded by thought about

whether any markets are likely to fail and accompanied by monitoring of the same. Policies designed to ensure that markets continue to function or develop where required seem likely to have high pay-off for both aggregate income and for poverty alleviation. Among the important factors identified by Winters (2000a) are:

(a) Infrastructural support

Potential opportunities for poor producers to benefit from a more open trading regime have been lost because critical infrastructure was either absent or had deteriorated. In both Zimbabwe and Zambia remote farmers have found their opportunities constrained by an inability to reach major market centres. In the same way, many of the benefits of relaxed retailing regulations and the availability of new and/or cheaper goods have been confined to urban and peri-urban areas.

(b) Market institutions

Just as important are failures in market institutions. The poor frequently seem unable to attain the economic mass required for the establishment of markets that, once established, may be viable. Policy should aim at the creation of the market as an institution, not the ongoing subsidisation of market activity. Part of facilitating the poor's participation in markets may be finding means to allow them to combine very small consignments of inputs or outputs into reasonably sized bundles. This is not the poor combining to achieve a measure of market power, which is not usually realistic, but of reducing transactions cost sufficiently to make it worth dealing with them.

(c) Missing credit markets

Development economics has many examples of missing credit markets preventing development, and the same phenomenon is visible in responses to trade liberalisation. Thus, for example, achieving minimum consignment size might entail hiring draught power or seasonal labour, but this is not possible without credit. Similarly, establishing informal businesses in activities such as trading may require more capital than the poor can raise. These cases in which poverty constrains the responses to incentives replicate the results of Lopez *et al.* (1995) in their panel study of Mexican agriculture. I have nothing to add by way of solutions, but note the issue as one of considerable importance.

(d) Establishing business

If trade liberalisation opens up business opportunities in new areas, new businesses are likely to be required. If the regulations for establishing these are restrictive, and their ability to get inputs (especially utilities) weak, these

opportunities will go begging. Similarly regulations on expansion and on labour recruitment and separation could curtail the willingness of existing firms to expand. The reservation of particular sectors for small firms in India may be having this effect. There is clearly a trade-off between labour protection and the number of jobs, but we suspect that for the purposes of poverty alleviation it will call for weaker rather than stronger protection.

Pre-requisites or concomitants?

Whether these complementary policies should be pre-requisites for or concomitants of trade liberalisation remains a contentious issue. While there is a literature on sequencing reform within the trade sector and between trade and capital accounts, there are no convincing empirical generalisation about sequencing in the sense discussed here. There may be a case for delaying liberalisation by a few months while some of the legislation on business and labour is put in place and plans for protecting market institutions laid. My own view, however, is that any further delay will be interpreted as a reluctance to liberalise trade and will send completely the wrong signal.[21] A credible plan for liberalising the borders – albeit one with significant transition periods – will be an important stimulus to reforming these other areas in ways that will typically have other benefits as well.

Key questions for policy-makers

The link between trade policy and poverty is evidently a very complex topic for which few generalisations are possible. The analysis above, however, does suggest some important questions that should be posed about any prospective trade reform. I conclude, therefore, with a check-list for policy-makers.

Will the effects of changed border prices be passed through to the rest of the economy?

Trade policy and shocks operate primarily via prices. If price changes are not transmitted, for example, because governments continue to fix the internal prices of goods which they have ostensibly liberalised internationally, the most direct effects on poverty (positive or negative) will be nullified.

Is reform likely to destroy effective markets or create them; will it allow poor consumers to obtain new goods?

Perhaps the most direct effect of trade reform on poverty is via the prices of goods/services in which poor households have large net positions. The largest price shocks occur when either the initial or final price is finite and the other infinite (i.e. when there is no market). A shock that completely undermines an important market – for example, for a cash crop or a form of labour – is likely to have major poverty implications. Similarly, bringing new opportunities, goods or services to the poor can greatly enhance welfare.

Is reform likely to affect different household members differently?

Within a household, claims on particular goods and endowments of particular assets (labour) are typically unevenly distributed. It is possible that poverty impacts will be concentrated on particular members – usually females and children, who may lose personally even when the household gains in aggregate.

Will spill-overs be concentrated on areas/activities of relevance to the poor?

Sectors of an economy are interlinked and, if substitutability is high, a shock will be readily transmitted from one to another. Frequently the diffusion will be so broad that it has little effect on any particular locality or sector, but sometimes – for example, where services are traded only very locally – the transmission is narrow but deep. Then it is necessary to ask whether the second round effects have serious poverty implications. Agricultural stimuli can confer strong pro-poor benefits on local economies via benign spill-overs.

What factors are used intensively in the most affected sectors? What is their elasticity of supply, and why?

Changes in the prices of goods affect wages according to factor intensities. Predicting either the price effects or the factor intensities of affected sectors can be complex, as was seen with the Latin American reforms of the 1980s and 1990s. In addition, if factor supplies show some elasticity, part of a trade shock will show up as changes in employment rather than in factor prices. In the limit, a perfectly elastically supplied factor will experience only employment effects. This is most pertinent for labour markets. If the prevailing wage is determined by subsistence levels, switching people from one activity to another has no perceptible effect on poverty. If, on the other hand, the trade-affected sector pays higher wages (because, say, it has an institutionally enforced minimum wage), increases in activity will tend to reduce poverty and declines increase it. The formal/informal divide is important in this respect.

   In all this, it is important to remember the difference between the functional and the personal distribution of income. Falling unskilled wages generate poverty only to the extent that the poor depend disproportionately on such wages.

Will the reform actually *affect government revenue strongly?*

One's immediate reaction is that cutting tariffs will reduce government revenue. While in the limit this is clearly true – zero tariffs entail zero revenue – many trade reforms actually have small or even positive revenue effects, especially if they convert NTBs into tariffs, remove exemptions and get tariff rates down to levels that significantly reduce smuggling. Even where revenue falls, it is not inevitable that expenditure on the poor will decline. That, ultimately, is a policy decision.

Will reform lead to discontinuous switches in activities? If so, will the new activities be riskier than the old ones?

If a trade liberalisation allows people to combine 'national' and 'international' activities, it is most likely to reduce risk: foreign markets are likely to be less variable than domestic ones and even if they are not, risk spreading is likely to

reduce overall risk. If, however, trade reform leads to more or less complete changes in activities, there is a possibility that risk increases as the new activity is riskier than the old one.

Does the reform depend upon or affect the ability of poor people to take risks?

The very poor can not bear risk easily. Because the consequences of even small negative shocks are so serious for the poor, they may be unwilling to take opportunities that increase their average income if they also increase the chance of losses. This might leave them with only the negative elements of a reform package. Similarly, if a reform makes it more difficult for the poor to continue their traditional risk-coping strategies, it may increase their vulnerability to poverty even if it increases mean incomes.

If the reform is broad and systemic, will any growth it stimulates be particularly unequalising?

Economic growth is the key to sustained poverty reduction. Only if it is very unequalising, will it increase absolute poverty.

Will the reform imply major shocks for particular localities?

Large shocks can create qualitatively different responses from smaller ones – for example, markets can seize up or disappear altogether. Thus if a reform implies very large shocks for particular localities mitigation in terms of phasing or, better, compensatory–complementary policy, could be called for. There is a trade-off, however, for typically larger shocks will reflect bigger shortfalls between current and potential performance and hence larger long-run gains from reform.

Will transitional unemployment be concentrated on the poor?

The non-poor will typically have assets that carry them through periods of adjustment. This might be unfortunate for them, but it is not poverty strictly defined. The poor, on the other hand, have few assets, so even relatively short periods of transition could induce descent deep into poverty. If the transition impinges on the poor there is a strong case for using some of the long-run benefits of a reform to ease their adjustment strains.

Acknowledgements

Notes

1 For example, the fact that trade liberalisation in Southeast Asia was associated with great strides in alleviating poverty is not sufficient to show that it caused those strides; too much else was going on. Similarly, the (mixed) evidence that liberalisation has gone with increasing poverty in Latin America since 1980 is not sufficient to prove the opposite.

2 Baulch (1996) offers a useful account of different poverty measures.

3 Elson (1991) and Haddad *et al.* (1994) provide useful overviews of these non-separabilities and their consequences.

4 Lest blocking price transmission seems automatically a good thing, remember that many shocks are positive and that official bodies have a tendency to take a cut out of the price in return for providing the 'service' of insulation.

5 Second round effects could, of course, be positive.

6 For example, see Timmer (1997), Delgado *et al.* (1998) and Mellor and Gavian (1999).

7 Feenstra (1994) has pioneered methods of approaching this problem, particularly in the context of the availability of inputs into production.

8 If the domestic and imported varieties of a good are identical and there are no constraints on sales, domestic prices will equal import prices.

9 The Stolper–Samuelson Theorem is described in all international economics textbooks – see, for example, Bowen *et al.* (1998). A full account appears in Deardorff and Stern (1994).

10 In fact, if the wage for unskilled labour increases, all sectors will switch to slightly less unskilled-labour intensive techniques of production.

11 Only if demand is inelastic will the increase in demand fail to outweigh the savings in factors implicit in the greater efficiency.

12 The expected wage is the actual wage multiplied by the probability of finding a job at that wage.

13 The Agreement does restrict production subsidies in principle but for developing countries the disciplines are relatively weak. A trading partner would have to demonstrate actual harm before acting against them, which seems very unlikely for the sort of subsidies that might help to alleviate poverty.

14 Foreign shocks are, of course, transmitted through the links discussed above. As above, they will pass through different amounts of the risk onto the poor according to the specifics of the case – for example, much if a sector makes heavy use of casual labour, little if price shocks are mostly absorbed by an official purchaser of export crops. Thus sectors with apparently similar distributions of international shocks can have very different implications for the probability distribution of shocks facing the poor.

15 And would be pleased to hear if such cases exist.

16 See, for example, Demery and Squire (1996) study on Africa.

17 For example, Dollar (1992), Sachs and Warner (1995) and Edwards (1998).

18 See, for example, Esfahani (1991) and Feenstra *et al.* (1997).

19 For example, Lee (1996) suggests the very opposite for Korea.

20 See Decker and Corson (1995) on the USA's Trade Adjustment Assistance Program. This doubles unemployment insurance cover from 26 to 52 weeks for workers certified as displaced by trade liberalisation. After serious abuse in its early years when it was merely a transfer – over 70 per cent of claimants went back to work for the employer from whom they were said to have been displaced – a training element was added. This had the effect of screening out claimants who did not want/need training, but apparently did nothing to increase the earning power of recipients.

21 In particular, in the absence of a clear and monitorable plan for specific pieces of infrastructure, a general wish to wait until the roads or ports are 'ready' is just a recipe for indefinite postponement.

Part II

The East Asian experience

3   Liberalisation, unemployment, inequality and poverty in urban China

Xin Meng

Urban unemployment has become one of the most important social and economic problems in China since the mid-1990s. Between 1995 and 1999, a period of radical economic restructuring in China, around 15–27 million state-sector workers were made redundant, which has generated serious income inequality and urban poverty problems. This study addresses two important questions related to urban unemployment: to what extent has involuntary retrenchments increased income inequality in urban China? And who are the most vulnerable people in the process of economic restructuring? To investigate these issues I use data from the Income Distribution Survey 1995 (IDS95) and Income Distribution and Employment Survey 1999 (IDES99) conducted by the Institute of Economics, the Chinese Academy of Social Sciences in 1996 and 2000, respectively.[1]

Background

Large-scale urban unemployment had not been an issue in China before the radical economic reform initiated in the mid-1990s.[2] Official unemployment figures had never exceeded 5.5 per cent over the last half century. Before the 1990s, China successfully achieved high economic growth while avoiding direct factor market reform and radical state-sector reform. However, accumulated excess workers within state enterprises were said to be more than 30 per cent of the total labour force. Due to large-scale hidden unemployment, soft budget constraints and other property rights related problems the Chinese state sector has been performing badly. By 1995–6, around 50 per cent of enterprises were making losses. In order to vitalise the Chinese economy, the policy of radical reform in the state enterprises was introduced, first on trial in 1993 and finally launched in 1997 (East Asia Analytical Unit 1997; Appleton *et al.* 2001).

As a result of this policy many small and medium size loss-making state enterprises were bankrupted. Those which survived started to take efficiency measures seriously. These two forces led to large-scale retrenchments (layoff or 'Xiagang' in Chinese). Xiagang differs from official unemployment in the sense that workers who lose their jobs still keep an employment relationship with the enterprises they used to work for. They receive housing, medical and other benefits from the enterprises, and the enterprises are obliged to pay their living allowance and work-related insurances, such as medical, unemployment and pension insurances. In addition, once jobs become available they will be re-employed.[3]

In addition to the state-sector layoff workers, many of state-sector workers who are close to retirement age chose to take early retirement, as the retirement pension is usually higher than the living allowance provided to layoff workers. Chinese official unemployment figures, however, do not count Xiagang and early retirees as unemployed. Only those who lost jobs from the collective or various forms of private enterprises together with the urban labour market new entrants who are unable to find jobs are accounted for unemployed. This group does not enjoy the benefits provided to the layoff workers. They have to register with the government unemployment centres to receive unemployment benefits. In this study, we choose to use a broader definition of unemployment, which includes (1) official unemployment; (2) layoff workers and (3) early retirees.

The Chinese official urban unemployment reached 5.75 million in 1999, which accounted for 3.1 per cent of the total urban labour force. Figure 3.1 presents the official urban unemployment (left-hand scale) and unemployment rate (right-hand scale). It indicates that, even without including layoff workers and early retirees, the urban official unemployment rate in the late 1990s is at its highest position since 1983.[4]

Several non-official estimates of a broader measure of unemployment are available (Appleton *et al.* 2001). The household survey conducted by the Institute of Economics, Chinese Academy of Social Sciences in 2000 indicates that including early retirees,[5] layoff workers, as well as registered unemployment, the total unemployment rate reaches 24 per cent of the total labour force in 1999. Excluding early retirement leads to a total unemployment of 17 per cent of the total labour force.

Figure 3.1 Official unemployment and unemployment rate.

Source: DX database.

Unemployment and income inequality

According to the Income Distribution Survey 1995 (IDS95) and Income Distribution and Employment Survey 1999 (IDES99) data, the average real household per capita disposable income during this period has grown at the average annual growth rate of 5.6 per cent – from 2,125 yuan in 1995 to 2,647 yuan in 1999. However, the estimates of the Gini coefficient for per capita household disposable income suggest an increase in inequality – from 27.4 in 1995 to 31.3 in 1999.

An interesting question is what is the cause of the increase in inequality? In particular, is it generated by an increase in the top and the lower end of the income distribution but the increase of the top end is greater than that of the lower end or is it generated by an increase in the top end and a decrease in the lower end of the distribution? The former may be considered of less concern than the latter with regard to the potential to generate social and political instability.

To address this question, Figure 3.2 presents the generalised Lorenz curve for the 1995 and 1999 and the difference of the two curves. The vertical axis in the top panel represents the cumulative percentage of per capita household income (PCHI) multiplied by the mean per capita household income. It shows the total resources being accessed by each percentile of population. If one generalised Lorenz curve lies everywhere above another, it is said that the higher curve is preferable to the lower curve with regard to social welfare as every percentile of the population distribution has access to more resources. The bottom panel of Figure 3.2 presents the difference in the 1995 and 1999 generalised Lorenz curves.

Figure 3.2 demonstrates that the 1999 generalised Lorenz curve lies below that of the 1995 curve for the bottom 10 per cent of the distribution (shown by the negative value of the vertical axis of the bottom panel of the graph indicating the difference between the two years) and above the 1995 curve everywhere after the bottom 10 per cent of the distribution. This result suggests that the social welfare of the bottom end of the income group is worse off in 1999 than that in 1995, while the above-tenth percentile income group is better off.

Another important question is why has the income at the lower end of the distribution reduced while median and high-income families have enjoyed significant income gains over the period 1995–9. This may be related to unemployment produced by the radical economic restructuring. Figure 3.3 presents the distribution of households with unemployed members across different income deciles in 1995 and 1999. It indicates that the number of households with unemployed members has more than doubled for the lower two deciles while it has hardly changed or even reduced for the top two deciles from 1995 to 1999.

If unemployment is an important cause for the reduction in income at the lower end of the distribution between 1995 and 1999, why is it that not all unemployed households fall in the low-income group? Perhaps households have cushioned some of the unemployment impact. The reduction in household income from one member being unemployed can be compensated by other members income if they are employed. This suggests that households with more unemployed members are more likely to fall in the lower end of the distribution. Indeed, in 1999 around 50 per cent of households with two or more unemployed

Figure 3.2a Generalised Lorenz curve, 1995.

Figure 3.2b Generalised Lorenz curve, 1999.

members are located in the bottom ten percentiles of the income distribution, and about 30 per cent of such households are concentrated in the lowest five percentiles of the distribution.

   To evaluate the contributing factors to the level of income inequality and its change across the two survey years an income-generating model with logarithmic real per capita household disposable income as the dependent variable is first estimated. Household income (or per capita household income) is normally defined as a function of the earnings of household members, income from

Figure 3.3 Distribution of households with unemployed members across income deciles.

household business, and household demographic characteristics. In the case of urban China, only a limited number of households have a family business, hence income from this source is not important. Thus, household income can mainly be attributed to factors that affect the earnings of household members and demographic features of the household. These attributes may be grouped into: human capital, economic restructuring, household composition and regional effects.

Table 3.1 reveals interesting results. First, party members earn significantly higher earnings than non-party members in urban China and increasingly so. In 1995 being a party member for a husband or a wife increased real PCHI by 7.0 and 4.8 per cent, respectively. This premium has increased to 10.3 and 10.3 per cent in 1999. It could be argued that with decentralised labour market institutions, the rate of return to unobservable productivity related characteristics as captured by the party membership has gone up significantly. It is, however, also possible that party members receive more favourable economic treatment through the political process in 1999 than previously. At this stage it is impossible to disentangle the two effects.

Second, the most important changes over the period come from variables representing economic restructuring. The adverse income effects of unemployment and working in loss-making firms have increased considerably. In 1995, when economic restructuring in the urban state sector began to accelerate, a household with an unemployed husband has a 9 per cent lower PCHI than a household without an unemployed husband. The income reduction for households with unemployed wives or sons/daughters is 10.5 and 7.5 per cent, respectively. In addition, working in loss-making firms also reduces income substantially. In 1995 a household with both husband and wife working in a loss-making firm received

Table 3.1 Determinants of real per capita household disposable income, 1995 and 1999

	1995		1999	
	Coef.	*T-ratio*	*Coef.*	*T-ratio*
Constant	7.4727	48.47	7.7957	44.13
Average age of HH labour	0.0234	3.37	0.0113	1.41
(Average age of HH labour)^2	−0.0002	−2.77	−0.0001	−0.90
Average years of schooling of HH L	0.0344	14.45	0.0442	14.35
H party membership	0.0702	5.51	0.1034	7.11
W party membership	0.0477	2.92	0.1029	5.73
H being unemployed	−0.1037	−3.69	−0.2880	−11.86
W being unemployed	−0.1135	−4.60	−0.2558	−12.66
2nd generation being unemp.	−0.0977	−2.77	−0.1627	−4.58
H working in loss-making firm	−0.1014	−6.44	−0.1717	−10.39
W working in loss-making firm	−0.0833	−5.36	−0.0846	−5.10
H working in local SOEs	−0.1038	−6.61	−0.0790	−4.42
H working in collectives	−0.1746	−7.55	−0.1427	−5.14
H working in private sector	−0.0602	−1.36	−0.0038	−0.14
H did not report sector	0.0145	0.33	−0.2693	−3.60
W working in local SOEs	−0.0446	−2.54	−0.0145	−0.74
W working in collectives	−0.1037	−5.04	−0.1129	−4.76
W working in private sector	−0.1639	−3.64	−0.0723	−2.49
W did not report sector	−0.2254	−7.57	−0.2684	−8.04
Male as the household head	−0.0430	−3.27	−0.0444	−2.96
% of children aged 0–5	−0.2637	−3.24	−0.2252	−2.36
% of children aged 6–10	−0.0580	−0.94	−0.0343	−0.49
% of children aged 11–16	−0.0520	−0.97	−0.1601	−2.74
% of elderly	0.2053	3.85	0.1687	2.88
Household size	−0.2749	−23.27	−0.1905	−13.98
Number of labourers in the HH	0.1905	13.46	0.1378	9.38
Regional dummy variables	Yes		Yes	
Number of observations	3,503		4,002	
Adjusted R^2	0.5301		0.5162	
R^2	0.5341		0.5198	

Notes
HH refers to household; H refers to husband, and W refers to wife.
The *T*-ratios are calculated using heteroskedasticity-consistent covariance matrix.

17.7 per cent less income than otherwise. Thus, working in a loss-making firm is equivalent to being laid off. The fact of the matter is that working in a loss-making firm is the first step towards being unemployed and in 1995 most layoff workers received similar pay as those who worked in the loss-making firms but had not yet been laid off.

By 1999, the radical urban state-sector reform had been in place for about four to five years and the effect of such a reform on household income variation became even more severe than that in 1995. Households with an unemployed husband, wife or son/daughter received 29, 26 and 16 per cent less income, respectively, than households without these members being unemployed. These ratios are double or triple those observed in 1995. Such a significant change may reflect the change in the general economic situation. In 1995, most layoff

workers were still paid by their previous enterprises. By 1999, many of these enterprises were bankrupted and the state-sector layoff workers were re-assigned to the re-employment centre and were guaranteed a minimum living standard, which is lower than the income received by normal layoff workers.

In addition to the increase in income loss due to unemployment between 1995 and 1999, the loss of income for households with husbands working in loss-making firms also increased. In 1995 per capita income of these households was about 9 per cent less than households without husbands working in loss-making firms. This ratio increased to 17 per cent in 1999.

As indicated earlier that the poorest 5 per cent of households has the highest proportion of households with unemployed members. It is, therefore, worthwhile investigating in more detail how incomes of these households have been affected by the economic restructuring. Income reductions for households with various combinations of unemployed members and working in loss-making firms are presented in Table 3.2. It shows that the income reduction for households with two unemployed members increased from 18 per cent in 1995 to 48 per cent in 1999. If an additional member (son/daughter) is also unemployed the total reduction in real PCHI increases to 27 per cent in 1995 and 71 per cent in 1999.

Fortunately, not many households have three unemployed members. Table 3.4 also presents the proportion of households with different number of unemployed individuals and the demographic composition of the unemployment within households for the two survey years. It indicates that the majority of households with unemployed members have only one member being unemployed. In addition, it is the women who bear the most consequence of economic restructuring, especially in 1999 where the number of households with only the wife unemployed is double that with only husband unemployed (11.8 vs 5.5 per cent). The proportion of households with two members being unemployed increased from 2.1 per cent in 1995 to 3.7 per cent in 1999. Among them the proportion of households with both husband and wife being unemployed increased from 1.6 to 3.6 per cent. 'Working in a loss-making firm' is a more widespread phenomenon than unemployment. It shows in Table 3.2 that in 1995 around 33 per cent of households have at least one member working in a loss-making firm, whereas this ratio increased to almost 49 per cent in 1999. Luckily, the income reduction for 'working in a loss-making firm' is not as severe as being unemployed in 1999.

Third, the effect of regional income variation has been identified as the main contributing factor to the increase in income inequality between 1988 and 1995 in previous studies (see, e.g., Gustafsson and Li 1999; Khan and Riskin 2000). Its significance has reduced since 1995. Without including other explanatory variables regional effects accounted for 20 and 17 per cent of the variation in per capita household income in 1995 and 1999, respectively.

Identifying the most vulnerable groups

The above analysis shows that during the economic restructuring in urban China in the late 1990s the most significant determinant of household income reduction is unemployment. In addition, not all households with an unemployed

Table 3.2 Percentage of different types of households with unemployed members or
members working in loss-making firms (LMFs)

	1995		1999	
	% of HH	Income reduction (in %)	% of HH	Income reduction (in %)
Total number of households	3503		4493	
HH without unemp. member	86.75		75.67	
HH with one member being unemp.	11.13	9.0	20.59	23.8
HH with two members being unemp.	1.94	17.9	3.65	47.5
HH with three members being unemp.	0.17	26.9	0.04	71.2
HH with four members being unemp.	0.00		0.04	95.0
HH with H being unemp. only	3.50	8.9	5.45	28.8
HH with W being unemp. only	5.23	10.5	11.84	25.6
HH with S/D being unemp. only	2.79	7.5	3.89	16.3
HH with H and W being unemp.	1.55	19.4	2.63	54.4
HH with H and S/D being unemp.	0.17	16.4	0.18	45.1
HH with W and S/D being unemp.	0.12	18.0	0.16	41.9
HH with H and W and S/D being unemp.	0.11	26.9	0.04	70.7
HH with H work in LMFs	10.88	9.0	16.03	17.2
HH with W work in LMFs	10.01	8.7	12.64	8.5
HH with H and W work in LMFs	12.40	17.7	19.90	25.7
Total HH with members work in LMFs	33.29		48.57	

Notes
1 The real per capita HH income equation is also estimated with a variable indicating the number
of household members being unemployed for 1995 and 1999 data. The estimated coefficients are
−0.0895 and −0.2376 for 1995 and 1999, respectively. The income reduction for the first panel
of this table is calculated according to these estimates.
2 HH refers to household, H is husband, W is wife and S/D is son/daughter.

member become poor, only those households which have more than one
unemployed member.

   In this section, we take one step further to investigate who are more likely to
become unemployed, what kind of households are more likely to be poor, and
what kind of households are more likely to have more than one unemployed
member (in this section they will also be refereed to as 'vulnerable households').
An understanding of these issues will help us to identify the most vulnerable
groups and to evaluate whether government policies towards layoff workers have
aimed at the right target and how these policies can be finetuned so that the
maximum effect can be achieved.

At the individual level

To identify who are more likely to be unemployed we estimate a probit model of
unemployment. Unemployment may be related to individuals' human capital

attributes and demographic factors, such as education, health, party membership, age and gender. In addition, as majority of individuals were assigned to their jobs originally in urban China, unemployment is also related to the place of employment. For example, workers employed in loss-making firms and sunset industries are more likely to be retrenched and so as those employed in more depressed regions. Let *Prob*(UE_i) be the probability of individual i being unemployed, the reduced form of the unemployment model may be specified as follow:

$$Prob(UE_i = 1) = f_i(age_i, sage_i, edu_i, party_i, loss_i, health_i, sector_i, sex_i, region_i)$$
(3.1)

where *sage* is a squared term of age; *edu* is years of schooling; *party* presents whether individual i is a party member or not; *health* indicates whether the individual is healthy; *loss* specifies if the individual works in a loss-making firm; *sector* is sector of employment; and *region* refers to a group of regional dummy variables. Both *loss* and *sector* refer to the individual's previous employment affiliation if the individual is unemployed. Equation (3.1) is estimated for all individuals aged 16–65 who are in the labour force.

The estimated results of equation (3.1) using the IDS95 and IDES99 data sets are reported in Table 3.3. The three columns report the results for the total sample and male and female samples, respectively. The omitted category for the employment sector is the private sector, which is defined as a combination of the local private, foreign owned, joint venture and self-employed sectors.

Over this five-year period, unemployment increased from 8.5 to 17.3 per cent. Table 3.3 indicates that this change is related to particular variables. First, gender was not an important determinant of being unemployed/displaced in 1995. In 1999, women were significantly more likely to be unemployed.

Second, middle-aged individuals have a much higher chance of becoming unemployed in 1999 than in 1995, especially for women.[6] Due to the quadratic age variable, it is difficult to 'read' the marginal effect. Consequently the results are summarised by predicting the change of probability of being unemployed at different ages (Figure 3.4). They show clearly that the middle-aged women suffered the most in 1999. The reduction of the probability of being unemployed after age 40–45 may reflect the fact that many older women have taken early retirement. Figure 3.4 also indicates that in 1995 the probability of being unemployed does not differ much for men and women, whereas in 1999 a significant gender difference is observed, especially for middle-aged individuals.

Third, although less-educated individuals have always suffered the most from economic restructuring in terms of unemployment, this effect is especially strong for males in 1999. In 1995, an additional year of schooling for men reduces the chance of unemployment by 0.5 per cent whereas this ratio increased to 0.7 per cent in 1999. Fourth, the effect of the individuals' health condition increased. In 1995 it only affected the probability of women being unemployed. In 1999, it became a significant determinant of unemployment for men.[7] Fifth, the effect of sector of employment on unemployment has changed. Individuals who were previously employed in the collective sector had less or no more chance of

Table 3.3 Results from probit estimation of unemployment

	Total sample		Males		Females		Total sample		Males		Females	
	Marginal effect	T-ratios	Marginal effect	T-ratios	Marginal effect	T-ratios	Marginal effect	T-ratios	Marginal effect	T-ratios	Marginal effect	T-ratios
	1995						1999					
Age	−0.0018	−9.04	−0.0012	−5.13	0.0034	1.83	0.0194	10.03	0.0088	3.99	0.0325	9.88
Age^2					−0.0001	−3.23	−0.0003	−11.89	−0.0001	−5.08	−0.0005	−11.12
Years of schooling	−0.0046	−5.92	−0.0043	−4.40	−0.0057	−4.59	−0.0059	−5.34	−0.0071	−5.10	−0.0050	−3.15
Dummy for being healthy	−0.0276	−1.81	−0.0030	−0.15	−0.0380	−1.75	−0.0286	−2.64	−0.0485	−3.02	−0.0167	−1.18
Dummy for party member	−0.0212	−3.89	−0.0174	−2.79	−0.0269	−2.80	−0.0413	−6.06	−0.0288	−3.53	−0.0516	−5.07
Dummy for work in LMFs	0.1185	8.82	0.1047	12.43	0.1248	13.58	0.1802	25.47	0.1609	16.57	0.1805	18.99
Central state sector	−0.0385	−4.83	−0.0419	−4.21	−0.0363	−2.91	−0.0426	−5.24	−0.0426	−4.17	−0.0392	−3.38
Local state sector	−0.0470	−4.64	−0.0511	−3.91	−0.0460	−2.97	−0.0020	−0.26	−0.0168	−1.68	0.0128	1.12
Collective sector	−0.0176	−2.09	−0.0218	−2.37	−0.0128	−0.91	0.0362	3.51	0.0209	1.55	0.0491	3.42
Dummy for male	0.0009	0.24					−0.0134	−2.62				
Regional dummies	Yes		Yes		Yes		Yes		Yes		Yes	
Number of obs.	7,871		3,868		3,843		9,378		4,615		4,763	
Pseudo R^2	0.217		0.218		0.232		0.2417		0.222		0.2677	

Notes
1 T-ratios are calculated using heteroskedasticity-consistent covariance matrix.
2 For 1995 data the number of observations for male and female samples do not add up to the total sample. This is because for some regions there is no variation on the dependent variable when the sample is separated into males and females. Those regions are consequently dropped from the sample.
3 In the 1995 data the term 'age squared' is not included in the total and male samples as they are not statistically significant.

Figure 3.4 Average predicted probability of being unemployed for different age groups.

becoming unemployed than those employed in the private sector in 1995. By 1999 the chance of an employee in the collective sector being made redundant has become much higher than an employee in the private sector.

Finally, the regional effect on unemployment is more significant in 1995 than in 1999. A simple test indicates that in 1995 the regional effect explains around 4 per cent of the unemployment probability, whereas this ratio is around 1.3 per cent in 1999.

These results coincide very well with our expectations. Since 1995, more and more middle-aged women have been made redundant. In addition, as the radical enterprise reforms occurred mostly in small and median sized enterprises, and as these enterprises are concentrated mostly in the collective sectors, unemployment is now more likely to happen in this sector than in the private sector. In summary, the less-educated, middle-aged, non-party members, who work in a loss-making firm and/or collective sector are more likely to be unemployed. This is more so for women than for men.

At the household level

To address the issue of what kind of household is more likely to fall below the twetieth percentile of income distribution (poor households) and are more likely to have more than one unemployed member, the following probit model is estimated:

$$Prob(Y_j = 1) = \Phi_j(\beta' X_j) \tag{3.2}$$

where *Y* is the dependent variable (*POOR* or *MUE* indicating whether the household has an income in the bottom two deciles or the household has more than one member being unemployed), and the subscript *j* indicating household. *X* is a vector of variables, which determine *POOR* or *MUE*. These variables are: average age of household labourers and its squared term, average years of schooling of household labourers, whether the husband and wife are party members, their health condition, whether they are working in a loss-making firm (for those who are unemployed this variable indicate their previous enterprise affiliation), their sector of employment, and region of resident.

Table 3.4 reports the estimated results for the *POOR* equation.

Average age of household labourers only has a linear effect and hence the quadratic term is dropped. Interestingly, it is found that young households are more likely to be poor, this is not only indicated by the age variable but also by the household composition variables. Households with young children are more likely to be poor.

The number of unemployed household members has a very significant effect on whether a household is poor or not, especially in 1999. Indeed, one extra unemployed member increases the probability of the household becoming 'poor' by 6 per cent in 1995 and by 11 per cent in 1999.

Working in a loss-making firm and not working in the central state sector both increase the household's chance to be poor, while having a party member in the household reduces the chance. Large households are more likely to be poor. In general, the results presented in Table 3.4 are consistent with those reported in Table 3.1. After all, these are similar equations estimated from different angles. If having more unemployed members is an important determinant for a household to be poor, it is worthwhile to know the characteristics of such households. The estimated results from the probit model of *MUE* are reported in Table 3.5. The results indicate that there have been significant changes as to the type of households which are more likely to have more than one unemployed member over the period of 1995–9. Controlling for household size, the only significant determinants in 1995 are 'education' and 'loss-making firm'. In 1999 however, 'age', 'party membership', 'sector of employment' and 'region of resident' all become significant determinants as well.

A higher incidence of more than one unemployed member is related to less educated households and a higher incidence of working in a loss-making firm. These effects are the same for both years.

The effect of sector of employment differs between the two years. In 1995, 'sector of employment' did not matter. In 1999, however, an interesting phenomenon appears. It is not those who work in the state sector, but those who are employed in the private or collective sectors that are more likely to be in households with more than one unemployed member. For wives, working in the local state sector also increases the chance of being in a 'vulnerable household'. Since most income compensation policies directed towards the unemployed are applicable only to those who work in the state sector, one might question the effectiveness of these policies in the context of poverty alleviation. Table 3.1 revealed that relative to the central state-sector employment, working in the collective or private sectors provides significantly lower PCHI. On top of that we have now shown that people who work in the collective or private sectors are also more

Table 3.4 Selected results from probit estimation of the determinants for being a poor
household

	1995		1999	
	Marginal effect	T-ratio	Marginal effect	T-ratio
Average age of HH labour	−0.003	−3.54	−0.003	−3.28
Average years of schooling of HH L	−0.019	−8.27	−0.021	−8.34
Number of members unemployed	0.064	5.38	0.111	12.60
Gender of the HH head	0.024	2.00	0.016	1.38
H working in loss-making firm	0.057	3.96	0.078	6.41
W working in loss-making firm	0.042	2.94	0.035	2.86
H working in local SOEs	0.066	4.08	0.061	4.19
H working in collectives	0.181	6.27	0.093	3.85
H working in private sector	0.095	2.16	0.048	2.02
H did not report sector	0.004	0.08	0.096	1.58
W working in local SOEs	0.033	1.73	−0.007	−0.45
W working in collectives	0.076	3.24	0.048	2.44
W working in private sector	0.126	2.66	0.041	1.68
W did not report sector	0.215	5.84	0.204	6.54
H party membership	−0.052	−4.33	−0.067	−5.98
W party membership	−0.023	−1.38	−0.056	−3.71
% of children aged 0–5	0.238	3.89	0.247	4.20
% of children aged 6–10	0.131	2.82	0.092	1.94
% of children aged 11–16	0.121	2.92	0.141	3.54
% of elderly	0.093	2.18	−0.014	−0.36
Household size	0.076	10.51	0.043	6.17
Region	Yes		Yes	
Number of observations	3,503		4,002	
Pseudo R^2	0.32		0.31	

Note
T-ratios are calculated using heteroskedasticity-consistent covariance matrix.

likely to live in a household with more than one unemployed member. Perhaps
policy measures should give this group more attention.

Another interesting issue is the age effect. Two series are plotted, one using the
actual average proportion of the vulnerable households for each age group and
the other using the average predicted probability for each age group (Figure not
presented here due to the space limitation). Both series indicate that it is the
30–45 age cohort which has the highest probability of falling into the vulnerable
household group. This may be related to the fact that many older individuals
have taken early retirement and hence are not counted as unemployed. However,
this does not explain why the 30–40 group has the highest probability of being in
the vulnerable household group. At this stage it is not clear why this is so.

Finally, the effect of the region of resident in 1995 is minimal. In 1999, how-
ever, a very significant regional effect is observed. Households living in Henan,
Gansu and Sichuan are more likely to have more households with more than one
unemployed member relative to those who live in Beijing. This may reflect the
seriousness of the unemployment problem in those regions and the ineffectiveness

Table 3.5 Determinants of the vulnerable households

	1995		1999	
	Marginal effect	T-ratio	Marginal effect	T-ratio
Household size	0.0054	2.93	0.0057	2.72
Average age of HH labour	−0.0018	−1.29	0.0052	2.22
(Average age of HH labour)^2	0.0000	0.97	−0.0001	−2.48
Average years of schooling of HH L	−0.0021	−3.08	−0.0017	−2.05
H party membership	−0.0042	−1.20	−0.0062	−1.67
W party membership	−0.0032	−0.66	−0.0123	−2.58
H working in loss-making firm	0.0213	4.21	0.0190	4.42
W working in loss-making firm	0.0072	1.78	0.0112	2.81
H working in local SOEs	−0.0023	−0.53	−0.0015	−0.32
H working in collectives	0.0004	0.08	0.0249	2.97
H working in private sector	−0.0012	−0.10	0.0196	2.24
H did not report sector	0.0058	0.48	−0.0002	−0.01
W working in local SOEs	0.0055	0.95	0.0224	3.30
W working in collectives	0.0181	2.23	0.0318	3.40
W working in private sector			0.0225	2.04
W did not report sector	0.0095	0.95	0.0038	0.40
H being healthy			−0.0117	−1.68
W being healthy	−0.0167	−0.81	−0.0030	−0.54
Region	Yes		Yes	
Number of observations	3,327		3,904	
Pseudo R^2	0.1538		0.1966	

Note
T-ratios are calculated using heteroskedasticity-consistent covariance matrix.

of local government policy in targeting the issue (the central government has a policy which specifically requires that enterprises should not layoff both husband and wife from one family).

Conclusions

This study has investigated two important issues related to large-scale urban unemployment which occurred in the late 1990s:

1   To what extent has increased income inequality in urban China been caused by large-scale unemployment flowing from the radical economic reform?
2   Who are the most vulnerable people in the process of economic restructuring?

The main conclusions may be summarised as following. First, large-scale unemployment has had a great impact on urban income inequality. Second, the most vulnerable individuals to the economic restructuring are those who are less educated, middle-aged women and those who worked in loss-making firms. Third, not all households with unemployed individuals suffered from significant income losses. Households with one unemployed member seem to have done relatively

well compared to households with more than one unemployed member in terms of per capita household income. Fourth, apart from less education, the most important characteristics of the households which have more than one unemployed member are: husband and wife work in loss-making firms, employed in the collective or private sectors, and living in a less-developed region.

The important policy lessons that can be drawn from this study are the followings. First, the government should try harder to eliminate the possibility of multiple household members facing unemployment simultaneously. Employment agencies should give priority to these individuals and try to help them find jobs. Perhaps the government should give more tax incentives and preferential lending treatment to these households to encourage them to set up their own business. Second, income support should be income tested and use household income as the criterion, because not all households with unemployed members fall into poverty. Some 30 per cent of households with unemployed members have above median real PCHI level. Also, many households without unemployed members are poor. The government should not use limited resources supporting households who can cushion the effect of the unemployment shocks within the household.

Notes

1 The survey includes eleven and six provinces in 1995 and 1999, respectively. To obtain consistent estimates, the 1995 sample is restricted to the six provinces used in the 1999 survey. A sample of 11,917 and 13,546 individuals and 3,848 and 4,489 households are included in each survey, respectively. Excluding those who are not in the labour force and those with missing values, the sample of individuals included in this chapter is 7,871 for 1995 survey and 9,378 for 1999 survey, while the sample of households varies between 3,327 and 3,503 for the 1995 survey and between 3,904 and 4,002 for the 1999 survey depending on the group of variables used.
2 There were two exceptional periods: the period after the Great Leap Forward and that after the Cultural Revolution (see Feng 1982; White 1998; Meng 2000).
3 For those whose original enterprises were bankrupted, they receive various benefits from a re-employment centre set up by local governments. All layoff workers are free to find jobs somewhere else. As long as one is not officially known as being re-employed one is entitled to all the benefits from the enterprises. This is probably why most layoff workers are not keen to reveal their current employment status.
4 The high urban unemployment rate in the early 1980s is entirely due to return 'intercellular youth' from the countryside after the Culture Revolution (see Feng 1982; White 1983).
5 Early retirees are defined as women retired before forty-five and men retired before fifty-five years of age.
6 The quadratic term for age is not statistically significant for the total and male samples of the 1995 data, and hence is excluded from the regressions.
7 The health variable is measured differently for the two data sets. In 1999 survey a direct question is asked about whether an individual thinks his/her health condition is healthy, not healthy, disabled or other. This question is not asked in the 1995 survey. The information on sick leave and health expenditure however is available in the 1995 survey. We, therefore, defined dummy variable for healthy as having less than thirty days sick leave or less than 500 Yuan health expenditure.

4 Economic reform, labour markets and poverty

The Indonesian experience

Kelly Bird and Chris Manning

Introduction

Indonesia was a relative latecomer in market-oriented, economic reforms in capitalist East Asia. The reform agenda slowed and then received a body blow when the country experienced its worst economic crisis in thirty years during the East Asian economic crisis. A new government reform agenda, now nearly four years old, under the watchful eye of the IMF, is haltingly attempting to restore investor confidence and bring the economy back onto its feet. An assessment of the impact of trade and related investment reforms on income distribution and poverty needs to deal with these different periods in recent economic history. Thus, this chapter focuses on developments from the mid-1980s. We take the East Asian crisis in 1997 as a watershed and deal with the pre-crisis and post-crisis periods separately.

What makes the Indonesian experience of globalisation and income distribution interesting in the Asian context? Two features stand out. First, despite its latecomer status, the reforms of both real and financial sectors were swift and wide-ranging, despite increasing cronyism and impediments to domestic competition in the later years of the Soeharto regime. Indonesia was widely recognised as one of the 'miracle' economies of East Asia by the early 1990s (World Bank 1993). The impact of reforms on the poor, and associated labour market developments, could be expected to share similarities with the relatively successful economies of Thailand and Malaysia in Southeast Asia, or Korea and Taiwan in northeast Asia, rather than with the much of South Asia.

Second, any discussion of links between trade reform, globalisation and poverty in the Indonesian context needs to take into account peculiar dimensions of economic and social structure. Most important is the coincidence of resource abundance, much of it in the 'Outer' Islands, with high population densities and relative 'labour surplus', much of the latter on Java. Resource abundance complicated macroeconomic policy, causing difficulties for the transition to a labour-intensive pattern of export-oriented development that had underpinned a more equal distribution of income in East Asia.

In a nutshell, we argue that economic reforms that transformed the economy and labour market in the 1980s were extraordinarily successful for a country that had heavily protected domestic industry from international competition for most

of the post-independence period. Its effects were pro-poor, in contrast to the popular perception (even more widespread in the post-Soeharto years) that widespread rent seeking and cronyism dominated distributional outcomes in the later years of the Soeharto, regime and that workers did not benefit from economic growth. Moreover, despite greater freedom in political and social life, economic outcomes for the poor have been less favourable in the post-Soeharto era. While the economic reforms facilitated employment growth, and hence poverty declined, economic growth has not recovered its pre-crisis momentum. Populist agendas, paradoxically, pose a potential threat to the creation of a more equitable distribution of income in a more democratic, yet fragmented, political system.

Falling poverty with economic growth

Indonesia experienced a rapid and sustained decline in incidence of poverty from the early years in the Soeharto regime in the 1970s through to the financial and economic crisis in 1997–8 (Figure 4.1).[1] Indeed the decline from nearly 40 per cent of the population in 1976 to 11 per cent in 1996 was as rapid as in any country in East Asia in the two decades prior to the crisis. The decline was rapid in both urban and rural areas, although urban poverty began to dip significantly below rural poverty by the 1990s.

Figure 4.1 Head count index of poverty, urban and rural Indonesia, 1976–98.

Source: CBS (Central Bureau of Statistics), *Statistical Yearbook*, Jakarta (various years).

Note
There was a slight change in the poverty line in 1993.

What are the main ingredients of economic performance that can be expected to link to this rapid decline in poverty? East Asian experience suggests that three are essential: rapid economic growth, macroeconomic stability and rapid increases in exports of labour-intensive manufacturing goods in the early decades of development (Jusuf and Stiglitz 2001). Indonesia shared two of these features for much of the Soeharto period (1967–97). First, from the recovery period in the late 1960s, aggregate economic growth rates were high, underpinned by high rates of investment and savings by developing country standards (Hill 1996). Second, macroeconomic stability – relatively low inflation and, and a small, well-managed budget deficit – were a feature of economic performance from the 1970s, compared with most other developing countries. Further, relatively balanced growth across sectors was combined with substantial structural change. Agricultural expansion was impressive by developing country standards. At the same time the manufacturing sector expanded faster than in any other developing country over an extended time period, and had assumed a major role in the economy when it overtook agriculture as a share of GDP in the 1990s.

Nevertheless, economic growth was lower than in several East Asian economies. Similarly, Indonesia did not have as good a record on macroeconomic stability as several neighbouring countries, such as Thailand, Malaysia or Singapore. Inflation rates were higher, and hence over-valuation of the rupiah tended to be a greater problem, contributing to a less predictable macroeconomic environment, than in several other rapidly growing East Asian countries.[2] This had important implications for poverty and income distribution.

On the third score, growth in manufacturing exports, Indonesia did considerably worse than neighbouring countries over much of the past thirty years. As we shall see in detail below, it was only in reform period from the mid-1980s that Indonesian manufacturing exports took off in a significant way. Perhaps surprisingly, poverty decline was substantial prior to the reforms. However, it took comprehensive trade reforms to sustain the process in the 1980s and 1990s.

What about contrasts in economic performance in different periods? The oil boom period was marked by high growth but some degree of macroeconomic instability. Rates of inflation were high (averaging close to 20 per cent 1975–80). This forced Indonesia to undertake two major devaluations (in 1978 and 1983) to counter the effects of an overvalued exchange rate on non-oil export sectors, caused by the expansion of the 'booming' sector ('Dutch disease' effects). The economy slowed in the wake of the oil boom and then recovered during the period of economic reform from the mid-1980s to the Asian economic crisis and fall of Soeharto in 1997–8.

Much is known about the financial crisis, and hence this subject need not detain us much here (Hill 1999). In 1998, the estimated slump in growth was greatest (−13 per cent) in Indonesia of all countries.[3] Even disregarding 1998, however, Indonesian economic performance was much worse in 1999–2002, than for most of the preceding thirty years. The average rate of economic growth (below 3 per cent) was than less half the rate achieved in the first half of the 1990s.

Performance on other macroeconomic indicators, in particular the investment rate, was similarly poor compared with the pre-crisis period. Inflation was low during the first year of recovery in 1999, but rose in 2000 and 2001, before slowing an improvement in the early months of 2002. The exchange rate also bounced around. It fell from a much-improved rate, after the first post-Soeharto elected government was installed in October 1999, to some 40 per cent lower when the Abdurrahman government fell some twenty months later.[4]

Setting the stage for reform: faltering growth in the early 1980s

Trade and associated investment reforms of the mid-1980s, and their impact, need to be viewed in the context of the policy environment of the time. Both the financial and trade sectors were highly regulated. State banks dominated the financial sector, entry of private and especially foreign banks was tightly controlled, interest rates were regulated and credit frequently directed by the government through major state banks (Booth 1992a). There were also extensive restrictions on foreign trade including high tariffs and a multitude of non-tariff import barriers (average ERPs were 56 per cent in 1980 and 50 per cent in 1987).[5] Import quotas proliferated in the 1980s, as the protectionist lobby gained influence and cronies close to the first family sought to capture monopoly profits as economic growth rates slowed (Basri 2001).

The cost of these controls were hidden to a considerable extent during the oil boom years when the government invested oil-revenues into badly needed physical and human capital or allocated them to import capital goods for industrial development. The effects on domestic demand were muted through judicious macroeconomic policies, which enabled the government to 'sterilise' the potentially destabilising effects of the boom (Warr 1992).

Structural weaknesses were exposed, however, following the crash in world oil prices and slower world economic growth that depressed commodity prices in the early 1980s. Growth slowed, trade and investment fell compared with the previous decade, debt increased and the government faced a major fiscal challenge because of falling oil revenues. Indonesia was in serious economic difficulty when the first package of trade reforms was introduced in May 1986.

Thus, the above-mentioned difficulties, strong leadership and good timing encouraged Indonesia to join several other East Asian countries in reforming trade and investment regimes in the mid-1980s. Soeharto dominated the political scene and was still advised by (and listened to) a group of 'technocrat' team of economic advisers, backed by international organisations, who were ready to put together a comprehensive package of reforms.[6] At the same time, Indonesia was an attractive alternative for north East Asian investors who were struggling to export from home, as their exchange rates appreciated, but were still wary of investing in China or Vietnam. Finally, there was strong regional support for more open economic policies, through AFTA and APEC.

Real sector liberalisation

Indonesia's economic policy reforms between 1986 and 2001 can be divided into three distinct phases. First, there was substantial trade and investment liberalisation from 1986 to 1991, followed by increasing signs of reform fatigue and government involvement in costly capital and technology intensive projects from 1991 to 1996. The third phase was the comprehensive reforms under the IMF programme from 1998 to 2002. These reforms are briefly described below.

Rapid liberalisation from 1986 to 1991

The plunge in oil prices in 1986, coupled with the persistent slow growth between 1982 and 1986, forced the government to embark on a substantial trade, industry and financial sector liberalisation. First, the government introduced the duty drawback facility for exporters in May 1986 allowing them to access inputs at world prices. In September of the same year, the government devalued the Rupiah by 45 per cent. These two policies were followed by a series of trade and investment deregulation packages between October 1986 and May 1995, which substantially reduced tariff rates and eliminated most quantitative import restrictions. The latter were replaced by tariffs.[7] Average tariff rates fell from 27 per cent in 1986 to 20 per cent by 1991, and the import coverage of non-tariff barriers (NTBs) fell from 43 per cent in 1986 to 13 per cent by 1991 (Table 4.1). Also, there was a significant decline in ERPs. The average ERP estimate for non-oil manufacturing sector declined from 59 per cent in 1987 to 16 per cent by the early 1990s (Fane and Condon 1996).[8]

Yet, despite this rapid trade liberalisation, Indonesia's foreign trade regime still adversely affected incentives to export in the early 1990s. Wymenga (1991), for example, showed that export-oriented textile and garment firms received negative effective protection, even though they had access to tradeable inputs at international prices.[9] On the other hand, domestic market-oriented textile and garment producers continued to enjoy high effective protection. A useful summary measure of the extent to which the overall system of tariffs, export taxes and NTBs inhibits trade is the anti-trade bias (ATB) in policy.[10] The estimated

Table 4.1 Average nominal tariff and non-tariff reductions, Indonesia, 1986–2001

	1986	1988	1990	1991	1992	1993	1994	1995	2001
Average tariff	27	24	22	20	20	19.7	19.5	15	7.3
Import weighted average tariff	13	14	12	11.9	11.9	13.7	12.5	9.5	na
NTBs as a percentage of imports	43	21	17	13	13	12	12	na	na

Sources: Pangestu 1996; authors for 2001.

Note
na = non-applicable.

ATB fell from 50 per cent in 1987 to 28 per cent in 1995, indicating that it was still significant by the mid-1990s, even though the ATB had been substantially reduced (see Fane and Condon 1996).

On the investment front, substantial progress had also been made in dismantling many (but not all) restrictions on investment during the last decade. Importantly, the number of industries closed or restricted in the negative investment list fell from seventy-five in 1989 to thirty-four in 1995.[11] In addition, equity restrictions and divestment rules on foreign investment were gradually eased between 1986 and 1994.[12]

Reform fatigue from 1991 to 1997

While the pace and extent of policy reforms in Indonesia had been remarkable since 1986, reform fatigue began to show in the early 1990s. Few reductions in import tariff rates followed until 1995 (see Table 4.1), and many of the government-sanctioned monopolies and cartel arrangements, as well as other 'sensitive' regulated sectors remained relatively untouched during the deregulation period. foreign direct investment (FDI) remained restricted in several major sectors listed in the 1995 negative list and thirty-seven sectors were reserved for small-scale producers. Also, there had been little progress in the area of state enterprise reform. Furthermore, there were a number of policy reversals, and business people close to the palace sought various non-transparent means of protection. Examples included the granting of a clove monopoly to a private-state trading enterprise joint venture in 1991, tariff protection to a large petrochemical plant in February 1995, and the granting of tax exemptions to a so-called 'pioneer automotive company' in 1996. All three companies were partly owned by former President Soeharto's children.

Several factors help explain why these sectors were not deregulated. In the case of the state enterprise sector, technical ministries have generally resisted privatisation. The SOEs under their control constituted a valuable source of additional funding. They were also viewed by the ministries as a vehicle for their development objectives, in areas of small enterprise development and the promotion of subcontracting networks. Some Ministers had regarded state enterprises as personal fiefdoms, immune from public scrutiny. The obvious example was the then Minister for Research and Technology, Professor Habibie from the early 1980s. He was able to circumvent the reforms and protect his extensive commercial interests through his direct and close contact with former President Soeharto.[13]

Limited SOE reform also related to concern over the likely asset buyers. The buyers would almost certainly be either foreign investors or the major domestic conglomerates which consisted mainly of non-*pribumi* (mainly ethnic Chinese) or politically powerful owners. Deep-seated *pribumi* reservations persisted over the extent of non-*pribumi* wealth and economic dominance. Faced with public sentiment towards non-*pribumi* business dominance, it is not surprising that the government was reluctant to initiate bold reforms in this area. Reservations over

transforming public monopolies into private monopolies was an additional concern, especially since privatisation without reforms in the fields of trade and competition policy would produce little benefit. The lack of microeconomic reforms in many of the industries can also be attributed to powerful vested interests.[14]

IMF supported reforms after the crisis: removing domestic distortions

The massive drop in the value of the rupiah during 1997/8, the ensuing capital flight and severe banking sector crisis led to a series of agreements between the Indonesian government led by the IMF and major donors (The World Bank, The Asian Development Bank and major bilateral donors) for a structural reform loan program of US$ 43 billion. The programme was comprehensive, covering trade and industry, the banking and financial sectors, and commercial laws and institutions. Measures announced dealt with many of the remaining restrictions on domestic trade and industry. On the international trade side, these reforms included reducing most import tariff rates below 10 per cent (by 2001 the average tariff rate was 7.3 per cent), and eliminating most of the remaining NTBs.

On the domestic trade side, reforms included removing the statutory basis of several monopolies and cartels, including the State Logistics Agency's (BULOG) agricultural monopolies, wheat flour imports, cement, cloves and plywood. Many of the investment restrictions on domestic distribution were also removed, including opening up wholesale and retail sectors to foreign investment. To promote domestic competition, the Indonesian parliament enacted a competition law in 1999.

Growth performance after the reform

Many labour-intensive manufacturing industries, where Indonesia's comparative advantage lie, grew rapidly after the 1987 reforms. There was a remarkable transformation of the Indonesian economy (see Figure 4.2). Indeed, the Indonesia of the 1990s was almost unrecognisable compared with that of the mid-1960s, or even the mid-1970s. Agriculture's share of GDP declined from around 53 per cent in the mid-1960s to less than 17 per cent by the mid-1990s. Conversely, manufacturing's share of GDP grew from just under 8 per cent in the mid-1960s to reach 25 per cent by 1996, having overtaken agriculture's share of GDP in 1990.

Structural change within manufacturing accompanied rapid growth. The non-oil and gas sector's share of manufacturing value added increased substantially from 1985 to 1996. Within non-oil/gas manufacturing there was also considerable structural transformation. Production shifted away from traditional resource-intensive commodities such as processed tea, coffee, sugar and cooking oil to labour-intensive exports, first, textiles, garments and footwear, and then later to a wider range of industries such as chemicals, toys, jewellery and electronics.

Figure 4.2 Structural change in the economy, 1965–2000 (% GDP).

Source: CBS, National Accounts (various years).

Structural transformation was also reflected in Indonesia's changing pattern of exports. Prior to the trade reforms, oil and agricultural commodities dominated exports. Exports of manufactures were negligible during the first eighteen years of the New Order government and rarely surpassed 5 per cent of total exports during this period. The devaluation of the rupiah in 1983 and 1986, and the related trade and investment reforms stimulated rapid expansion in non-oil manufacturing exports in the late 1980s. Manufacturing exports as a share of total exports grew from less than 3 per cent in 1975 to around 8 per cent in 1986 and to just over 51 per cent in 1995. Within manufacturing there was a shift in the composition of exports. In particular, the share of total exports emanating from labour-intensive industries increased from 45 per cent in 1986 to 61 per cent in 1995. This pattern of manufacturing exports – dominated by labour-intensive products – is expected in a labour abundant, developing economy like Indonesia.

The increasing diversification of exports was a second feature of the pattern of manufacturing exports, particularly during the 1990s. Table 4.2 shows the export shares of major products between 1980 and 1995. In 1986, 73 per cent of manufacturing exports came from three products: plywood (43 per cent), garments (20 per cent) and woven fabrics (11 per cent). By 1995, the share of these three products had fallen substantially to 45 per cent and by 2000 they accounted for less than 30 per cent in all manufacturing exports. Exports had diversified into a much wider range of products. Rapid export growth occurred in paper products, electronics, footwear, yarn, furniture, jewellery, toys and sporting goods in the 1990s.

Resource-intensive (RI) manufacturing exports were dominated by plywood exports, accounting for over 80 per cent of RI exports by the mid-1990s. Surprisingly, processed-agricultural manufactures made up a small proportion of total RI manufacturing exports. This can be attributed to a combination of

Table 4.2 Major manufactured exports, Indonesia, 1980–95 (US$ million or %)

	1980	1986	1990	1995	2000
Labour-intensive					
Major items					
Garments	98	522	1,646	3,205	4,737
Woven fabrics	43	287	1,132	1,820	2,178
Footwear	1	8	570	1,888	1,672
Electronics	3	42	146	1,464	4,327
Furniture	3	9	286	783	1,518
Yarn	3	20	109	678	1,327
Toys, sporting equipment	n	n	57	245	455
Jewellery	n	36	57	726	109
Resource-intensive					
Major items					
Plywood	68	1,127	2,791	4,125	3,260
Cement	26	41	96	30	172
Leather	6	15	63	47	96
Capital-intensive					
Major items					
Paper products	5	33	154	594	2,261
Machinery and equipment	106	23	222	2,346	6,442
Steel products	8	58	188	272	421
Fertiliser	35	127	193	178	209
Rubber tyres	n	11	66	103	293
Total (all manufactures)	501	2,639	9,041	20,458	36,233
Three largest as % of total	52	71	68	38	28
Manufactures as % of total exports	2	8	28	51	58

Source: CBS, Statistik Ekspor (Export Statistics), various issues.

Notes
The following definitions (SITC) are used:
    Resource-intensive – SITC items 61, 63, 66 (excluding 664–666), 671.
    Labour-intensive – SITC items 54, 55, 65, 664–6, 695–7, 749, 752, 763, 776, 778, 793, 81–5, 89.
    Capital-intensive – SITC items 5 (excluding 54 and 55), 62, 64, 67 (excluding 695–7), 7 (excluding 749, 753, 763, 776, 778, 793), 86–8. This classification was used by Ariff and Hill 1985 for ASEAN.
'n' indicates less than $1 million.

factors, including numerous restrictions in the agricultural sector (e.g. BULOG's import monopoly over several agricultural commodities) and restrictions on foreign investment in this sector.

Foreign investment played an important role in Indonesia's labour-intensive export boom after 1987. After liberalisation of trade and investment regime, almost one-quarter of all foreign investment in the non-oil and gas manufacturing sector flowed into the export-oriented sector, namely textiles, garments and footwear industries (see Table 4.3). The presence of foreign firms in the domestic market also had positive spillovers to private domestic firms, encouraging them to move towards export-orientation as well. Several mechanisms facilitated

Table 4.3 Distribution of foreign firms in manufacturing, Indonesia, 1975–93 (%)

Sector	1975	1985	1993
Food, beverages	23.0	12.3	11.8
Textiles and garments	13.1	13.4	24.4
Wood products	9.3	11.1	7.9
Paper and paper products	4.1	2.6	2.3
Chemicals	23.5	30.4	20.0
Non-metallic mineral products	3.4	3.5	2.7
Iron and steel	1.1	0.5	2.2
Machinery and transport	22.0	24.8	23.9
Other manufacturing	0.4	1.4	4.8
Total manufacturing (%)	100.0	100.0	100.0

Sources: Bird 1999; Manufacturing Survey, 1975–93 CBS.

such a shift, including technological transfers, and perhaps most important, the attraction of international buyers to Indonesia.

A primary goal of openness is to sustain economic growth through productivity improvement. However, there are divergent views on whether growth in Indonesia and elsewhere in East Asia until the mid-1990s was brought about by factor accumulation or productivity improvement (Krugman 1994). In this context, several studies have attempted to estimate total factor productivity (TFP) growth in the Indonesian manufacturing sector. On balance the evidence indicates that TFP growth was an important factor contributing to economic growth after 1987 (Aswicahyono 1999; Timmer 2001). In his study on TFP growth in the manufacturing sector, Aswicahyono (1999) found a distinct shift in growth rates across manufacturing industries after 1987. This was most evident in labour-intensive sectors. He also found that TFP was positively related to FDI and exports, as well as greater import and domestic competition.

There is also evidence that the trade reforms improved price allocative efficiency in oligopolistic industries. In a comprehensive study of the effects of these trade reforms on industrial concentration and profitability in the manufacturing sector, Bird (1999) found that the reforms reduced excessive profits in highly concentrated industries. This result established a direct link between trade policy reform and competition in Indonesian manufacturing during the pre-crisis period. Trade policy reform increases import competition in concentrated manufacturing industries, which in turn narrowed profits across concentrated industries.

During the recovery period after the 1997 economic crisis, sectors with large tradable components – for example manufacturing – did not contract as much as

non-tradable sectors and have largely recovered to their pre-crisis levels by 2001. For instance, based on the national income accounts, the level of output in the manufacturing sector contracted by about 10 per cent in 1998. But by 2001 it stood at 2 per cent above its 1997 level. On the other hand, levels of output in the construction and commerce sectors in 2001 were about 70 and 90 per cent respectively of 1997 levels, although the pace of recovery in these sectors has increased.

Within manufacturing recovery has been strongest in the relatively labour-intensive sectors: food processing (about 7 per cent above its 1997 level), clothing and textiles (10 per cent higher) and slowest in the relatively capital intensive sectors of steel production (18 per cent below its 1997 level). The recovery in 2000 was partly driven by rapid recovery in non-oil and gas exports. Indeed, Indonesia's non-oil export performance in 2000 was the best ever recorded and were about 16 per cent higher than its 1997 level. A significant proportion of the growth was in labour-intensive electronics (assembling of computers, sound recorders and television sets). Exports of other manufactures also performed well.

This asymmetric response is to be expected given the substantial real depreciation of the rupiah, which by the end of 2000 was 50 per cent lower than in June 1997. But the success of export sector also reflects the dynamic benefits of trade liberalisation, which began in the mid-1980s. These reforms greatly improved competitiveness and helped create a private sector that could respond to adverse economic conditions. In particular, exports of manufactures from foreign firms increased substantially in 2000, as these firms were less affected by the domestic banking crisis.

Employment and poverty implications of the reform

What impact did the reform packages, especially of trade and investment, have on income distribution and poverty from the mid-1980s? To answer this question first we focus on the pre-crisis period before turning to the post-crisis period.

The Soeharto years: 1980–97

Unlike in China and several other countries in East Asia, a dramatic fall in the incidence of poverty does not appear to be closely associated with the timing of trade reforms in Indonesia, and nor did income distribution indicate a significant improvement (or indeed deterioration) following the reforms.[15] Although poverty incidence continued to decline during the reform period from the mid-1980s, it had already fallen substantially across the country in the first half of the 1980s, both on heavily population Java and in the Outer Islands (Tables 4.4 and 4.5). This occurred *despite* the slower rates of economic growth discussed above.

Thus, intriguingly, does the Indonesian experience contradict the 'Washington Consensus' that trade reform is a necessary condition for improvements in living standards and a reduction in the incidence of poverty. In the

Table 4.4 Poverty incidence in urban and rural Indonesia, 1976–2000

Year	Urban	Rural	Total	Ratio urban/rural	% Population urban
1976	38.8	40.4	40.1	0.96	20.0
1980	29.0	28.4	28.6	1.02	22.2
1984	21.2	23.1	21.6	0.92	25.4
1987	20.1	16.4	17.4	1.23	27.9
1990a	16.8	14.3	15.1	1.17	30.5
1990b*	16.1	15.7	15.8	1.03	30.5
1993*	13.4	13.8	13.7	0.97	33.0
1996*	9.7	12.3	11.3	0.79	36.0
1998*	14.4	20.1	17.9	0.72	39.3
1996**	13.7	19.9	17.7	0.69	36.0
1998**	21.9	25.7	24.2	0.85	39.3
1999**	16.3	34.1	27.1	0.60	39.9
2000**	7.3	20.7	15.2	0.48	na

Sources: CBS 1992, *Poverty and Income Distribution in Indonesia*, 1976–1990; CBS 2000 *Pengukuran Tingkat Kemiskinan di Indonesia 1976–1999: Metode BPS* (Measurement of Poverty in Indonesia 1976–1999: the BPS Methodology), Jakarta. Data for 1999 are from the full SUSENAS (National Social Economic Survey), and for 1998 and 2000 for the sample SUSENAS.

Notes
  * Based on new methodology employed by CBS.
** New (higher) poverty line based on an expanded basket of goods.

Indonesian case, trends in poverty would appear to be consistent with views of many critics who emphasised the negative effects of KKN (*korupsi, koneksi* and *nepotism* – corruption, contacts and nepotism) on income distribution under Soeharto.

In part, the answer depends on an assessment of counterfactual arguments. Would poverty have declined faster had Indonesia adopted trade reforms earlier? Alternatively, would the rapid fall in poverty have continued in the late 1980s and 1990s, had the government not adopted the reform packages discussed above?

We are not in a position to test either of these propositions directly. Nevertheless, the data on employment and wages provide strong indications that trade reform did make a significant contribution to poverty decline. First, however, we need to look briefly at the pre-reform period, in order to understand developments after the reforms and later during the economic crisis.[16]

Partial labour markets transition and poverty in the pre-reform period

Under Soeharto, relative macroeconomic stability created a stable environment for investment and savings after nearly four decades of economic instability in the pre- and post-independence periods (dating from the Great Depression in 1929–30 to the mid-1960s). Economic growth rates were high, even by East

Table 4.5 Incidence and change in head count measure of poverty by major province group, urban and rural Indonesia, 1980–7 and 1990–6

| | % of population in poverty | | | | % Population | | % Change in poverty incidence | | | |
| | 1980 | | 1990 | | 1980 | 1990 | 1980–7 | | 1990–6 | |
	Urban	Rural	Urban	Rural	Urban	Urban	Urban	Rural	Urban	Rural
Java & Bali	40.0	45.8	18.4	12.5	25.3	35.4	−64.6	−65.6	−45.1	−10.1
Larger provinces										
Sumatra	30.8	20.0	15.4	14.2	20.0	25.9	−64.5	−30.8	−42.2	−23.6
Kalimantan	24.5	16.6	20.7	25.9	18.9	23.1	−58.8	−17.4	−45.8	−18.2
Sulawesi	45.3	42.4	15.7	10.7	17.6	23.8	−55.2	−49.2	−39.0	−21.9
W/E. Nusa Tenggara	52.5	54.3	26.7	23.1	10.8	14.4	−44.9	−47.1	−36.9	−15.4
Smaller provinces*	39.2	29.2	12.8	18.4	15.8	22.9	−41.9	3.4	−48.2	−14.8
Indonesia	38.6	39.1	17.9	14.0	22.6	30.9	−62.4	−55.7	−45.1	−12.9

Sources: Adapted from Manning 1999: table 5. Data for 1980/7 and 1990/6 are based on different poverty lines. For 1980 and 1987, the data on poverty are taken from Booth 1992b: table 10.18, using the national poverty line in 1976 adjusted to 1980 prices using the GDP deflator, and converting them into provincial poverty lines based on cost of living index for each province. The 1990/6 data are based on the official poverty line estimates made by CBS (see Indonesia. CBS, *Statistical Yearbook*, 1996). See table 6.

Note
* Includes Jambi and Bengkulu in Sumatra, Central and East Kalimantan, Central and Southeast Sulawesi, Irian Jaya and Maluku. East Timor is included in 1990 and 1996.

Asian standards. The oil boom provided an opportunity to invest in public goods, primarily roads and bridges, irrigation and schools, on a scale far beyond the budgetary capacity of the regime in earlier periods. The Soeharto regime promoted these expenditures across the archipelago to an extent that was quite unusual among oil-exporting countries that had experienced a windfall gain in revenues in the 1970s.

Associated with the above, a large proportion of total revenues were devoted to rural agricultural development and especially rice production which was basically pro-poor. The subsidies involved price support schemes, input subsidies and credit to farmers, as well as substantial improvements in irrigation and road networks to support rice production. Whatever the losses in efficiency, relatively poor rice producers, workers in the rice sector and ultimately poor urban consumers, benefited from government support (Timmer 1993). Thus employment expanded quite rapidly in agriculture, especially in the Outer Islands from the 1970s (Table 4.6). Following a rice crisis in the early 1970s, rice prices tracked international prices for much of the oil boom period, thus making rice affordable to the growing urban working class. Thus it is not surprising that poverty declined as rapidly in rural areas as in urban areas in this earlier period (see Tables 4.4 and 4.5).

However, manufacturing employment grew quite slowly, despite substantial output growth in this sector. Import substitution and state-sector led economic development did not provide the same stimulus to employment of industrial workers, as in other East Asian countries, such as Korea, Taiwan and

Table 4.6 Employment growth by selected sector, Java and the outer islands, Indonesia, 1976–2000

	Agriculture	Manufacturing	Services/ other	All sectors
Pre-reform (1976–87)				
Java	0.9	3.9	5.0	2.7
Outer Islands	5.1	1.8	6.5	5.3
Indonesia	2.6	3.5	5.4	3.6
Reform period (1987–96)				
Java	−1.2	5.0	3.0	1.5
Outer Islands	0.8	7.8	3.9	2.2
Indonesia	−0.2	5.6	3.3	1.8
Crisis and recovery (1996–2000)				
Java	1.5	1.2	0.1	0.8
Outer Islands	0.7	0.1	0.6	0.6
Indonesia	1.1	1.0	0.3	0.7

Source: CBS, National Labor Force Surveys (SAKERNAS), 1976, 1987, 1996 and 2000.

Notes
Data for 1976 and 1987 include the population aged ten and above for all provinces of Indonesia. For 2000, data include the population aged ten and above, and excludes Maluku province (not covered in SAKERNAS in that year) and East Timor. Data for 1996 have been adjusted accordingly.

Malaysia. Unlike the NIEs, Indonesia did not make the transition to relatively labour-intensive, export-oriented manufacturing growth until quite late. As a result, labour force growth tended to be accommodated through new job opportunities in service activities rather than in manufacturing, and the urban informal sector grew very quickly.[17] The share of total jobs held by workers in urban areas, and in services also rose.

Accelerated labour market change in the wake of the reforms

Following the reforms, there were three fundamental labour developments in the 1990s:

- a sharp decline in low productive employment in agricultural sector;
- much faster expansion in manufacturing employment than in previous periods;
- rapid growth in real wages across all major sectors.

The situation was reversed compared with the oil boom period. Agricultural employment declined nationally and especially on Java. On the other hand, manufacturing employment grew strongly. Whereas jobs in industry had expanded at less than 4 per cent per year in the pre-reform period, at about the same pace as total labour force growth, they grew by nearly 6 per cent in 1987–96 (see Table 4.6). Especially in the early reform years, a high proportion of new jobs were in export-oriented labour-intensive manufacturing. The share of textiles, clothing and footwear (TCF) employment in total large and medium manufacturing rose to one-third in just seven years, after being little over 20 per cent in the mid-1980s (Manning 1998: 105). Removal of barriers to trade and investment was associated with rapid growth in relatively labour-intensive jobs.

In the earlier period, real wages had grown in the modern sector, but relatively slowly in traditional sectors, such as agriculture. However, during the period of deregulation, wage increases were large across all sectors. Figure 4.3 shows that real wages rose quite steeply in manufacturing and services as well as agriculture from the late 1980s until the eve of the crisis in 1997. On average, growth was close to 5 per cent a year across sectors and at over 6 per cent in manufacturing in this period. The labour market had become much more integrated and had tightened in response to booming labour demand conditions. The take-off in manufacturing exports was a driving force in contributing to this improvement in labour market conditions.

In sum, labour market developments suggest that poverty decline in the 1990s should at least partly be attributed to economic reform and the stimulus which it provided to labour-intensive sectors, in particular. Even though it was manufacturing output and employment growth that provided the dynamic stimulus for income expansion, the increase in real wages spilled over into rural areas. At the same time, in contrast to the earlier period, poverty decline was most rapid in urban areas, which had begun to account for a significant share of the total population by the 1990s.

Figure 4.3 Real wages in major sectors, Indonesia, 1989–2001 (1996 prices).
Source: CBS, National Labor Force Surveys, 1989–2001.

The economic crisis and beyond

How about the economic crisis? The head count index of poverty rose substantially during the crisis, as Indonesia faced a major shock to macroeconomic stability and economic growth. During the crisis, it rose from 18 per cent in 1996 to 24 per cent two years later.[18] The incidence of poverty recovered equally as quickly, however, falling back to 15 per cent in 2000 (see Table 4.4).[19]

What can we say about the impact of economic reforms on the labour market and poverty, as Indonesia came out of crisis? Any analysis of the determinants of social-economic change in the post-crisis period is fraught with difficulty, owing the coincidence of a large number of changes, in addition to genuine economic reform discussed above.[20] Nevertheless, three patterns of adjustment and recovery were clearly apparent: expansion in employment in tradeable industries after the initial shock of the crisis; sluggish growth in employment in non-tradeable industries and, third, a sharp fall and then recovery in real wages, although at a slower rate than before the crisis.

First, the labour market adjusted remarkably quickly, both in employment and wages, to the economic shock of 1997–8, and this probably played a major role in softening the impact on vulnerable groups and workers in those sectors worst hit by the economic crisis (especially construction and segments of manufacturing). Agricultural sector played a significant role in absorbing labour once again,

even on Java, after almost a decade of labour shedding during the economic reform period. At the height of the crisis in 1998, some 4–5 million people are estimated to have sought work in the agricultural sector. Moreover, this did not merely represent crowding back into rural areas as jobs dried up in the towns. Farmers who produced a marketable surplus benefited from the sharp increases in food prices and relative improvement in terms of trade of agricultural commodities (Maurer 1998). There was also a significant rise in agricultural employment outside Java, in response to improved domestic prices for cash crop exports in some provinces such as South and North Sulawesi and Lampung (Potter 2000).

In subsequent years, 1999–2000, this process was reversed somewhat as people moved back into towns and cities in search of jobs. In the period 1998–2000, agricultural employment fell again. Agriculture and rural areas were a shelter in time of crisis, but could not provide more than a temporary respite for many families. Over the entire period 1996–2000, agricultural employment only rose by 1 per cent, and can be expected to play only a minor role in total labour absorption in years to come.

In contrast to agriculture, manufacturing employment fell by a large margin in both Java–Bali and the Outer Islands at the height of the crisis, but recovered quite quickly thereafter (Manning 2000). Within Java, the declines were particularly marked in the major industrial centres of Jakarta, West Java and East Java where import supplies for export-oriented industries were severely disrupted, and manufacturing employment fell by close to 15 per cent at the height of the crisis in 1998.

Nevertheless, the large changes in relative prices opened up new opportunities in manufacturing and employment expanded in 1999 and 2000. This was especially true in the labour-intensive, export-oriented industries which were ready to take advantage of greatly improved price incentives (the rupiah was still at Rp. 8,000–9,000/$US, more than three times its pre-crisis level). Several clusters of small and medium industries in Java also benefited. Expanding export of traditional textiles and furniture in smaller urban locations are good examples.[21] Products that had once been part of the traditional Javanese economy – bamboo mats and bags, and processed food relying entirely on local food products – began to be produced by rural people at a fraction of the cost of imported goods.[22]

Second, as might be expected from the huge depreciation of the exchange rate, employment declined in non-tradable goods industries, in contrast to the overall expansion of jobs in tradeable activities. Overall service sector employment, including construction, barely rose from 1996 to 2000, although employment in retail and wholesale trade and transport had both recovered somewhat by 2000.[23] In addition, there were indications of an informalisation of work in urban areas, as non-wage employment grew more rapidly than wage jobs.

Third, real wages, which had fallen mainly because of the sharp bout of unanticipated inflation in 1998, had also recovered to pre-crisis levels by 2000 and 2001. While real agricultural wages grew much slower after the crisis, they remained relatively stagnant in major rice-producing areas on Java where a high proportion of relatively poor households are located. Manufacturing wages

recovered partly due to the government regulation of wages. Social safety nets were put in place to help overcome the worst effects of the crisis. Also, minimum wages was one policy aimed at improving worker incomes. Minimum wages increased rapidly in 2000–2. The much more active trade union movement, combined with a more sympathetic government, sought to implement wage regulations widely, at least in the modern sector.[24] A flexible labour market, especially through real wage adjustment had helped Indonesians cope with the crisis. However, the tight regulation of wages by the government (at levels much closer to average wages than in the past) may signal an important change in the capacity of the labour market to adjust to future sharp shifts in demand.[25]

By far the most important influence on these changes in the labour market was the shift in relative prices, due to depreciation of the rupiah, which provided an entirely new mix of incentives for tradable and non-tradable production. Both the floating of the rupiah and the earlier trade reforms were critical, nevertheless, in facilitating a swift transmission of changing price signals to domestic producers. The impact of other reforms to domestic trade discussed above were probably not great for employment. But they did mean prices were substantially cheaper in a range of imported goods, such as flour and soy beans. Partly, the improvement in the poverty status of many households since 1998 can be attributed to these favourable price movements.

Conclusions

The Indonesian experience suggests three important lessons. First, a country can experience a major improvement in indicators of welfare in the early 'catching up' stages of development. Such improvements are dependent on economic reforms that closely integrate domestic and international markets, provided that political environment and macroeconomic policies establish a secure environment for investment and production. Besides stable prices and a predictable exchange rate, a balanced budget can also play a key role in macroeconomic stabilisation, as was the case in Indonesia during the oil boom period of the 1970s.

In the Indonesian case, poverty declined substantially during the early stage of State-led development. Although, Indonesia had an open capital account from the early years of the Soeharto regime, welfare improvements occurred despite high and increasing barriers to international trade and heavily regulated investment, in particular foreign capital inflows. In part, government investment facilitated the mobilisation of 'surplus' labour into more productive activities, especially in the rice sector and related trade and service activities in rural areas. These policies helped create jobs and reduce poverty, supported by the windfall gains from the oil boom.

Our second lesson suggests that gains through macroeconomic stability and public investment, alone, are likely to have diminishing returns over time. Opening markets to international competition becomes a pre-requisite for continued economic growth and improvements in living standards. In the case of Indonesia, the crunch point occurred in the early to mid-1980s, when further

substantial increases in per capita incomes depended on expanding exports in the international market place. Trade and investment reforms gave a significant incentive to Indonesian and foreign investors to export labour-intensive manufactures, for the first time in the nation's forty year history. As in China later, the results were quite spectacular, as manufacturing exports rose from a tiny share to dominate total exports in less than a decade, in the second half of the 1980s and early 1990s. Urban employment expanded rapidly in manufacturing and real wages rose, since many exports used labour, Indonesia's most abundant resource, intensively. This was the conduit for poverty decline from the mid-1980s, through to the crisis a decade later.

   Third, and finally, we suggest that Indonesia benefited from a more open and competitive economy in being more able to adjust rapidly to major economic shocks, such as the economic crisis, despite the increased vulnerability faced by some sections of the community. The financial crisis, and associated political and real sector crises, hit Indonesia harder than any other country in the region. Domestic and international players revised their assessment of growth prospects, as reflected in massive capital flight and dramatic decline in the value of the rupiah. These price adjustments were quickly reflected in relative prices in the domestic economy. Many Indonesians faced privation, and the government and NGOs learnt some valuable lessons on how (and how not to) to shelter the poor from hardship at times of crisis. But adjustment was swift, and the dramatic increase in poverty was transitory for most households whose livelihoods had been threatened by the crisis. A flexible labour market, where wages adjusted rapidly (thus providing some job protection in labour-intensive industries) and workers were deployed to new sectors, supported the quick recovery in tradable goods sectors following initial disruption in 1998.

   There is one warning, however. The value of more open markets for the poor is widely debated in Indonesia in the early twenty-first century. Association with the shortcomings of the Soeharto regime (poorly implemented financial sector reform, corruption and heavy handed political controls) took the gloss off achievements that flowed from far-sighted economic reforms. As the debates rage over the causes and consequences of the crisis, this has left the door open for self-serving business people and allied politicians and bureaucrats, to press for re-regulations in trade and investment. The danger is a reversal in many of the initiatives that underpinned poverty decline in the last decade of the former regime. There is no doubt that it will be more difficult to sustain economic reform, necessary for continued growth and poverty decline, in a more open and decentralised political system that is dominated by the legislative branch of government. A major challenge to Megawati and her cabinet in mid-2002 was to hold the line on reform, and indeed to move forward in the more competitive political environment, as Indonesia seeks to maintain its remarkable record on poverty decline.

Notes

 1 The data presented in Table 4.1 and subsequent tables all relate to the head count index of poverty, that is, the proportion of the population living below a given poverty

line (the official poverty line set by the Central Bureau of Statistics (CBS). Other indicators of poverty such as the poverty 'gap', measuring the depth of poverty, all showed similar declines during the same time period. The data are based on a fixed basket of goods that were increased in 1998 to reflect longer-term changes in living standards. See discussion of poverty trends in the section on 'Employment and poverty implications of the reform'.

2 Indonesia was forced to undertake several major rupiah devaluations (in 1978, 1983 and 1986) which raised the risk premium on the rupiah and made for a less certain investment climate.

3 Although Thailand had already begun to suffer significantly in the previous year (1997).

4 The exchange rate was just under Rp. 8,000/US$ when the newly elected government of Abdurrahman Wahid was installed in October 1999 but had declined to above Rp. 11,000, before rising again in value to below Rp. 9,000 in early 2002 under the Megawati administration.

5 See Pangestu and Boediono (1986) and Fane and Phillips (1991).

6 The contrast is striking with efforts at reform during the Asian financial crisis a decade later. Soeharto failed to take to technocrat advice partly because he had removed all of the early advisers from positions of influence, and replaced many of them with 'political' appointees, and partly because he now listened to alternative sources of advice mainly through his children.

7 Major financial sector reforms were also introduced in October 1988. All domestic banks were free to open new offices, and new private banks were permitted. These reforms had a dramatic impact. The private banking sector boomed, as these institutions began to compete for customers and market share. The state banks were slow to adjust to the new environment, and their market share declined rapidly. The stock market grew rapidly over the same period. An intensive study by Goeltom (1995) on the investment impact of the 1983 and 1988 reforms showed that small and medium-sized firms and export-oriented firms benefited greatly from improved access to bank funds, compared with the period before the reforms.

8 Equally important, the dispersion of real ERPs in non-oil manufacturing narrowed considerably: the standard deviation of real ERPs declined from 102 per cent in 1987 to 39 in 1995, indicating a considerable reduction in trade policy distortions based on this measure of protection.

9 Their non-tradable intermediate inputs still had to be purchased at prices above international benchmarks.

10 ATB is defined as the effective rates of protection for import-competing sectors, relative to the ERP for exporting sectors.

11 In 1989, the Investment Coordinating Board (BKPM) replaced the Priority Investment List with the much simpler Negative Investment List. This new publication listed the sectors closed to domestic and/or foreign investment, and sectors closed to investment unless certain requirements are met.

12 In the deregulation package of June 1994, foreign firms could either form a joint venture with 95 per cent foreign ownership with no further divestment required thereafter or alternatively form a wholly foreign-owned subsidiary, in which case some divestment would have to be undertaken after fifteen years. This deregulation represented a major policy shift: previously, the maximum initial foreign ownership permitted in a joint venture was 80 per cent, except in the case of export-oriented investments (95 per cent). The previous rule on divestment was that foreign ownership had to be reduced to 49 per cent after twenty years, except for export-oriented investments in export processing zones.

13 To further protect Habibie's interests, the Strategic Industry Board (*Badan Pengelola Industri Strategies*, BPIS) was established in 1989. Under this arrangement, ten of the largest state enterprises were placed under his direct control with no public scrutiny.

Among these industries were aerospace, shipbuilding and repair, nuclear energy, ammunitions and the state steel company, P.T Krakatau Steel.

14 Several politically powerful business groups operated in many of these industries (often with SOE partners), and were extracting rents through the competition-restricting regulations. They used their strong political connections to resist the reform process (Mackie and MacIntyre 1994).

15 The Gini ratio (based on expenditure data) remained relatively constant at around 0.32–0.36, without any obvious trend, for most of the 1980s and 1990s.

16 See especially Booth (1992b) for a discussion of poverty decline during the oil boom and periods of economic recovery in Indonesia.

17 Outside agriculture, non-wage employment grew at just under 8 per cent per annum during the oil boom years in the 1970s, compared with wage jobs which grew at less than 5 per cent (Manning, 1998: 101).

18 See data in the bottom half of the Table 4.4. The basket of goods on which the poverty line is derived was revised in 1998.

19 Prior to 1998, the full poverty survey (full SUSENAS survey) had only been conducted every three years by the CBS. A smaller sample survey was used in 1998, 1999 and 2000 to provide timely data on poverty trends.

20 The latter include political reforms, the dramatically different set of relative prices (as result of the substantial depreciation of the rupiah from 1997), the break-up of many of the Soeharto monopolies and, from January 2001, and decentralisation of major revenue and expenditure responsibilities in the regions.

21 This included sarongs from the Majalaya district, Bandung, West Java, and furniture from Jepara, Central Java and Pasuruan in East Java.

22 See Jellinek and Rustanto (1999).

23 By far the greatest decline was in construction employment in both urban and rural areas. All non-tradable goods sectors experienced an overall decline in employment during the crisis, except transport and communications, the latter perhaps reflecting crowding into labour-intensive segments such as *becak* (trishaws) and *ojeg* (private motor cycle transport services).

24 Research conducted by the National Planning Agency Bappenas suggests that increases in quarterly wages were closely correlated with minimum wage increases from 1999 onwards. See especially SMERU (2001) for a discussion of the impact of minimum wages on employment.

25 From January 2001, the responsibility of setting minimum wages was turned over to the regions, both provinces and districts, with final authority resting in the hand of the provincial governor.

5 Trade and investment policy and equity in South Korea

Oliver Morrissey and Dirk Willem te Velde

The 1990s began well for South Korea but ended with a severe but brief recession following the East Asian crisis of 1997; GDP declined by over 6 per cent in 1998, although growth has been estimated at 10 per cent in 1999. Over the decade as a whole, real GDP grew by over 5 per cent per annum. The impressive growth performance since the 1960s has been associated with declining levels of inequality and poverty, although many of these gains were lost immediately following the crisis of 1997. Trade (and industrial) policy played an important role in Korean growth. Contrary to the predictions of traditional trade theory, however, increased trade has not been associated with increasing wage differentials or income inequality. Although average tariffs are relatively low in Korea, they are variable and there is significant government intervention in the economy, as has underpinned Korean growth since the 1960s. Korea had a relatively liberal trade regime by the 1980s, and few significant trade reforms were implemented in the 1990s excepting significant liberalisation of trade in services. For these reasons, Korea is a worthwhile case study on the links between trade, growth and inequality, and provides a case where growth has been poverty reducing.

Morrissey and Nelson (1998) argue that Korea resembles a case of planned growth, to the extent that savings and exports followed investment and imports. A government policy of high investment required increasing savings rates, which was achieved; import needs, of raw materials and initially of capital goods, required foreign exchange so export growth was promoted. They also argue that an important feature of Korea's success was the relative equality of incomes so that the gains from growth were shared. The East Asian crisis has induced some changes in government intervention, but the underlying economic policy of the past few decades has been stability and continuity, a general policy of growth with equity. This has persisted after the crisis, and poverty and inequality are being reduced towards the low pre-1997 levels.

The 1990s was not a period of dramatic domestic policy reform in Korea, with the exception of policy reactions to the financial crisis of 1997. The trade liberalisation implemented was part of an ongoing process, added to by regulatory changes to comply with WTO commitments. The opening up of the economy to foreign direct investment (FDI) was a significant policy change, motivated largely by joining the OECD, but has yet to result in levels of FDI stocks (relative

to investment or GDP) comparable to those observed elsewhere in East Asia. Korea had an established reputation of 'sound' macroeconomic management and flexible factor markets and such policies were maintained rather than required by liberalisation. Korea in 1994 announced its intention to join the OECD (in 1996), and at that point could be said to have become an 'advanced industrialised nation' (Sohn *et al.* 1998: 49). Since poverty is not a major issue in Korea, the chapter focuses on inequality (specifically, wage inequality). It is the effects of trade and FDI on the relative demand for skilled and less skilled workers that is of greatest importance in terms of effects on inequality.

Trade, FDI, growth and inequality: issues

Income inequality, as measured by the Gini index, is low in Korea by world standards, close to the average in OECD countries. Korea experienced a sustained reduction in inequality in the 1980s, with the Gini measure falling from about 0.39 in 1980 to 0.34 in 1988. The richest 20 per cent of the population have about five times the income of the poorest 20 per cent in the 1990s, a very low ratio by international standards (UNDP 2000: 169). Li *et al.* (1998) identify four factors that appear to explain about three-quarters of the variation in income inequality across countries – measures of initial schooling, civil liberties, equality in the distribution of land and financial development (the ratio M2/GDP). All of these are relatively high in Korea, which helps to explain why inequality is relatively low; the mean value of the Gini for Korea over 1953–88 was 0.34, compared to an overall average for forty-nine countries of 0.36 (Li *et al.* 1998: 30).

An increasing labour share in total incomes together with a reduction in wage inequality underpinned the fall in income inequality into the 1990s (Moon 1999). Sustained job creation raised labour's share in total incomes from 52 per cent in 1980 to 59 per cent in 1990 and 61 per cent in 1995. The share of wages and salaries in national income is more evenly distributed than property and incomes from non-agricultural self-employment. Wage inequality by occupation and education has fallen since the late 1970s (after the big push towards chemical and heavy industry in the 1960s and 1970s) and the fall accelerated after 1987 when union activity began to have more impact.

Table 5.1 provides a summary of trends in the major social indicators for Korea. It shows a decreasing trend in the percentage of households classified as poor (based on national absolute poverty lines) that has continued into the 1990s, albeit at a slower pace. The poverty gap – income needed to raise poor households to the poverty line expressed as a ratio of total incomes – has also fallen dramatically into the 1990s. Korea has a good record in reducing poverty, and this appears to have been in line with declining levels of inequality. By international standards, Korea has a relatively low level of poverty: in 1993, less than 2 per cent of the population were below international poverty lines (World Bank 2000: 63). The fact that poverty is very low, and not perceived as a major issue, is revealed by the fact that Korea is not reported in databases on poverty (UNDP 2000), or even in specific studies of poverty in East Asia (David *et al.* 2000).

Table 5.1 Trends in major social indicators in Korea, 1970–99

	1970	1975	1980	1985	1990	1995	1998	1999
Absolute poverty								
Head count ratio			24.5	11.0	8.3[1]	7.04[2]		
Poverty gap			9.5	2.5	1.7[1]	1.78[2]		
Health								
Birth rate, crude (per 1,000 people)	30.0	25.9	22.3	—	16.3	15.2	—	14.1
Health expenditure, total (% of GDP)	—	—	—	—	5.2	5.1	5.1	—
Hospital beds (per 1,000 people)	0.5	0.5	1.7	1.7	3.1	4.4	5.1	—
Mortality rate, infant (per 1,000 live births)	46.0	33.2	25.8	17.6	12.2	9.8	—	8.4
Life expectancy at birth, total (years)	59.9	63.9	66.8	68.7	70.3	71.8	—	72.9
Physicians (per 1,000 people)	0.5	0.5	0.6	—	0.8	1.1	1.3	0.7
Education								
Illiteracy rate, adult total (% of people ages 15 and above)	13.2	9.8	7.1	5.5	4.1	3.0	2.5	2.4
School enrolment, tertiary (% gross)	7.4	8.8	14.7	34.0	38.6	52.0	—	—
School enrolment, secondary (% gross)	41.6	56.3	78.1	91.6	89.8	100.9	—	—
School enrolment, primary (% gross)	103.4	106.9	109.9	97.0	104.9	95.3	—	—
Population								
Population, total (millions)	31.9	35.3	38.1	40.8	42.9	45.0	46.4	46.9
Population growth (annual %)	2.1	1.9	1.6	1.0	1.1	1.2	1.0	0.9
Memorandum								
GDP per capita, PPP (current $)	—	1,612.7	2,988.5	4,791.5	8,922.5	13,758.8	14,096.7	15,712.4
Gini coefficient			0.39	0.34	0.32[1]	0.30		

Sources: World Bank 2000; Moon 1999.

Notes
1 Average 1988 and 1993.
2 1996.

Countries with lower levels of poverty tend to be those that invested in human capital, sustained a relatively open trade regime and typically have low levels of inequality. All of these apply to Korea. Table 5.1 also shows that economic growth has led to big improvements in other social indicators such as life expectancy, infant mortality and education. Moon (1999) argues that the remarkable drop in poverty was facilitated by a reduction in population growth and fast economic growth rather than specific anti-poverty policies.

Economic development in Korea has been based on investment in human resources, both general education and vocational training. The secondary and tertiary enrolment rates in Korea are higher than in other developing countries. In particular, Korea has managed to achieve very high technical tertiary enrolments, useful to absorb technological knowledge. The quality of education in Korea has also been exceptionally high. One indicator of quality is the 1995 TIMSS (Third International Mathematics and Science Study); of the forty-two developed and developing countries included, Korea achieved second place in mathematics (below Singapore, but above Japan and others) and fifth place in science.

Education and investment in human capital more generally, has contributed both to growth and to spreading the benefits from growth widely and relatively evenly. Much of this growth has been associated with, if not fuelled by, exports. Koreas open trade regime has been associated with growth and poverty reduction. More recently, FDI has begun to play a role. It is appropriate therefore to review briefly the issues on links between trade, investment and growth and inequality.

There is a vast literature on the relationship between trade and growth and we do not attempt a review here. There are three broad conclusions from the empirical literature that we can take as a starting point (see Greenaway and Morrissey 1994; Greenaway *et al.* 1998; Rodrik 1999). First, there is a robust positive relationship between outward orientation and growth and a corresponding negative relationship between inward orientation (defined as high levels of protection) and growth. Second, outward orientation cannot be narrowly interpreted as export-led growth. It requires that there are policies to promote export sectors, but also implies openness to imports, technology, learning and international competition (in this sense it encompasses, although does not require, FDI). Third, the evidence for a link between trade liberalisation and growth is more limited and less convincing. This is not to say that trade liberalisation is not beneficial, but rather to emphasise that trade policy reform alone is no guarantee of growth. There is a need to liberalise other domestic policies and institutions if the potential incentives of trade liberalisation are to be translated into growth.

There is also an important debate about the implications of growing trade and investment on national economies. While something of a consensus exists over the positive association between openness and growth, there is less agreement about who gains within societies. Wood (1997) reviews the conventional wisdom that export-oriented industrialisation in East Asia promoted distributional equity.

In this view trade allows the expansion of sectors that use the abundant factor of production intensively. The abundant factor in the 1970s and 1980s in East Asia was low-skilled labour, and hence trade should have raised the demand for low-skilled labour. Wood argued that this has probably happened. However, the effects on wage inequality were considered less clear partly because only a few analyses control for domestic influences. Controlling for domestic influences is important as in 'open Asian economies and the Philippines … relative supply shifts could explain relative wage outcomes' (Robbins 1996: 24). Furthermore, trade liberalisation is often accompanied by rising relative wages and skill demands, in contrast to predictions of traditional trade theory.

In principle, the desirability of trade liberalisation is because it instils appropriate relative incentives, not because it necessarily increases growth in itself. Trade reforms are but a component of openness, which also includes capital and investment flows, itself an element of what is commonly referred to as 'globalisation' (the increased intensity of inter-linkages between countries in the global economy). On balance, the evidence suggests that openness to trade is conducive to growth, conditional on appropriate domestic policies and institutions (Rodrik 1999).

The contribution of FDI to economic growth has been debated quite extensively in the literature. The 'traditional' argument is that an inflow of FDI improves economic growth by increasing the capital stock, whereas recent literature points to the role of FDI as a channel of international technology transfer. There is growing evidence that FDI enhances technological change through technological diffusion, for example because multinational firms are concentrated in industries with a high ratio of R&D relative to sales and a large share of technical and professional workers (Markusen 1995). Multinational corporations are probably among the most technologically advanced firms in the world. Moreover, FDI not only contributes to imports of more efficient foreign technologies, but also generates technological spillovers for local firms. In this approach, technological change plays a pivotal role in economic growth and FDI by multinational corporations is one of the major channels in providing developing countries with access to advanced technologies.

Empirical evidence that FDI generates positive spillovers for local firms is mixed (see Saggi 2000, for a survey). This does not necessarily imply that FDI is not beneficial for growth (for a survey of FDI and growth in developing countries, see De Mello and Luiz 1997). It may be that the spillovers are of a different nature.

The impact of trade liberalisation on poverty has attracted interest recently. Much of this work is concerned rather broadly with globalisation and poverty, and tends to involve identifying a set of research questions rather than providing answers based on empirical evidence. There is no direct link between trade liberalisation and poverty – some sectors will gain and others may lose, and the net effect depends on the flexibility of factor markets and responsiveness of the economy. Similarly, foreign investment does not have an unambiguous impact on poverty, although if it provides employment and contributes to growth one

would expect the net impact to be positive. Following Morrissey (2000) we can draw a number of conclusions.

- Domestic policies will determine the ability of an economy to respond to the opportunities and dangers posed by globalisation (of which greater exposure to trade and investment is one aspect). More flexible economies are better able to meet the challenges of globalisation and to protect domestic constituencies that face the highest adjustment costs.
- Growth, in general, is conducive to poverty reduction.
- Policies to promote sectors with potential for increased employment should assist poverty reduction. This suggests a role for an industrial policy as part of a development strategy.
- In economies with developed manufacturing sectors, factor market flexibility (for labour and investment) is important in maintaining competitiveness. When the economy is growing, this may contribute to poverty reduction. When the economy is subject to adverse shocks, this may mitigate the adverse impacts on poverty.
- Social sector spending, especially in health and education, is vital to any long-term strategy of human capital development.

Trade and FDI policy in Korea in the 1990s

Trade and industrial policy have been central to Korea's growth strategy since it abandoned import-substitution in 1961. If the 1960s were the decade of export promotion and the 1970s the decade of industrial promotion, the 1980s were the decade of liberalisation followed by consolidation in the 1990s (Sohn *et al.* 1998). The Asian financial crisis of 1997–8 highlighted a number of inherent structural problems in the Korean economy that resulted from decades of interventionist strategies. These have been described by the IMF as 'detailed government intervention at the micro level, an inefficient financial sector, a highly leveraged corporate sector, and an inefficient market discipline' (Bark and Moon 2000: 10). The importance of the crisis notwithstanding, we limit attention to trade and FDI policy.

  The simple average tariff in Korea was 23.7 per cent in 1982, with two-thirds of tariff lines subject to rates of 20 per cent or higher. By 1994, the simple average was 7.9 and 93 per cent of tariff lines were at rates less than 20 per cent (WTO 1996). Agricultural products tended to be subject to the highest rates (on average, 31 per cent in 1982 and 17 per cent in 1994), while raw materials attracted the lowest rates (12 and 2.8 per cent, respectively). Finished goods attracted rates of 26.4 and 7.1 per cent, respectively. On this basis, Korea has liberalised trade significantly. However, these figures are based on the low in-quota tariff rates, and Korea applies many tariff quotas, especially for agricultural goods. If this is taken into account, the simple average applied tariff was 14.4 per cent in 1996 falling to 13.8 per cent in 2000 (WTO 2001a: 40). In both years, average tariffs on agricultural goods exceeded 50 per cent, although the average on industrial

goods fell from 7.7 to 7.5 per cent. The import weighted average tariff was 10.9 per cent in 1996 and 10.6 per cent in 2000. In general, Korea has low tariffs, although agriculture sector is highly protected.

Table 5.2 provides information on the composition and patterns of trade, and a number of points are worth noting. First, between 1995 and 1998 Korea moved from a slight deficit to a significant trade surplus (the Asian crisis appears to have been reflected in import compression). Although imports rose by 28 per cent in 1988, exports rose by almost 10 per cent and there was again a significant surplus. The improvement in exports was concentrated in electronic goods, especially semiconductors and automobiles, whereas the rise in imports applied to capital and consumer goods (Yang and Kim 2000: 12–14). Second, the composition of trade was very stable: Korea exports manufactures, especially office and telecommunications equipment, but also imports manufactures (implying considerable intra-industry trade) in addition to fuels and other raw materials. Third, East Asia is the major trading partner, although its share has fallen as a result of the crisis (which appears to have impacted most on Japan).

The Asian crisis reduced real wages and, with the associated devaluation, increased the competitiveness of Korean exports. Between 1990 and 1999, the

Table 5.2 Composition (%) and pattern ($) of Korean trade, 1995–9

	Exports		Imports	
	1995	*1998*	*1995*	*1998*
Agricultural	3.6	3.0	10.9	10.0
Mining and fuels	3.0	5.1	20.3	26.2
Fuels			14.1	19.5
Manufactures	91.5	86.3	66.5	58.4
Iron and steel	4.3	5.4	4.4	3.0
Chemicals	7.2	7.7	8.8	9.9
Office and telecom. equipment	26.6	24.1	12.6	17.8
Non-electrical machinery	5.6	5.3	10.9	8.9
Automotive products	7.3	8.6	5.5	3.2
Other electrical machines	7.2	3.8	3.3	4.0
Other semi-manufactures	7.0	6.1	4.3	3.2
Other consumer goods	6.7	5.8	6.9	4.8
Textiles and clothing	13.8	12.0	3.6	2.9
America (North, South and Central)	26.6	25.1	27.4	26.2
USA	19.5	17.4	22.5	21.7
Europe	16.8	21.8	16.8	15.4
East Asia	47.0	40.8	39.6	36.6
Japan	13.6	9.2	24.1	17.8
Africa	2.4	3.0	1.7	2.4
Total ($ billion)	125.1	132.3	135.1	93.3

Source: WTO 2001a: 13–15.

Note
Automotive imports refer to 'transport equipment'.

real effective wage in Korea fell by almost a half, in the USA by about 4 per cent whereas in Japan it rose by almost 30 per cent (Yang and Kim 2000: 33). Increased exports at lower prices lead to some claims, for example from the US regarding steel, that goods were being dumped. Prospects for exports remain good and Korea expects to sustain its trade surplus in the early 2000s.

Investment policy

There have been three distinct periods in the inward investment regime in Korea: 1960–83, 1984–97 and post-1998 (Kim 1999). Korea adopted a predominantly anti-FDI stance in 1960, through the Foreign Capital Inducement Act, allowing foreign investment only into the light manufacturing export sector. The government also imposed performance requirements, such as export and technology transfer requirements. This policy remained in place until 1984, when the government accepted that FDI could be an important means to upgrade Korea's industrial structure and eased the scope for FDI and simplified procedures, although certain sectors remained restricted (notably agriculture and financial services). Various performance requirements were abolished in 1989 (Kim 1999).

In preparation for Korea's accession to the OECD in 1996, the Act on Foreign Direct Investment replaced the Foreign Capital Inducement Act, thereby allowing more types of FDI as well as friendly mergers and acquisitions – only greenfield investment was allowed before 1996. Korea's approach remained passive, in sharp contrast to the active approach taken by some other East Asian countries, notably Singapore and Malaysia (Lall 1996). The stock of inward FDI was only 2.3 per cent of GDP in 1995, the lowest in the region (except for India).

The financial crisis in 1997 prompted a more active pro-FDI stance. The volatility of short-term capital was seen as part of the problem, whereas FDI was a long-term investment that could contribute to stability. Korea adopted an 'attractiveness' approach, with policies designed from the perspective of foreign investors (easier rules, documents in English, etc.) and local government given a greater role to attract FDI for regional development (Bark and Moon 2000: 27–8). The government introduced the Foreign Investment Promotion Act in 1998. This law aimed to streamline investment procedures, to expand investment incentives, to establish a one-stop agency and to liberalise procedures regarding foreign land ownership. Since the signing of the IMF assistance programme of 1997, the Korean government also liberalised M&A activity substantially.

Inflows rose from about US$ 350 million per year in the early 1980s to more than US$ 1 billion per year over 1987–91, mostly in manufacturing (especially electronics and chemicals). Japan's share fell from almost half to about a quarter, Europe increased from one-fifth to more than half, and the US remained around a quarter (WTO 1996). FDI inflows reached US$ 2 billion in 1995 but had risen to almost US$ 16 billion by 1999; the EU accounts for about a third and the US a quarter. Manufacturing (especially electronics) remained important, but there was significant growth in banking and other services (WTO 2001a). The increase in services FDI was a result of a gradual opening of the services sector

Table 5.3 Liberalisation of FDI in Korea, 1993–2000

	Number of business categories			
	Total	*Liberalised business categories*		*Restricted*
		1993–6	*1997–2000*	*May 2000*
Manufacturing	585	9	5	0
Services	495	113	41	2 (22)
Primary	68	17	11	2 (2)
Total	1,148	139	57	4 (24)

Source: Kim and Kim 2000: table 1.

Notes
Primary sector refers to agriculture, fisheries and mining. Figures in parentheses for May 2000 refer to number of categories only partly liberalised.

starting in 1994, which followed accession to the OECD. While manufacturing received 80 per cent of inward FDI flows in 1990 and services 20 per cent, by 1998 this changed to 55 and 42 per cent respectively.

Table 5.3 shows that whilst manufacturing was almost fully liberalised by the early 1990s, the liberalisation of the services sector began for a significant number of business categories only in the mid-1990s. Over the period 1990–7, distribution services, business services, entertainment and recreational services and other personal services have been liberalised in addition to the partial liberalisation of transportation services, financial services and telecommunication services (Kim and Kim 2000). After the 1997 crisis, more categories were fully opened to FDI, such as real estate rental and sales, land development, waterworks, investment companies, publishing of books and others. Radio and television broadcasting are still fully restricted alongside partial restrictions in publishing of newspapers, water and air transport, telecommunications, electric power generation and some others.

Impact of trade and FDI policies on the economy

There is compelling evidence for Korea that export orientation contributed to productivity increases and growth (Aw *et al.* 1998; Feenstra *et al.* 1999; Nam 1999). There is also evidence that imports, a measure of openness to technology, are associated with productivity growth while protection (higher tariffs) is negatively related to productivity growth (Lawrence and Weinstein 1999). The evidence that FDI has had a positive impact on growth is weaker (Kim and Hwang 1998), but Korea only really opened up to FDI in the 1990s and the volume remains low relative to GDP. All of this is evidence that outcome indicators of openness (actual exports or imports) are correlated with economic performance. There is disagreement on the relative role played by non-trade and trade policies in Korea. On the one hand, there is the view that exports and export orientation

(export incentives) were the main sources of economic, employment and productivity growth (World Bank 1993). Taking this view, trade liberalisation enhances the effectiveness of industrial policies. On the other hand, Rodrik (1995) argues that the most important role was played by industrial policies, which coordinated investment decisions and created a favourable climate for domestic investment. Initial conditions (a high ratio of skilled labour to capital stock and income level) enabled a high return on capital, supporting the investment boom. This coincided with a rise in capital goods imports financed out of exports, hence avoiding balance of payments problems. Taking this view, appropriate domestic policies enhanced the effectiveness of trade policy.

Morrissey and Nelson (1998) weave an intermediate path, stressing the importance of the mix of compatible and reinforcing policies. An active industrial policy targeted some sectors for exporting and others for import-substitution, and subsidised investment provided the sectors followed the designated strategy. Labour market flexibility was supported by constraining wage demands and unionisation, compensated by policies that were relatively egalitarian in the distribution of the gains from growth. It is evident that there was an interaction between trade and non-trade policies, but this owed more to complementarity than to causality. The importance of good macroeconomic management is agreed on by all commentators on Korean performance. Good domestic policies without outward orientation and low tariffs for imported capital goods (needed for investment) would not have supported the strong growth rate observed. Trade policy alone would not have been as successful without the availability of a skilled workforce or without the co-ordination of investment decisions (i.e. the industrial strategy).

Galhardi (1999) argues that domestic policies to support human capital accumulation have been essential to the success of outward oriented trade policies. Korea is still relatively abundant in unskilled labour compared to other developed countries. Traditional economic models would predict that trade enables the country to specialise in unskilled labour-intensive products, thereby raising the relative demand for unskilled workers. However, Galhardi argues that this was not the case for Korea. She argues that whilst exporting manufacturing industries are less skill intensive than other industries over 1970–90, skill-upgrading was fastest within the exporting industries over this period to meet global competition. Overall demand for skilled workers increased sharply and this was supported by an active role of government in providing the skills to meet the employment needs of the rapid growth in the exporting sectors.

A strong (and pro-active) education policy also prevented a sustained rise in skill differentials and social unrest. Wood (1997) argues that Korea's heavy and chemical industry drive in the mid-1970s raised wage differentials. However, by the late 1970s, higher education expanded fast enough to more than offset a general tendency in the direction of a widening in income inequality, as observed in other Asian economies that adopted export-oriented policies on the basis of wages (e.g. Malaysia, Thailand, Indonesia and China).

The sequencing of policies in Korea remains a debated issue, but it is certain that both domestic and trade policies have contributed to economic

performance: Korea's domestic policy delivered a relatively skilled workforce, a favourable domestic investment climate and a directed industrial strategy (that supported R&D and technical innovation). Low import tariffs ensured the ability to import cheap capital goods that were effectively utilised within the industrial strategy. While Korea continued to upgrade its workforce, especially in the export sector, it was able to maintain competitiveness, internationally and against imports. The main issue of current concern in Korea in respect of FDI is the need for technology transfer. Foreign investment and a government 'technology strategy' are seen as essential to maintain competitiveness (Hong 1998). Korea appears to have an institutional capacity to implement such a policy.

Manufacturing trade and productivity

There appear to have been benefits from the Korean export promotion strategy in terms of productivity growth. Entry into foreign markets offers a number of benefits to individual firms, such as the ability to exploit economies of scale and diversify risk, increased exposure to international competition and the ability to acquire knowledge of new production methods and designs, management techniques and business opportunities. There is evidence that Korean exporting firms have availed of such benefits.

Aw *et al.* (1998) provide support for the causality running from exporting to productivity at the firm level, finding that the productivity differential between exporting and non-exporting firms continues to widen after entry into the foreign market in four out of five industries in Korea (and Taiwan). This micro-evidence provides some underpinning for macro-based studies. Feenstra *et al.* (1999) find that changes in export product variety are positively related with productivity growth for sixteen industrial two-digit sectors in Korea (and Taiwan) over the period 1975–91, whilst export volumes were positively but not significantly related. Nam (1999) finds a correlation coefficient of 0.93 between total factor productivity (TFP) growth and real export growth in nine manufacturing sectors.

Aw *et al.* (1998) also find that the productivity differentials between Korean plants according to export status are not well determined, in contrast to Taiwanese plants. One explanation for this is that government intervention in Korea has concentrated on the provision of credit at below market rates and provided implicit guarantees to encourage exporting. Results reported in Lawrence and Weinstein (1999) suggest that there is little systematic evidence that greater levels of targeting of industrial policy improved Korean productivity growth. Lawrence and Weinstein (1999) report findings that *imports* are positively related to productivity growth over the period 1968–83 in thirty-nine Korean manufacturing industries. They also find that protection is negatively related to productivity growth.

FDI and productivity

There is some evidence that liberalisation of the inward FDI regime had a positive impact on growth performance. However, compared to other countries in the region, inward investment in Korea is still relatively low as a percentage of GDP

and any impact is likely to have been limited. Further, the liberalisation of the services sector has taken place only recently and hence the evidence is preliminary.

Kim and Hwang (1998) examine the role of inward FDI in six Korean manufacturing sectors over 1974–96. They find that the growth rate of inward FDI is positively but insignificantly related to TFP growth. Hence, case study results showing positive results (Kim and Hwang 1998) cannot be confirmed in a statistically significant way. Kim and Kim (2000) argue that it is too early to give a definite answer to whether liberalisation in services has caused an increase in productivity. However, they do find some positive results that efficiency as measured by sales per employee and by establishment increased in the distribution sector over the 1990s. In particular, efficiency rose quickly in 1996, which they argue was the result of service liberalisation and large FDI inflows. After liberalisation in the mid-1990s, foreign firms were allowed to open hypermarkets, which replaced the smaller and less efficient domestic firms.

Hwang and Shin (2000) discuss liberalisation in the banking sector. While barriers to foreign commercial presence of financial services were to be gradually removed when Korea entered the OECD in 1996, the financial crisis accelerated these reforms. Cross-border trade in financial services remains restricted. Hwang and Shin (2000) conjecture that the entry of foreign banks will make domestic banks more competitive. In this context it should be noted that foreign penetration in the banking sector is low by Asian standards. As financial sector reform is one of the priorities identified by the IMF for Korea's response to the financial crisis, liberalisation will be an important issue over the next few years. There is pressure for the government to loosen its ties with business and speed the reform process – 'the slow financial reform process is acting as a bottleneck to development of the rest of the economy' (Sohn *et al.* 1998: 63).

FDI, trade and wage inequality

It would be wrong to conclude that FDI (or trade) contributes automatically to poverty reduction even if FDI raises average growth. It may well be that FDI benefits high-income workers but not low-income workers, in which case a one-for-one relationship between (FDI-caused) growth and poverty reduction would not hold. Korea is relatively abundant in unskilled labour compared to other indistrialised countries. Traditional economic models would predict that trade enables the country to specialise in unskilled labour-intensive products, thereby raising the relative demand for unskilled workers. Galhardi (1999) argues that this was not the case for Korea. She argues that whilst exporting manufacturing industries are less skill intensive than other industries over 1970–90, skill-upgrading was fastest in the exporting industries over this period to meet global competition. Overall demand for skilled workers increased sharply and was met by an active role of the government in providing the skills in order to meet the needs of the rapid growth in the exporting sectors.

Changes in underlying income inequality can only arise from changes in relative incomes from different sources, and in countries like Korea wages and salaries constitute the largest component of average incomes. Within this category,

Figure 5.1 Wage inequality (skilled relative to low-skilled workers), 1990–1.

Source: Te Velde and Morrissey (2002).

it matters how earnings of less-skilled (typically poorer) workers change relative to more skilled (typically higher paid) workers. We confine attention to changes in wage inequality, specifically between skilled and unskilled workers; for a country like Korea this should be quite representative of what is happening to inequality overall. Figure 5.1 shows trends in wage inequality for Hong Kong and Singapore, to compare with Korea. Wage inequality rose initially but then declined in Korea (where it was initially low), but remained roughly constant in Singapore and Hong Kong (where it was relatively high initially).

Wage inequality between skilled and low-skilled workers is the outcome of the interaction of supply and demand for skills and labour market institutions affecting wage-setting behaviour. Te Velde and Morrissey (2002) show that the share of skilled workers in total employment in Korea more than doubled from about 10 per cent in the early 1970s to over 25 per cent by the mid-1990s. Using marginal productivity analysis in traditional economic theory this should have reduced wage inequality, if other factors did not influence the market for skills (the supply effect in Robbins, 1996). However, there are of course various factors that may affect the demand for skills (e.g. skill-biased technology), supply of skills (e.g. education) and wage setting factors (e.g. unionisation trends), which may ultimately affect wage inequality.

There are various ways in which FDI can affect the market for skills, and hence relative wages. *First*, the effects of FDI comprise a composition effect (foreign firms may have different skill intensities from domestic firms) pushing up the average skill intensity. *Second*, FDI could induce faster productivity growth of skilled and/or low-skilled labour in domestic firms (spill-over effect). *Third*, the approach includes a potential sector bias of FDI, if FDI causes a relative expansion of skill intensive sectors, leading to a higher relative wages for skills. *Fourth*, FDI may affect the relative bargaining position of skilled workers, who may be able to negotiate higher wages in foreign-owned firms less familiar with the local labour market. *Final*, FDI may affect the supply of skills through training and contributions to general education.

Te Velde and Morrissey (2002) include Korea in the panel of five East Asian countries (including Singapore, Hong Kong, Thailand and Philippines) for which they estimate determinates of relative and skill-specific wages over the period 1985–98. They find that a 1 per cent increase in the employment of relatively skilled labour reduces wage inequality by 2.8 per cent (the elasticity of substitution can be estimated at $(-1/-0.35) = 2.8$). However, independent from the substitution effect there has been an 'exogenous' increase in the relative wage. The average trend indicates that there is an average increase of 2.3 per cent per annum in relative wages in the East Asia sample countries. After accounting for the trade ratio, unionisation rate and relative unemployment of skilled workers, FDI had no effect on wage inequality in Korea. They also found that an increase in the trade ratio is significantly correlated with relative wages, especially in Korea. This is consistent with Galhardi (1999) who argued that intra-sectoral skill upgrading in Korea more than off-set the impact of specialising in less-skilled sectors over the period 1970–90. However, we should bear in mind that the trade ratio (exports and imports of goods and services as percentage of GDP) declined sharply after 1987 due to a loss of competitiveness after high wage rises and recovered only by the mid-1990s. According to the regression results this should have helped to reduce wage inequality in the late 1980s and early 1990s. Te Velde and Morrissey (2002) also estimate individual wage curves for skilled and low-skilled workers jointly. FDI raised wages in all five East Asian countries significantly, regardless of skill level. The main exception to an otherwise predominantly neutral relationship between FDI and wage inequality was Thailand, where FDI can explain an important part of the increase in wage inequality.

Conclusions

Poverty and equity in Korea suffered a major setback as a result of the financial crisis (Moon 1999). Much of what had been gained through the 1990s was lost in the single quarter (from Q4 1997 to Q1 1998). Employment declined in all sectors except agriculture, unemployment increased dramatically from 2.8 per cent in 1997 to 6.8 per cent in 1998, with less educated and unskilled suffering more severely. Nominal wages declined, but most severely for less skilled workers, so that wage inequality rose. The strong rise in unemployment and decline in real wages, especially among the low-income and less skilled groups caused a rapid increase in the number of households living in absolute poverty (Table 5.4). Income inequality also increased. Given Korea's strong performance prior to the crisis, and the relatively speedy economic recovery since 1999, this is likely to be a temporary upset. Nevertheless, it may take a few years to bring poverty back down to the low levels of the mid-1990s.

Korea began with a strong performing economy and stable macroeconomic management, only to be hit by the Financial Crisis in late 1997. The underlying strength of the economy may be one reason why Korea was able to recover from the adverse impact of the crisis relatively quickly. The effect of the crisis was to cause a large reduction in imports while labour productivity helped exports to bounce back quickly so that the country experienced a trade surplus in the late

Table 5.4 Poverty, inequality after the financial crisis in Korea

	1997		1998	
	Q3	Q4	Q1	Q2
Absolute poverty (head count rate) – urban workers	2.4	3.0	6.4	7.1
Mean income of all households (000 won)	2,421	2,218	2,232	2,094
Gini coefficient	28.73	28.14	32.22	32.83
Income share of top 20%/bottom 20%	4.49	4.32	5.52	5.49

Source: Moon 1999.

1990s. Korean liberalisation in the 1990s could be considered as marginal, in the sense that it was continuing a process of import liberalisation. Korea had established export promotion policies, liberalised sectors (excepting parts of agriculture in respect of imports), flexible factor markets (albeit with distortions in the financial sector) and relatively developed infrastructure and institutions. Trade liberalisation was not a significant policy reform in the 1990s.

In countries such as Korea where the manufacturing sector is developed, the interaction of trade and labour markets is a major determinant of performance, especially in terms of the distribution of earnings. Trade liberalisation provides opportunities to exporters but exposes firms competing with imports to increased competition. Labour market flexibility allows workers to move more easily between sectors, facilitating the response of the economy. Wage flexibility may also be a factor influencing the ability of specific sectors to increase their competitiveness; where firms have been able to increase labour productivity they have become more competitive and maintained real wages. This appears to have been important in Korea.

Wage inequality has tended to decline in Korea since the late 1980s (notably since 1987). However, FDI cannot explain this as inflows of FDI have been small and regression analysis indicates that FDI tends to increase wages of skilled and unskilled workers in Korea equally. Our analysis also shows that the trade ratio is positively related to skill upgrading and wage inequality in Korea. The trade ratio increased over most of the period 1970–90, and this should have raised wage inequality in the absence of significant education and training activities. As the trade ratio dropped in the late 1980s and recovered only by the mid-1990s, this may have reinforced the reduction in wage inequality after 1987 as a result of union activity.

Despite a severe economic downturn after the financial crisis in 1997, Korea did not move towards protectionist measures. Instead, Korea liberalised its foreign investment regime further, particular in the services sector, with active promotion of FDI. An active domestic policy of skill-upgrading has prevented trade liberalisation from encouraging a growing income differential between skills. While poverty and inequality indicators improved at least until the mid-1990s, Korea suffered major setback in poverty levels and income distribution towards the late 1990s because of the financial crisis.

6 Growth, employment and equity

The Malaysian experience

Prema-chandra Athukorala

Equitable distribution of gains from rapid growth has been a well-known feature of economic transformation in the newly industrialized economies (NIEs) in East Asia – Hong Kong, South Korea, Taiwan and Singapore. Mainstream economists interpret this achievement as an intrinsic feature of export-led industrialisation, which, given the right policies, can be replicated in other developing countries. The argument is that as the comparative advantage of developing countries in international production is in relatively labour-intensive production, the expansion of manufactured exports translates into higher employment. As labour is the most widely distributed factor of production in the economy, employment expansion and the subsequent increase in real wages reduce poverty and income inequality (Fei *et al.* 1979; Balassa 1989; Krueger 1997; Little 1999).

Revisionist (structuralist) economists, however, doubt whether the NIC experience can be replicated in other developing countries (Helleiner 1994; Hoeven 1996). These economists argue that 'growth with equity' was brought about largely by favourable initial conditions of these countries and highly accommodating world markets at the formative stage of their economic transformations. Initially, the NIEs had higher educational standards, more even distribution of income, and broader-based wealth ownership than other developing countries, which helped establish a virtuous circle of high growth and low inequality. As well, the rapidly expanding markets in developed countries in the 1960s and early 1970s facilitated rapid expansion of labour-intensive manufactured exports without requiring real-wage restraint. If the NIEs firms were forced to operate in a depressed world market (such as the period since the mid-1970s), so the revisionist argue, they would have been obliged to cut costs rather than to raise prices, leading to real wage stagnation and a massive shift of income from labour to capital (Amsden and Van Der Hoeven 1996).

This chapter seeks to shed light on this debate by examining the case of Malaysia, a country which embraced an export-led industrialisation in about one-and-a-half decades after the NIEs. Malaysia's initial conditions and structural characteristics had more in common with the many other developing countries than with the NIEs. The Malaysian experience is particularly relevant for the current debate on how to 'manage' economic development in the context of a socio-economic setting polarised by ethnicity.

Initial conditions and policy trends

The prognoses of development prospects for Malaysia (then the Federation of Malaya)[1] at the time of transition to independence in 1957 were at best mixed. On the positive side, Malaysia's per capita income was on a par with Hong Kong and Taiwan and higher than other countries in East Asia except Japan.[2] Although the rate of population increase was already rapid, the highly favourable ratio of land and other natural resources to total population offered great potential to raise income per head. The colonial inheritance included well-developed infrastructure, an efficient administrative mechanism and a thriving primary export sector with considerable potential for expansion.

The mobilisation of this developmental potential for building the new independent Malaysian economy had to be done under conflicting challenges posed by a plural society inherited from the colonial past. At the time, the native Malays accounted for 52 per cent of the population dominated politics, but were relatively poor, and involved mostly in low-productive agricultural activities. The ethnic Chinese (37 per cent of the population) enjoyed greater economic power and dominated most of the modern-sector activities, but they did not match the ethnic solidarity or political power of the Malay. While ethnic divisions weakened the national fabric, the machinery of government was fragile and the democratic political leadership remained untested. In this context, there was little room for optimism regarding the development policies that might be expected from the newly elected government (World Bank 1955). All in all, challenges of development for Malaysia were generally considered more problematic compared to a number of other countries newly emerged from the colonial era – in particular India, Pakistan, Ghana, Kenya and Burma.[3]

As in many other developing countries, industrialisation through import substitution was a key emphasis of the Malaysian development strategy in the 1950s and the 1960s (Alavi 1996). But Malaysian policy makers, unlike their counterparts in other countries, never resorted to non-tariff protection and direct government involvement in manufacturing through setting up of public-sector enterprises as a means of 'promoting' industrialisation. Moderate tariff protection was by and large the key instrument used in encouraging new investment in manufacturing. Tariff protection to domestic manufacturing in Malaysia has also been low relative to other developing countries (Power 1971). The role of the government was by and large limited to the provision of conventional public services and implementation of rural development schemes. As already noted, unlike in most other developing countries, there was no direct government involvement in manufacturing though the establishment of SOEs.

Economic expansion during the 1950s and the 1960s, although respectable, failed to make a substantial contribution towards solving the 'special' problems of the Malays. With urban unemployment rising and education and language again looming as issues, non-Malays began to question the extent to which their interests were being safeguarded in the new Malaysia. The disenchantment growing among all segments of the population ultimately erupted in the bloody communal

riots on 13 May 1969. This event gave birth to a weeping affirmative action policy, the New Economic Policy (NEP), which came into effect in 1970 (later modified and renamed National Development Policy, NDP, in 1990) (Leigh 1992; Snodgrass 1995). The overriding objective of NEP was to maintain national unity through the pursuance of two objectives: eradication of poverty among the entire population and restructuring of the Malaysian society so that the identification of race with economic function and geographical location is reduced.

There was a heavy emphasis on the promotion of heavy industries through direct government involvement in the first half of the 1980s, as part of the 'look East' policy of Dr Mahathir who became Prime Minister in 1981 (Chee 1994). The Heavy Industries Corporation of Malaysia (HICOM), a public-sector holding company, was formed in 1980 to go into partnership with foreign companies to set up industries in areas such as petrochemicals; iron and steel; cement; paper and paper products; machinery and equipment; general engineering; transport equipment; and building materials. The symbol of the selective industrial policy was the Proton (the Malaysian national car) project, which was set up by HICOM in collaboration with the Mitsubishi Corporation in Japan. By 1987, there were 867 corporate public enterprises in Malaysia, more than a third of which were in manufacturing. Tariffs on a wide range of manufactured goods were increased in the first half of 1980s as part of the move towards heavy-industrialisation.[4]

The economic crisis during 1985–7, which was originated in a combination of budget deficits caused by the heavy industrialisation move and adverse trends in prices of Malaysia's major export products (Corden 1996), put an end to the push towards state-led heavy industrialisation. The crisis management policy package placed greater emphasis on the role of the private sector and strengthening the conditions for export-oriented industrialisation through greater participation of FDI.

The structural adjustment reform package introduced in response to the crisis involved a gradual process of privatisation and restructuring of state-owned enterprises. By the early 1990s state-ownership in manufacturing was limited only to some politically sensitive ventures in automobile manufacturing (the Proton project), petrochemical, iron and steel and cement industries (Kanapathy 2000). The Promotion of Investment Act of 1986 introduced fresh, more generous incentives for private investors, and some of the ethnic requirements on company ownership of the NEP were relaxed. The reforms after the mid-1980s also involved significant tariff reductions and removal of quantitative import restrictions. The percentage of imports (in value terms) subject to direct import licensing had declined to a mere 3 per cent by 1996 (Athukorala 2002). This limited reliance on non-tariff protection meant that the domestic price signals were not insulated from world market conditions and that there was no significant direct government involvement in the private-sector performance through import quotas.

In the early 1990s, Prime Minister Mahathir came up with a policy blueprint (the Vision 2020 Statement) for transforming Malaysia to a developed-country status by the year 2020.[5] Most of these proposals – in particular those relating to the provision of infrastructure, maintaining macroeconomic stability, human capital

development and commitment to a more equitable distribution of the fruits of economic growth – simply reconfirm the long-standing commitment of the Malaysian government to good governance. The new policy also introduced a plethora of new incentives geared to industrial upgrading and strengthening domestic linkages of the manufacturing sectors, which opened up new opportunities for policy-maker desecration. However, the long-standing commitment to private-sector oriented growth in the context of an open trade and investment regime continued to remain the basic tenet of Malaysia's national development strategy.

Some elements of the NEP, as it was introduced in 1971, ran counter to the country's commitment to attracting FDI. These included the requirement to increase the share of Bumiputra in the corporate sector, to reserve certain percentage of employment in foreign ventures for these people, and a ceiling of 70 : 30 on Malaysian–foreign equity ownership. But the government subsequently took initiatives to ameliorate the adverse impact of these strictures on export-oriented FDI. For instance, as part of the policy package formulated in response to the mid-1980s crisis, 100 per cent foreign ownership was allowed in firms exporting 80 per cent or more of their output. As already noted, transferring a progressively large share of foreign-owned plantation companies to the nationals was a declared government policy. However, the government always adhered strictly to the practice of transferring ownership through formal share trading rather than through arbitrary expropriation. Moreover the resource cost of direct redistribution policies of NEP (and subsequently NDP) was not a major drag on growth because the government continued to maintain an outward-oriented overall policy stance. Given that the trade and foreign investment regimes continued to remain open, and the government by and large continued to maintain its firm commitment to basic rules of 'good governance' (in particular, maintaining macroeconomic stability, infrastructure development, and preserving private property rites) there was ample room for the private sector to expand through greater integration in the global economy.

Liberal trade and investment policies in Malaysia have been appropriately backed by a firm commitment to maintaining labour market flexibility, giving priority to job creations rather than 'protecting' the rights of those who are already employed. From the early stage of promoting export-oriented FDI in the early 1970s, the government took legislative measures to restrict and regulate trade union activities. In 1974, when the global electronics companies started establishing assembly plants in Malaysia, apparently the government reached an understanding with foreign electronics companies not to allow unionisation of workers. In 1976, when the Electrical Industry Workers Union attempted to enrol workers employed in the electrical and electronics industries, the registrar of trade unions ruled that the electrical and electronics industries were not similar and hence it was unlawful for the electronics workers to join the union. Attempts by electronics workers to form a union of their own under the umbrella of the Malaysian Trade Union Congress (MTUC) was repeatedly rejected by the government until 1988 when the formation of in-house unions (limited to individual pants rather than a national union) was permitted. In the textile and

garment industry, the government also prevented the formation of a national union combining state and regional unions (Crouch 1996: 225).[6] The Industrial Relations Act was amended in 1977 to set the framework for maintaining strong government control over the conduct of collective bargaining. Legislation enacted in 1988 changed rules of collective bargaining with a view to expediting dispute settlement and to minimise the possible dominance of the interests of unions over those of workers in the bargaining process. Under the Wage Council Act of 1947 the Minister of Labour has the power to lay down minimum wages (and other conditions of employment) through the setting up of National Wage Councils in trades or industries with a view to providing protection for certain categories of workers in the absence of effective collective bargaining or other mechanism to protect their rights. However, this legislation has hardly been used over the past four decades. By the mid-1990s, the total number of workers covered by minimum wage legislation amounted to a little over 200,000 (2 per cent of total employment in the country) and in most cases minimum wages, being well below actual (market determined) wages, had little impact on labour-market behaviour.

Given government legislation that continuously hobbled trade unions and collective bargaining, limited coverage of collective bargaining, and the absence of minimum wages, conditions of labour in Malaysia are determined by and large unilaterally by employers within the confines of the existing labour legislation. This does not, however, mean that workers in Malaysia have been marginalised in the process of distribution of gains from economic expansion. On the contrary, Malaysia has had a surprisingly good, orderly system of industrial relations for providing social benefits and services such as pension, unemployment compensation and disability insurance. The system, which originated in the colonial era, has been further expanded and consolidated throughout the post-independence era, reflecting 'the paternal attitude of the Malay dominated governments towards the predominantly Malay industrial labour force' (Galenson 1992: 115). This elaborate system of industrial relations and worker welfare provision has certainly ensured orderly labour relations and industrial peace.

Despite some instances of policy slippage, by and large Malaysia's macroeconomic policy has been sound throughout, supporting growth and structural transition in the real sectors. Budget deficits were generally kept within prudent limits while minimising the use of borrowed funds. When the overall deficits arose occasionally, they were financed from non-inflationary domestic sources, in particular private savings accumulated in the employee's provident fund (EPF). Moreover, broadening of the tax base in a booming economy, coupled with greater efficiency in tax collection, brought about rapid increase in government revenue. In particular, macroeconomic policy was remarkably sound during the recovery phase following the mid-1980 crisis and well into the mid-1990s. The Central Bank of Malaysia (Bank Negara Malaysia) has maintained an impressive track record by the developing country standards in maintaining domestic price stability and a realistic exchange rate (Athukorala 2001).

A key characteristic of government policy in Malaysia since independence has been the emphasis on infrastructure development. At the time of independence,

in 1957, Malaysia had a satisfactory supply of electric power, transport and the means of communication to support growth. During the first two decades following independence the government successfully made use of the surpluses extracted from the booming plantation and mining sectors to build on this initial endowment. Every Malaysian Plan placed a major emphasis on developing the country's infrastructure. By the early 1970s, the government was putting almost a quarter of the total annual development expenditure into infrastructure development. This figure had increased to over 35 per cent by the mid-1990s. As the influx of FDI accelerated in the late 1980s, the plans had already been laid for the expansion of required supporting services. The government also managed to alleviate bottlenecks resulting from urban congestion by setting up industrial estates and export processing zones at the state level and building a world-class road network.

Heavy investment in education has been a prominent feature of Malaysia's national development policy since the early post-independence years (Snodgrass 1980). This policy emphasis was instrumental in setting the stage for rapid employment expansion under export-led industrialisation in the subsequent decades. By the early 1990s, Malaysia had almost universal primary education, with 99 per cent of students finishing primary school, 82 per cent lower secondary school and 53 per cent upper secondary school.[7]

Policy response to the financial crisis

The Malaysian economy was shattered by the Asian currency crisis in the late 1997 financial crisis. The currency and stock market turmoil that began in July 1997 was quickly translated into an economic collapse. Unlike the other crisis countries, Malaysia succumbed to the crisis with only a little foreign debt exposure of its banking system. For this reason, the Malaysian policy makers were able to face the crisis without entering into an IMF-sponsored rescue package. However, for almost one-and-a-half years following the onset of the crisis, policy indecisiveness seriously hampered the recovery process. It was difficult for the Malaysian authorities to mobilise foreign financing for crisis management because of the market perception that Malaysia would be less committed to pursue the required reforms in the absence of an IMF programme. To make matters worse, the massive private sector domestic bank debts in the lead-up to the crisis,[8] constrained the use of the interest rate policy to support the exchange rate in face of continuing capital outflow. By mid-1998, the economy was in its worst recession during the post-independence era and there were no signs of achieving currency and share price stability.

In this volatile economic climate, the Malaysian government had to choose between two alternatives. The first was to obtain a 'good housekeeping seal' on its policies from the IMF. This would, as in Korea and Thailand, have stabilised the exchange rate and set the stage for applying the Keynesian therapy to speed up the recovery. The second option was to embark on a capital-control based macroeconomic stimulation package to insulate the domestic financial markets from short-term financial flows through capital controls. The first alternative

was not politically acceptable to the Malaysian leadership. Given the intimate links developed between business and government under the NEP programme, naturally the positive stabilising impact of any policy move had to be weighed against its potential negative effect on socio-political stability of the country. Thus, the Malaysian leadership opted for the second alternative, ending the policy uncertainty that had pervaded the policy scene for almost a year.

   The purpose of capital outflow controls in the new policy package was to make it harder for short-term portfolio investors and offshore hedge funds to drive down the currency. Thus these controls were confined to short-term capital flows only. With the exception of limits on foreign exchange for foreign travel by Malaysian citizens, there was no retreat from the country's long-standing commitment to an open trade and investment policy. Profit remittances and repatriation of capital related to FDI in the country continued to remain free of control. Moreover, some new measures were introduced to further encourage FDI participation in the economy. These included allowing 100 per cent foreign ownership of new investment made before 31 December 2000 in domestic manufacturing regardless of the degree of export orientation and increasing the foreign ownership share in the telecommunication project from 30 to 69 per cent (under the condition that the ownership share is brought down to 49 per cent after five years). Also, foreign ownership in stockbroking companies and the insurance sector increased from a previous uniform level of 30 to 49 and 51 per cent respectively. Apart from some minor tariff increases introduced by the 1998 Budget speech, the Malaysian authorities by and large avoided the use of import restrictions to cushioning local producers in the wake of the crisis.[9]

Growth and structural change

Annual growth in the Malaysian economy during 1965–2000 averaged 5.5 per cent, indeed a respectable figure by global standards. The performance record was, however, rather uneven during the first two decades of this period, reflecting the impact of primary commodity cycles and changes in government expenditure. Thanks to windfall gains from the newfound oil reserves and boom in world prices of tin, rubber and palm oil, growth of real GDP averaged about 6.5 per cent per annum during the 1970s. But in the 1980s, difficulties emerged with the decline in oil and commodity prices, and aggravating budgetary imbalances resulting from the heavy industrialisation move (discussed below). Consequently, during 1985–6 Malaysia plunged into the first economic crisis in the post-independence era. The economy contracted by 1.1 per cent in 1985 and took two more years to regain the pre-crisis output level (Figure 6.1). Following the far-reaching structural adjustment reforms undertaken in response to the crisis, the Malaysian economy entered a period of unprecedented growth in 1988. The Malaysian economy expanded at an annual average rate of over 8 per cent during the ensuing years up to the onset of the financial crisis in 1997. Per capita GNP increased from US$ 1,850 to US$ 4,400 during this nine-year period.

Figure 6.1 Malaysia: growth (1965–2000)* and unemployment (1979–2000) (%).

Source: Based on data compiled from Ministry of Finance, *Economic Survey*, Kuala Lumpur (various issues).

Notes
* Period-average growth rates:
1961–84   6.7
1986–97   9.0
1961–2000   6.2

    The financial crisis that started in mid-1997 severely disrupted the Malaysian economy and in 1998 real GDP contracted by a staggering 7.5 per cent, the worst recession during the post-independence era (Figure 6.1). But, the economy began to recover from about the second quarter of 1999 and regained the pre-crisis growth momentum by 2000.[10] As we will see below, given the remarkable agility shown by the manufacturing sector and labour market flexibility, Malaysia was able to withstand the crisis with little adverse impact on employment and living standards.

    In the 1970s and early 1980s, the economic expansion in Malaysia was predominantly accounted for by primary sectors (Table 6.1). Malaysia's achievements during this period included reaching agricultural food self-sufficiency by the mid-1970s, maintaining its supremacy in the world natural rubber market by a remarkable improvement in efficiency of production through a replanting scheme, and reduction in the vulnerability of the plantation sector to vagaries of the world rubber prices by successful diversification into palm oil and cocoa. From the late 1980s, much of the growth has come from the expansion of manufacturing. Between 1987 and 1997, the manufacturing sector grew at an average

Table 6.1 Sectoral growth performance, Malaysia, 1970–2000

(a) Composition (%)	1970	1975	1980	1985	1990	1997	2000
Agriculture	28.5	26.9	22.9	20.8	18.7	12.6	8.8
Industry	32.3	32.6	35.8	36.7	42.2	41.3	46.3
Manufacturing	15.8	17.3	19.6	19.5	26.9	34.2	32.6
Services	33.5	40.5	41.3	42.6	39.1	38.9	44.9
GDP	100	100	100	100	100	100	100

(b) Average annual growth (%)	1970–5	1975–80	1980–5	1985–90	1990–7	1997–2000
Agriculture	9.5	5.1	3.1	4.6	2.4	−0.9
Industry	6.7	10.7	5.7	9.8	12.8	2.1
Manufacturing	6.7	11.4	5.3	13.7	13.2	5.7
Services	12.2	13.9	5.8	5.1	10.2	1.5
GDP	10.6	8.5	5.2	6.8	8.1	2

(c) Contribution to output increment (%)	1970–5	1975–80	1980–5	1985–90	1990–7	1997–2000
Agriculture	10.1	21.1	31.2	13.4	−2	1.5
Industry	35.8	37.2	32.2	46.2	48.5	68.9
Manufacturing	33.1	20.6	20	35.7	38.4	83.4
Services	114.1	41.7	36.2	30.2	48.5	29.7
GDP	100	100	100	100	100	100

Source: Ministry of Finance Malaysia, *Economic Report* (various issues).

Note
Output shares and growth rates are based on constant (1978) prices. Growth rates are annual averages between the reported years.

annual rate of 14 per cent, almost double the rate of expansion achieved in the previous ten years. The share of manufacturing in GDP increased from about 20 to over 34 per cent during this period, contributing to over 50 per cent of the increment in GDP. In addition, much of the output expansion in the tertiary (service) sectors in recent years has been closely related to the expansion of the manufacturing sector. The share of the agriculture in GDP declined from over 20 per cent in the mid-1980s to less than 9 per cent by the turn of the century, when the economy started to face severe labour shortages.

   With rapid industrialisation, the Malaysian economy has become increasingly urbanised. The percentage of population living in urban areas increased from 34 per cent in 1980 to 51 per cent in 1990 and, then to 61.8 per cent in 2000 (Government of Malaysia 1996 and 2001). Unlike in many other middle-income countries outside the East Asian region, the rate of urbanisation has continuously been matched by the rate of expansion in urban activities. Consequently, as we will see below, rapid urbanisation has been accompanied by a reduction (*not* an increase) in the incidence of urban unemployment and poverty. Also, rural–urban migration has not reached alarming levels in Malaysia partly because the emphasis on industrialisation never involved a compromise on the long-standing commitment to agricultural and rural development.

As in the other high-performing East Asian countries (HPAEs),[11] Malaysia's economic transformation was underpinned by rapid export orientation. The 'export coefficient' (total merchandise exports as a percentage of GDP) increased from about 50 per cent in the mid-1980s to over 90 per cent by the mid-1990s.[12] The ratio of exports to total production (gross output) in manufacturing increased from around 10 per cent in the early 1970s to over 70 per cent by the mid-1990s. The share accounted for by export-oriented product sectors in total manufacturing output (value added) increased persistently from 10 per cent in the mid-1970s to over 55 per cent by the turn of the century.

The sectoral composition of manufacturing output has been greatly influenced by growth of exports. In the early 1970s, the share of manufactures in total merchandise exports was about 10 per cent (Table 6.2). Since then, manufactured goods have emerged as the most dynamic element in the export structure. By the mid-1990s, with manufacturing accounting for 80 per cent share in total exports, Malaysia had become the sixth largest exporter of manufactured goods in the developing world, after the four NIEs of East Asia and China (WTO 2001b).

Up to the mid-1980s, resource-based products such as processed food, wood products and basic metals dominated the composition of manufactured exports from Malaysia (Table 6.2). The transformation of the export structure in line with emerging patterns of the international division of labour gathered momentum from the mid-1980s. At first, Malaysia's market niches were in simple assembly operations in electronics and electrical goods, and standard light manufactures such as clothing, footwear and rubber goods. From about the mid-1990s the export composition began to diversify into mature technology final products such as radios, TVs, cameras and computers. But, by the turn of the century, semiconductors and other electronics components still accounted for over 45 per cent of total merchandise exports. Most of these 'products' consist of simple assembly operations, although some electronics firms have entered into higher value added fabrication and design activities. The share of electrical appliances increased from 2 per cent in the early 1980s to around 20 per cent by the late 1990s, but even this category is composed largely of labour-intensive component assembly, rather than end products.

Foreign direct investment has played a pivotal role in export-led industrialisation in Malaysia. The entry of FDI into export-oriented production, particularly electronics assembly, began with the establishment of Free Trade Zones in the early 1970s. This process intensified from the late 1980s reflecting the combined impact of both supply and demand factors for global production. On the supply side liberalisation reforms in Malaysia made the country increasingly attractive as a location for export-oriented production. On the demand side mounting cost pressure in Japan, Taiwan and Korea due to wage increase and exchange rate adjustment following the Plaza accord in 1986 acted as a strong push factor for relocation of labour-intensive production from these countries to Malaysia (Athukorala and Menon 1999).

Foreign firms accounted for over 45 per cent of total manufacturing value added and they accounted for over three-quarters of total manufactured exports by the mid-1990s (Athukorala 1998). There is a close association between the degree of foreign presence in product sectors and their relative contribution to

Table 6.2 Composition of merchandise exports (%), Malaysia, 1970–2000

	1970	1975	1980	1985	1990	1995	2000
Primary products	77.9	70.7	72.4	61.5	36.3	16.7	11.8
of which:							
Rubber	34.4	21.9	16.4	7.6	3.8	2.2	0.7
Palm oil	5.3	14.3	9.2	10.4	5.5	4.5	2.4
Tin	20.2	13.1	8.9	4.3	1.1	0.3	0.1
Crude oil	4.0	9.3	23.8	22.9	13.4	3.6	3.8
Liquefied natural gas	—	—	—	6.0	3.3	1.7	3.0
Manufactured goods	9.1	21.9	22.4	32.8	58.8	79.6	85.2
Food, beverages and tobacco	2.3	1.0	0.9	1.6	2.4	3.1	1.1
Textiles, clothing and footwear	0.6	2.4	2.9	3.4	4.9	3.5	2.8
Wood product	1.8	2.2	1.7	1.0	1.7	2.7	1.8
Rubber products	0.3	0.5	0.3	0.3	1.7	1.8	1.3
Paper and paper products	0.1	0.1	0.1	0.2	0.5	0.4	0.4
Petroleum products	3.2	1.1	0.7	2.7	1.6	1.7	2.2
Chemicals and chemical products	0.7	0.9	0.7	1.6	1.8	3.4	4.0
Non-metallic mineral products	0.4	0.2	0.2	0.4	1.0	0.9	0.7
Metal products	0.7	0.7	0.9	0.9	2.0	2.5	2.3
Electronics and electrical products	1.0	5.5	10.7	17.1	33.3	52.3	61.7
Semiconductors	—	—	8.1	11.7	14.7	17.9	19.0
Electronic equipment and parts	—	—	0.7	1.2	4.6	12.7	25.6
Electrical machinery and appliances	—	—	1.9	4.2	14.0	21.6	17.0
Transport equipment	0.7	0.7	0.8	1.5	2.4	2.8	0.8
Optical and scientific equipment	0.1	3.6	0.4	0.6	1.3	1.6	1.8
Toys and sport goods	—	0.2	0.2	0.4	1.2	1.2	0.9
Furniture and parts	—	—	—	—	0.6	1.2	1.6
Unclassified goods	13.0	7.5	5.2	5.7	4.9	3.7	3.1
Total merchandise exports (%)	100.0	100.0	100.0	100.0	100.0	100.0	100.0
US$ million	1,630	3,570	12,704	15,752	29,520	72,815	98,239

Source: Bank Negara Malaysia, *Monthly Bulletin of Statistics*, Kuala Lumpur (various issues).

Note
— Data not available.

total manufactured exports. The electronic industry (which is almost completely foreign owned) alone contributed to over 65 per cent of total non-oil exports in 1995. Malaysia's efforts in attracting FDI in the electronics industry from the early 1970s were so successful that from the late 1980s it has been the largest

developing-country exporter (and one of the world's major exporters) of electronic components, particularly integrated circuits.

Employment, real wages and equity

At the time of independence, the Malaysian economy showed less resemblance to a labour surplus economy (Athukorala and Manning 1999). Most Malay peasants operated small family farms and faced difficulties in expanding into larger commercial units owing to labour shortages. While there was evidence of under-utilised labour on a seasonal basis in food crop production, returns to labour were high by regional standards and under-employment was not a major factor contributing to low incomes and productivity. A growing informal sector already existed in larger towns and cities, but there was little sign of chronic labour surplus.

It was only by about the late 1960s that Malaysia began to face a structural problem of excess labour supply (Snodgrass 1976). Both labour demand and supply factors were at play. On the supply side, Malaysia, like several other countries in East Asia, began to experience a labour force 'explosion' as a result of rapid population growth from around this time. Population growth had accelerated to over 3 per cent per annum by the mid-1950s, after more than a decade of slow expansion. Labour force growth followed suit, accelerating to over 3 per cent by the mid-1960s.

On the demand side, the plantation sector, which was the backbone of the economy at the time, was predominantly based on indentured labour from China and India. It played a minor role in absorbing native Malays entering the labour force because they were unwilling to take socially 'inferior' wage work. Thus the country faced the dilemma of a large non-indigenous labour force working alongside a swelling labour force of Malays. In non-plantation agriculture, there were major constraints to finding enough new jobs. The smallholder rubber industry was no longer expanding, and productivity improvement could only be supported through labour-displacing technical change (Barlow and Jayasuriya 1987). Structural change in estate agriculture was underway, but largely through extension of the more capital-intensive oil palm industry. There were also signs of surplus 'under-utilised' labour in rice agriculture, as this industry expanded slowly and only with considerable government support. Thus, whereas a significant share of employment had been absorbed in agriculture (mainly into rubber) through to the early 1960s, this sector's share of jobs fell steeply to around only 20 per cent from 1962 to 1967 (Snodgrass 1996: 283–90). Growth in the number of unemployed was high – in absolute terms it was only slightly smaller than the (net) number of people who found new jobs in agriculture in the same period. Moreover, the spread of primary and increasingly secondary education to young rural women, in particular, had also begun to fuel search for urban wage employment on a scale never experienced in the past.[13] Thus, increasing numbers of rural Malays were seeking work in cities such as Kuala Lumpur, in response to shortages of jobs (or an aversion to less-preferred jobs in agriculture) in their native villages.

The industries set up under tariff protection in the 1950s and 1960s were characterised by a 'natural' capital intensity in line with the general experience with import-substitution industrialisation in developing countries (Alavi 1996). Thus, manufacturing absorbed a small proportion (13 per cent by the late 1960s) of the work force and the main burden of non-agricultural jobs had to be shouldered by the services industry whose expansion had been naturally constrained by the limited real-sector growth. As a result, recorded unemployment rates rose to around 8 per cent by 1970 with urban unemployment hovering around 10 per cent (Snodgrass 1980: 59). After a drop to around 5 per cent in the early 1980s, the unemployment rate continued to increase reaching a peak of 8.3 per cent in 1986 (Figure 6.1).

From the late 1980s, rapid growth was accompanied by persistent decline in the unemployment rate. By the mid-1990s the Malaysian economy was at virtual full-employment, with an unemployment rate of only 2.8 per cent.[14] Most of the new employment opportunities came from the rapidly expanding manufacturing sector (Table 6.3). The share of manufacturing in total labour deployment increased from 14 per cent in the mid-1970s to 35 per cent in 1997. The direct contribution of manufacturing to the total increment in employment between 1987 and 1997 was as high as 63 per cent. In addition, much of the output (and hence employment) expansion in the tertiary (service) sectors in recent years was closely related to the expansion of export-oriented industries.

The contribution of MNE affiliates to employment expansion has been remarkable. The percentage of workers employed in these firms increased from about 28 per cent in 1974 to 45 per cent in 1992 (Athukorala 1998, chapter 8).

Table 6.3 Employment by sector (% shares), Malaysia

	Sectoral composition (%)					
	1975	*1980*	*1985*	*1990*	*1997*	*2000*
Agriculture	43.6	40.6	31.3	29.9	16.6	18.4
Industry	20.9	22.7	23.6	24.6	37.3	41.9
Manufacturing	14.2	15.8	15.2	17.6	26.9	22.8
Services	35.5	36.7	45.1	45.5	46.0	39.7
Total	100	100	100	100	100.0	100
Total	4,376	4,817	5,622	6,682	8,060	9,318

	Contribution to employment growth				
	1976–80	*1980–5*	*1985–90*	*1990–7*	*1997–2000*
Agriculture	10.8	−24.3	22.5	−24.8	49.2
Industry	40.6	29.0	29.9	77.2	122.1
Manufacturing	31.7	11.6	30.3	56.2	−50.0
Services	48.6	95.4	47.6	47.6	−71.3
Total	100	100	100	100	100

Source: Ministry of Finance, *Economic Report* (various issues).

This increase in employment has been faster than the increase in the share of output of these firms (43–45 per cent). This suggests that with the rapid expansion of export-oriented manufacturing, the composition of manufacturing production by foreign firms has become more labour-intensive over the years. This pattern is particularly noticeable in non-metallic minerals, basic metal products, fabricated metal products and miscellaneous manufacturing. In the case of electronics, the employment and output shares have remained virtually unchanged at comparable levels, as this industry had been highly labour-intensive right from the start. The export-oriented and FDI-dominated electronics and electrical machinery sector (ISIC 383) alone accounted for over 23 per cent of total manufacturing employment by the mid-1990s.

Trends in real wages

At the formative stage of export-oriented industrialisation in the early 1970s, there was an apparent decline in manufacturing real wages in Malaysia.[15] The index of real wages (1990 = 100) in manufacturing was sixty-one during 1970–4, down from sixty-eight during 1965–9 (Figure 6.2). At the time, critics of the export-led industrialisation strategy claimed that the working class was subject to high 'disciplines' (through restrictions on labour unions) and low wages for the benefit of multinationals and local capitalists (Osman-Rani 1983; Jomo and Osman-Rani 1984; Lee 1998). This pessimistic view was, however, repudiated by subsequent developments. The observed decline in real wages was largely a reflection of the shift in the structure of production away from (capital-intensive) import substitution activities and towards (labour-intensive) export production. At the same time, growth of real wages was also naturally constrained by the excess supply of labour in the economy, particularly from rural areas.

Wages started to rise from the late 1970s, as the export-led industries rapidly gained dominance over import-substitution industries, providing an effective vent for surplus labour. The index of real wage (1990 = 100) increased from an average level of 74 in 1975–9 to 105 in 1985. Following a slowdown during the years of macroeconomic adjustment in the late 1980s, the index increased continuously reaching 140 in 1997. Following the onset of the financial crisis in 1997, the index recorded a significant decline in 1999 but regained pre-crisis level in 2000 (Figure 6.2). Overall, these wage trends suggest that, in the absence of minimum wage legislation and other related labour market rigidities (discussed below), employment increased first followed by market-driven increases in real wages.

It is interesting to note that wage growth in export-oriented manufacturing begun to persistently surpass that in domestic-oriented manufacturing especially from the early 1990s. During 1990–2000, respective compound annual growth in real wage in the two product sectors were 6.5 per cent and 4.4 per cent. Thus there is no support from the Malaysian case for the proposition that internationalisation of production leads to wage suppression in developing countries (e.g. Amsden and Van Dar Hoeven 1996).

Figure 6.2 Employment and real wages in Malaysian manufacturing, 1975–2000 (1990 = 100).

Sources: Based on data compiled from: Department of Statistics, Malaysia, Malaysia, *Monthly Manufacturing Statistics* – output, employment and wages for the period 1976–2000; and Ministry of Finance, Malaysia, *Economic Report* – the consumer price index.

Note
* Nominal wage deflated by the consumer price index.

Poverty and income distribution

Right from the start, the problem of poverty was a major concern of the Malaysian policy makers as it had a delicate ethnic and a regional dimension. In 1957/8, 34.9 per cent of households had incomes of less than RM 120 per month (the official cut-off point for measuring poverty). More than half of these households were Malays, and more than two-thirds were rural (Snodgrass 1980). Rural development programmes in the 1960s brought about some improvement in education, public health services and other amenities (Anand 1983). The impacts of these programmes in reducing poverty and income inequalities were, however, limited, to say the least. According to a socio-economic survey conducted in 1967/8, while the percentage of households with incomes below RM 120 had decreased by 0.2 per cent, the total number of households receiving incomes less than this limit had increased substantially. The ethnic and rural–urban distribution of poverty and income inequality had hardly changed over the period. According to the post enumeration survey of 1970, 78 per cent of poor households were Malay. Mean household income among the Malay community was RM 41 per month, compared with RM 79 per month for Indians and

RM 86 per month for Chinese.[16] Poverty continued to remain very much a rural problem; 88 per cent of poor households were rural, and almost 60 per cent of rural households were poor.

Over the past two decades, particularly from the late 1980s, growing opportunities for non-agricultural work, particularly in the rapidly expanding export-oriented manufacturing industries has acted as an even more powerful factor. The demand for unskilled labour created by the process of export-led industrialisation has been so great that it is now a scarce factor with a rising price (real wage rate). A rise in both new employment opportunities and real wages have become powerful forces in alleviating poverty and improving living standards. In addition, the increase in the number of two-income households has contributed to the increase in total household income. This was underpinned by the increasing importance of women in the work force.[17] Again, much of this increase is due to the demand for low-skilled labour generated by the rapid expansion of labour-intensive export-oriented manufacturing activities.

According to official estimates, the incidence of poverty among all households (as measured by the so-called head-count measure (the percentage of population below the poverty line) fell from 18.4 per cent in 1984 to 9.6 per cent in 1995; and to 6.0 by 1999 (Table 6.4). A significant decline in the incidence of poverty is observable for both urban and rural households, even though the incidence of poverty is still high in rural areas. The patterns reflected in the official estimates have by and large been corroborated by various independent estimates (Bhalla and Kharas 1992; Snodgrass 1995; Pramanik 2000). The available state-level estimates point to a decline in poverty across all states, but the poverty incidence still (as of 1997) remain well above the national average in predominantly rural states such Kehad (12.2 per cent), Kelentan (19.2 per cent), Terengganu (23.4 per cent), Sabah (16.5 per cent) and Perlis (11.8 per cent) (Pramanik 2000).

This impressive record of poverty reduction has gone hand in hand with improvement in quality of life in terms of various indicators. The literacy rate increased from about 30 per cent in the late 1950s to 90 per cent by the turn of the century. In 2000, life expectancy was 70 (up from 40 in the late 1950s), which was only six years behind the average for the developed countries. According to the Human Development Index (HDI) of the United Nations – a composite index of literacy, infant mortality and life expectancy – Malaysia ranked fourth (after Saudi Arabia, South Korea and Mauritius) in the world in terms of an improvement in living standards between 1970 and 1998 (UN 2001).

While less impressive than its record in reducing absolute poverty, Malaysia also has been successful (by the standard of developing countries at the same stage of economic development) in addressing inequality in the size distribution of income. Between 1970 and 1990, the Gini coefficient fell from 0.513 to 0.445 (Table 6.5). During the same period the income share of the bottom 40 per cent increased from 11.5 to 14.3 per cent and that of the top 20 per cent declined from 55.7 to 50.4 per cent between these two years (Shari 2000: 116). The trend towards greater income equality observed during the 1970s and 1980s seems to have dissipated somewhere in the recent rapid growth phase, although as yet there is no clear indication of reversal in the trend.

Table 6.4 Incidence of poverty and hardcore poverty in Malaysia

	1970#	1984	1990	1993	1995	1997	1999
Poverty							
Rural	58.6	24.7	21.8	18.6	14.9	10.9	12.4
Urban	25.5	8.2	7.5	5.3	3.6	2.1	3.4
Total	49.3	18.4	17.1	13.6	8.7	6.1	7.5
*Hardcore poverty**							
Rural	44.6	8.7	5.2	4.3	3.6	2.5	2.4
Urban	44.6	8.7	1.4	1.3	0.9	0.4	0.5
Total	—	6.3	4.0	3.0	2.1	1.4	1.4

Sources: Anand 1983; Malaysia, Ministry of Finance, *Economic Survey 1998*, Kuala Lumpur; Malaysia Economic Planning Agency 2001, *Eighth Malaysia Plan 2001–2005*, Kuala Lumpur.

Notes
Refers to Peninsular Malaysia only.
* The cut-off income level for the determination of hardcore poverty is set at half of that used in defining poverty (which varies from year to year; refer to source documents listed above).

Table 6.5 Household income by strata and the Gini coefficient, Malaysia, 1970–99

	1970	1979	1987	1990	1995	1999
Top 20%	55.7	55.7	51.2	50.4	—	—
Middle 20%	32.9	32.4	35	35.3	—	—
Bottom 40%	11.5	11.9	13.8	14.3	—	—
Gini coefficient	0.513	0.508	0.456	0.445	0.456	0.443

Sources: Shari 2000, table 4 and Government of Malaysia 2001, table 3.4.

This recent Malaysian experience with income distribution is in sharp contrast to the experiences of Korea and Taiwan where a decline in absolute poverty under the export-led industrialisation went hand in hand with both greater equality in the size distribution of income and decline in urban–rural income differentials (Little 1999). This could be due to the influx of migrant workers in Malaysia (Shari 2000: 121). As the inflow of unskilled migrant workers has continued, the rapid export-led industrialisation seems to have failed (unlike in Korea and Taiwan) to generate rising wages for local unskilled workers who predominantly come from low-income families. In other words, migrant workers seem to have blunted the income equalising role of wage growth in Malaysia.

The recent trends in urban–rural distribution of income and the distribution by ethnic groups are strikingly similar to those of the size distribution of income (Table 6.6). The continuous narrowing of urban–rural income equality and income equality by ethnicity observed from the late 1970s up to the early 1990s seems to have recorded a mild reversal thereafter. The 'migrant labour' explanation in the above paragraph is relevant for explaining recent patterns in income distribution by ethnicity; native unskilled workers come predominantly from the

Table 6.6 Urban–rural and inter-ethnic group income disparity ratios, Malaysia, 1970–99[*]

	1970	1980	1990	1993	1995	1999
Urban–Rural	2.14	1.77	1.7	1.75	1.95	1.81
Chinese–Bumiputra	2.29	1.9	1.74	1.78	1.80	1.74
Indian–Bumiputra	1.77	1.29	1.29	1.29	1.33	1.36
Chinese–Indian	1.29	1.47	1.35	1.38	1.35	1.28

Sources: Shari 2000, table 4 and Government of Malaysia 2001, table 3.4.

Note

[*] Disparity ratios are calculated using monthly gross household income.

Bumiputera community. The recent widening of rural–urban income disparity is consistent with the fact that in recent years the agricultural sector, the mainstay of the rural economy, has lagged behind other sectors in productivity improvement (Shari 2000: 122).

Inferences and lessons

Malaysia has come a long way along the development path since gaining independence in 1957. While Malaysia's economic performance has been impressive by developing-country standards throughout the post-independence period, the achievements have been remarkably since the late 1980s when there was a decisive policy shift towards greater outward orientation. Sustained high growth has been accompanied by the rising living standards with a relatively equal distribution of income, ameliorating the twin problems of poverty and racial imbalances. The positive relationship between highly labour-demanding growth and equity is vividly illustrated by the Malaysian experience.

The affirmative action programme under the NEP was instrumental in establishing the legitimacy of government policy and achieving political stability and social harmony. At the same time, the resource cost of these direct redistribution policies was not a major drag on growth because of the key role played by FDI flows and rapid export expansion in augmenting the domestic resource base, and rapid export expansion. Moreover, while there were some policy excesses triggered by conflicting objectives in a plural society, the policy makers have been successful in rectifying policy errors swiftly.

The key lesson to come from the Malaysian experience is that in a small open economy, the task of achieving the conflicting objectives of growth and equity is facilitated by a long-term commitment to a liberal trade and investment policy regime. As a small, open economy, Malaysia's economic policy stance has not been to isolate itself from these global trends, but rather to respond to developments on the international front as they unfold. Despite the affirmative action policies under the NEP, the private sector was never marginalised. Unlike many other developing countries, Malaysia never resorted to stringent quantitative trade restrictions. Domestic price signals were therefore never insulated from

world market conditions, and resource costs arising from rent-seeking activities have always been minimal by developing country standards. There has also been a continuous emphasis on infrastructure development and expansion of education. In the area of labour market policy, the emphasis has been on creating a conducive setting for job creation while ensuring that the workers get a fare share of the growth process through overt policies, rather than attempting to preserve workers, rights through direct labour market intervention. This policy regime, coupled with political stability and ethnic harmony achieved with the help of the NEP, enabled the Malaysian economy to take full advantage of the new opportunities arising from integration with the global economy.

The prime aim of this chapter has been to examine the major policy shift and the key elements of the policy package that underpinned Malaysia's success in achieving growth with equity while facing conflicting socio-economic challenges germane to a pluralistic society. We have deliberately avoided getting into the now-fishable debate on the relative importance of economic policy over 'luck' or 'non-policy' factors, owing to the space constraint and, more importantly, because of our conviction that this debate has grown out of proportion, distracting attention from key policy lessons. However, it is important to end this chapter with some remarks on the (perceived) role of non-policy factors in the Malaysian success story.

Two 'non-policy' explanations often highlighted in the literature on Malaysian development are the rich resource endowment and geography – location in a dynamic growth region. To comment first on the former, Malaysia has of course benefited from her initial position as a thriving primary exporter, which was further strengthened by the new-found oil wealth from the mid-1970s. In particular thriving primary export industries ensured a strong balance of payments position for the country and this was instrumental in avoiding 'stop-go policy cycles' (i.e. costly discontinuities in development policy caused by periodic balance of payments crises) as seen in many other developing countries (Krueger 1992). However, it is important to emphasise that many other resource-rich countries have lagged behind Malaysia in achieving developmental objectives. Based on the comparative economic performance of resource-rich and resource-scarce countries, some economists even argue that abundance of primary resources can even be a constraint on growth (Lal and Myint 1996; Lal 1999). This is because vested interests of groups who benefit from resource rent could well thwart economic reforms needed for sustained long-term growth. Moreover, there is clear evidence that it is the sound policy framework, rather than the mere existence of resources, that enable a country to excel in primary commodity trade, and this view is clearly supported by the Malaysian experience (Jenkins and Andrew 1991; Athukorala 1998).

To comment on the role of geography, Malaysia has no doubt benefited from its location in a dynamic growth region. In particular, the massive direct investment from the NIEs and Japan in the late 1980s and early 1990, and the continuous shift of relatively labour-intensive production process by MNEs from Singapore to Malaysia, have no doubt been aided by the geography (Jomo and Associates 1997). However, interestingly, the benefits from these developments

have been greater for Malaysia than to other developing countries in the region. This difference vividly demonstrates the role of the Malaysian national policy environment in benefiting from geographical advantages.

Two additional initial conditions often highlighted as important for sustained rapid growth in the 'new wave' interpretation of the East Asian experience (notably the experience of Taiwan and South Korea) are the relatively equitable distribution of income and wealth, and socio-cultural homogeneity (Rodrik 1999). In terms of these pre-conditions, Malaysia as an independent nation had rather bleak developmental prospects. As mentioned at the outset of this chapter, economic policy making in post-independence Malaysia was essentially a continuing struggle to achieve development objectives while preserving communal harmony and political stability against an initial state of highly unequal distribution of wealth and economic opportunities. These considerations lead us to a closer look at distinctive characteristics of Malaysia's economic policy in search of explanations for its economic achievements.

Notes

1 The Federation of Malaya, comprising eleven states in the Malay Peninsula secured independence from Britain on 31 August 1957. Sabah, Sarawak and Singapore joined Malaya to form Malaysia on 16 September 1963. Singapore left the federation in August 1965.
2 Alternative estimates of Malaysia's per capital income in the mid-1950s vary between US$ 300 and US$ 360 (World Bank 1955; Higgins 1959). Among the former British colonies only Ghana had a per capital income comparable to that of Malaysia. It is important to note that growth was limited to the plantation enclave (foreign investment-based) and related urban sector activities (trade and commerce), and did not bring rising living standards to the average people. The per capital income of the peasants was perhaps about a mere US$ 50, within the range prevalent throughout Asia (Higgins 1959: 439–40).
3 In the famous Rosentein-Rodan (1961) growth trajectory up to 1976 for sixty-six of today's developing countries Malaysia was classified (together with South Korea, Taiwan, Singapore, Thailand and Indonesia) in the 'low-growth' category.
4 But there was no significant reliance of quantitative import restrictions; only 8 per cent of total merchandise imports (on an import-weighted basis) were under such restrictions by the mid-1980s (Athukorala 2002).
5 Government programmes and procedures for achieving these goals were embodied in the Seventh Malaysia Plan (1996–2000) and the Second Industrial Master Plan released in 1996.
6 The average number of strikes per year declined from thirty-five in 1970s to twenty-two in 1980s and fifteen in the 1990s (up to 1998). The average number of wage earners involved in strikes in a given year during these three decades never exceeded 0.2 per cent of the total workforce except in 1990 when the figure reached 1.4 per cent.
7 However, in terms of achievements in secondary and tertiary levels of education, which is crucial for the acquisition of workplace skills, Malaysia has continued to lag behind the first generation East Asian NIEs. There is also a growing concern that the education policy component of the NEP, despite its remarkable achievement in improving general literacy, has had an unintended negative effect on the quality of tertiary education (Musa 1999).

  8 At the time Malaysia had by far the largest bank credit to GDP ratio (165 per cent) among the crisis-hit Asian countries (and in the world at large).

  9 For a fuller treatment of the Malaysian experience in the Asian crisis, see Athukorala (2001).

10 Although the expansion of export-oriented industries aided by the recovery in the global electronics industry played an important role, the recovery was not entirely export-led. Domestic demand expansion triggered by expansionary macroeconomic policy played a pivotal role in achieving a broad-based recovery. Moreover, the fixed exchange rate is belied to have helped the recovery process by preventing premature exchange rate appreciation as part of improved market sentiments about the recovery prospects. Capital controls also assisted banking and corporate restructuring by facilitating the mobilization of domestic resources, and more importantly, providing a cushion against adverse market sentiments of improper practices of protecting favoured companies and corporations (Athukorala 2001).

11 The term HPAEs, first used in World Bank (1993), refers to the four 'tiger economies' – Hong Kong, South Korea, Singapore and Taiwan, and the three newly industrialising economies in Southeast Asia – Indonesia, Malaysia and Thailand.

12 Note that in calculating this ratio exports have been measured in gross terms while GDP is naturally in value-added terms. Given the fact that around 40 per cent of total value added is generated in non-traded sectors, a high trade share of this magnitude simply reflects Malaysia's heavy dependence on production process which involve adding a fairly small amount of value to intermediate goods, benefiting from the ability of modern industry to slice up the value chain and relocate labour-intensive activities in developing countries. By the mid-1950s Malaysia's export coefficient was the third highest in the developing world after Singapore (over 170 per cent) and Hong Kong (over 140 per cent) (Krugman 1995).

13 Female school enrolments, which had lagged far behind those of males, began to rise steeply in the 1950s, at both primary and secondary level (Rudner 1994, chapter 12).

14 It is interesting to note that this impressive employment record has been achieved in a context of increasing labour force participation. The rate of labour force participation increased from an average level of 65 per cent in 1980–5 to over 67 per cent by the mid-1990s (Athukorala and Menon 1999).

15 Real wage indices used in this study are based on average annual earnings. The deflator used is the consumer price index. Average annual earnings are derived by dividing the reported estimates of the salary and wage bill for the entire year by the reported level of employment at the end of the year. The average earnings derived in this fashion include the salary and wages as well as bonuses, leave pay, overtime pay, cash allowances for maternity, cost of living and housing allowances, retrenchment benefits and employers' contribution to the Employees Provident Fund (EPF) and the Employees Social Security Scheme (ESSS). Disaggregated data on these various forms of 'non-basic' wages are not available. But, together they account for 15 per cent or more of the total wage and salary bill (Galenson 1992: 39).

16 While intra-community distribution of income was fairly equal for the Malays and Chinese (Gini coefficients of 0.48 and 0.49, respectively), there was significant variation in income within the Indian community (Gini coefficient of 0.54).

17 The labour force participation rate for women increased from 37.2 per cent in 1970 to 45.8 per cent in 1990 and 47.1 per cent in 1995, while the share of women in employment increased from less than 30 per cent in 1970 to 31.4 per cent in 1990 and 33.7 per cent in 1995 (Government of Malaysia 1991; 1996).

7 Trade policy, economic growth and poverty reduction in Taiwan

Pan-Long Tsai and Ching-Lung Tsay

Although the world economy grew well during the 1990s, many people in the developing countries continue to live in extreme poverty. Almost a half of the world's 6 billion people, 2.8 billion, live on less than US$ 2 a day, and a fifth, 1.2 billion, live on less than US$ 1 a day (World Bank 2000). For decades, a lot of resources and efforts have been mobilised for the noble objective of reducing poverty. Unfortunately, the above records indicate that the outcome of all the efforts was nothing but a disappointment. This fact explains why poverty reduction has remained and recently become the central challenge to many international development institutions as well as bilateral aid agencies (Warr 2000).

While there is little dispute that poverty reduction is the final goal of all economic policies, recent controversies arise with respect to 'how to achieve that goal?' (Ravallion 1995; Dollar and Kraay 2000a). More precisely, the question centres around 'would the poor benefit from economic growth irrespective of the quality of growth?' There are people, notably NGOs and street protestors from rich countries, arguing that the wrong kind of growth fails to help the poor and even destroys the environment, and that in general all of the benefits of growth accrue to the middle and upper classes. On the contrary, another group of people firmly believe that the sustained economic growth is the key to poverty alleviation (Srinivasan 2001). In spite of this debate, more and more empirical evidence does suggest an association between episodes of rapid growth and poverty reduction (Dollar and Kraay 2000a). This, along with the strong empirical regularity that openness to international trade and investment is an efficient means to achieve rapid growth (Dollar 1992; Srinivasan and Bhagwati 1999), implies that outward-oriented trade regime and integration into the global trading system might be essential to poverty alleviation.

In this respect, Taiwan distinguishes itself as a particularly interesting case. Like many other developing countries, poverty was widespread in Taiwan during the early post-war years. However, as the government decisively reoriented its development strategy from import substitution towards export promotion at the end of the 1950s, the exceptional economic progress has not only brought with it the well-known record of economic growth and income distribution, but has also resulted in rapid poverty reduction. What has happened in Taiwan in the past four decades thus suggests that there is a close link between trade policy,

economic growth and poverty reduction.[1] Admittedly, it is impossible to provide a definite answer to the question posted above simply based on the Taiwanese experience. Yet it is useful to study the lessons of this successful case and see whether it can shed light on the way to reduce poverty in other developing economies to date. The aim of this chapter is therefore to examine how the adoption of various trade policies in Taiwan could have contributed to poverty reduction in Taiwan since the mid-1960s.

Poverty in Taiwan

In spite of the remarkable economic achievements, Taiwan is no exception to many developing countries in having to face the poverty problem, especially in the early post-war years. However, this problem has almost been completely neglected by economists in their studies of the development experience in Taiwan. When looking over such important works on Taiwan's economic development like Lin (1973), Ho (1978), Galenson (1979), Fei *et al.* (1979), Wade (1990) and Li (1995), one would be surprised to notice that the word 'poverty' is essentially absent from all the indexes. The neglect could be attributed to the fact that the government's top priority by the 1960s was simply 'security', 'survival' and 'legitimacy' of the Nationalist regime. Moreover, poverty was traditionally treated as an individual's rather than a social problem for which the government or the society has to be responsible. After the economy took off in the mid-1960s, the economic success worked unexpectedly to disguise or even distort the fact that a considerable amount of Taiwanese continued to struggle in hardship on a daily basis.

   In the early post-war years, there was no consistent definition of poverty in Taiwan. In fact, social assistance to the poor was sporadic, mainly for so-called 'winter season relief' as well as relief for natural disaster and catastrophes. The 'Means Test Act Governing the Poverty Relief in the Taiwan Providence' of 1963 for the first time set a uniform standard of poverty and made the means test a regular work of the local government. The standard, or the definition of poverty, has been revised several times since then. At present, there are three categories of low-income family:

i   First-type low-income family: a family with no real estate, no one in the family having working ability, no sensible revenues and thus cannot survive without assistance.
ii Second-type low-income family: a family with less than a third of the total family members having working ability, and per capita monthly revenues of the family are less than two-thirds of the per capita monthly minimum costs of living (MCL).
iii Third-type low-income family: a family with per capita monthly revenues less than the per capita monthly MCL.

The MCL is currently defined as 60 per cent of the average local per capita expenditure in the most recent year published by the central government.

Figure 7.1 Official data of headcount measure of poverty incidence.

Source: Department of Statistics, *Statistical YearBook of Interior* (various issues).

The official headcount measure of poverty incidence since 1965 is shown in Figure 7.1. However, caution should be taken in reading this measure. First, as noted above, the definition of poverty has been changing from time to time. For instance, the revision in 1978 changed the concept of poverty from absolute to relative poverty. As a result, the number of the poor jumped more than three times from 33,170 in 1977 to 108,667 in 1978. Strictly speaking, therefore, the measure is not comparable over time. Second, the measure could be affected by the way MCL is defined. For example, with the MCL fixed at NT$ 200 (New Taiwan Dollar) during 1963–75, the purchasing power was in fact not held constant given that inflation rate reached 120 per cent during that period. Consequently, the drastic decline in the official poverty incidence in 1963–75 was misleading; it should reflect mainly the effect of inflation rather than reduction in poverty. Finally, the government sometimes manipulated the poverty incidence for political purpose. For instance, just one year after the so-called 'Well-To-Do Program (WTDP)' started in 1972, the number of the poor was incredibly cut by half (from 391,463 to 196,362).[2] How could that happen? The fact was that the local governments greatly tightened up the eligibility of the poor to avoid the heavy financial burdens under the WTDP. As a result, many of the poor were disqualified simply by administrative manipulation.

With these obvious defects, it is certainly not appropriate to use the official measure for any quantitative study. However, taking all the available evidence into account the drastic decrease in poverty incidence in Taiwan after the mid-1970s as shown in Figure 7.1 seems to be indisputable (Tsai 2001). The fact that this apparent alleviation of poverty occurred only after Taiwan veered towards a more open trade regime and the export-led economic growth sustained for around a decade has indeed had important implications for the trade/poverty nexus.

Trade policy, growth and poverty alleviation: theoretical underpinnings[3]

To the extent that trade policies are well planned and successfully carried out, they could have impact on poverty either through economic growth or through income distribution.[4] As mentioned above, countries adopting outward-oriented trade policy tend to have a higher rate of economic growth. The key for this outcome is that an open trade regime facilitates efficient transmission of price signals from the international market to national economy, enhances diffusion of production and management knowledge and improves domestic efficiency as a result of intensive international competition. Undistorted price signals allow more efficient resources allocation in accordance with a country's comparative advantage, which in turn leads to more rapid economic growth.[5] Naturally, whether the resulted economic growth could indeed 'raise all boats' including the poor depends on where a country's comparative advantage lies.

Given the fact that the absolute majority of the world's poor live in developing countries and that these countries' comparative advantage lies in the labour-intensive sector, adoption of freer trade policy in developing countries should favour the poor as labour-intensive exports increase. Liberalisation of import would generally raise the relative price of the exportable and thus the expansion of the export sector. This would result in either higher wage rate for labour *a la* the celebrated Stolper–Samuelson theorem in the international trade theory, or more jobs for the unemployed who are usually poor almost by definition. Moreover, higher economic growth means more tax revenue for the government. The government could then possibly invest in various infrastructure such as education, transportation, disease control and social safety net which are of crucial importance for poverty alleviation.

As for the effect on income distribution, it could be viewed from the pure theoretical or from the political economy point of view. Theoretically, trade policy could affect the welfare of the poor through what they consume and what they produce. This is best understood by envisaging a change in trade policy, say trade liberalisation. Liberalising import would lower the relative price of the importable. At constant income, those who consume relatively more of the importable will gain while those who consume relatively more of the exportable will suffer. However, this 'consumption effect' might not be as serious as it first looks since households generally diversify their consumption so that the gains and losses tend to offset each other. In contrast, trade liberalisation necessarily leads to the expansion (contraction) of the export (import) sector. Some of those working in the import sector would lose their job and thus their income unless they are able to transfer to the export sector in a sufficiently short period of time. Since the most important asset owned by the poor is low-skilled labour, this 'income effect' could be disastrous (Reimer 2002).

Compared to the pure theoretical consideration, the political economy of income distribution of the trade policy is equally important if not more. Inherently having a strong effect on income distribution, any protective trade

policy is doomed to work against the poor who have no way to influence the policy. Protective measures are typically put in place to shelter domestic producers from foreign competition, which usually benefits the powerful interest groups, not the poor. In this regard, it is worth noting that non-tariff barriers such as quotas, licenses or monopoly power to import are particularly pernicious to economic growth and poverty reduction for at least two reasons. First, there are rents arising from price differentials caused by restrictions on imports. Contrary to the case of tariff which is collected by the government, the rents are captured by those who have the right to import. This leads to the second reason; namely, to seek for the rents, valuable real resources will be spent to compete for the right to import and to maintain the protective policy. There is evidence that the rent-seeking activities could be an important source of inefficiency in many countries. As the import license holders and rent-seekers are usually among the wealthiest in a country, non-tariff trade barriers work to transfer income towards the rich and away from the poor in addition to the inefficiency costs noted above.

The direct implication from the discussion above is that trade liberalisation should in general help poverty alleviation both through enhancement in efficiency and the ensuing economic growth as well as through improvement in income distribution. It needs to be emphasised, however, that trade liberalisation *per se* is at most a necessary condition for poverty reduction. To ensure a successful fight against poverty, appropriate complementary policies such as a stable macroeconomic environment and an efficient social safety net have to be in place (Dollar and Kraay 2000b; Hoekman *et al.* 2001).

Tariff and non-tariff restrictions in Taiwan

Before examining the specific trade policies which are more relevant to our purpose, we will first briefly review the evolution of trade regime after 1950. As trade policies are part of the overall development strategy, their formulation and adoption naturally are in consonance with stages of economic development in Taiwan. Roughly speaking, economic development in Taiwan could be divided into three phases: primary import substitution (1950–8), transition and export promotion (1958–80), and accelerated liberalisation (1980–present) (Li 1995; Tsai 1999).[6]

Like most developing countries in the 1950s, Taiwan resorted to the so-called primary or 'easy' import substitution (Lin 1973; Ho 1978). A battery of interventions, including foreign exchange controls and multiple exchange rates, protective tariffs and import restrictions, was used to save foreign exchange and to encourage domestic production of substitutes for imported goods such as textiles, cement and fertilisers. Along with other measures like deficit financing and selective credit allocation, these policies made a significant impact on Taiwan's earlier economic development.

As is usually the case, the small, protected domestic market was quickly saturated, and primary import substitution lost momentum. Real GNP growth rates

fell every year during 1952–6; the growth rate of industrial output declined to 11 per cent and that of employment to 5 per cent in the second half of 1958. Hardly any foreign exchange was saved; in 1958, Taiwan was still running a trade deficit of some US$ 70 million. These problems led to a wide-ranging reorientation of development strategy. Multiple exchange rate system was gradually dismantled and in 1963 the rate was unified at NT$ 40 to US$ 1; import restrictions were liberalised and the trend towards substituting tariff for non-tariff protection became more established by 1964 (Lin 1973).

To promote export, various measures were adopted and implemented. The export promotion policies could be divided into two categories. One was the policies aiming at removing and neutralising distortions resulting from protectionist policies enacted during the import substitution phase. It included, among others, the liberalisation of foreign exchange allocation system, rebates of import duties and a special export loan programme to exporters. The other one involved the offering of new incentives for exports, to which the establishment of EPZs and tax incentives for exports belong. Despite several rounds of import liberalisation and tariff reduction in the 1970s, it is noteworthy that, as argued vividly by Wade (1990) and others, trade liberalisation was generally limited to the export sector, with the domestic market remaining heavily protected. In other words, Taiwan's trade regime by 1980 was a double-tracked regime attempting to encourage exports while protecting the domestic market at the same time.

Interestingly, the rapid accumulation of foreign exchange made possible by the successful implementation of the double-tracked trade regime turned out to become the major force for accelerated trade liberalisation since 1980 (Chen 1999). In 1984, trade surplus jumped to US$ 8.5 billion, a 76 per cent increase from its 1983 level. This not only put a tremendous pressure on domestic money supply as well as the exchange rate of NT$, but also worsened the trade friction between Taiwan and USA. A decisive shift in development strategy in general, and trade policies in particular, first appeared in 1984. Under the general guidance of 'liberalisation, internationalisation', both tariff and non-tariff barriers were dramatically reduced. Meanwhile, many of the export incentives initiated during the export promotion phase were lifted. The special export loan programme was abolished in 1989; tax incentives on 15 per cent of revenue from exports were removed in 1990. While still in operation, the duties rebate system has been greatly scaled down, accounting for 0.4 per cent of the total tax revenue during 1991–4, and is expecting to be phased out in the near future.

Judicious decisions or simply responses to impending problems, the description above reveals that there is a general, clear trend towards liberalisation with respect to trade policies in Taiwan. If trade liberalisation does have the merits in alleviating poverty as predicted by the theory, then what happened in Taiwan during the past fifty years warrants a careful examination. Now let us turn to the evolution of tariffs and import restrictions. The two representative export promotion policies, the duties rebate system and the EPZs, will be discussed in next section.

Import liberalisation

Because of the aggravating difficulty in balance of payments in the 1950s, import controls were used to conserve foreign exchange and to protect domestic infant industries.[7] Before July 1994, importing goods were put into three categories: permissible, controlled and prohibited. The prohibited goods were not allowed to be imported under whatsoever situation. The controlled goods could be imported only with the approval of the trade authorities. It is noticeable that a good cannot always be imported freely even if it belongs to the permissible category. Specifically, it could be under one of the following four types of restriction: (1) to be imported by firms only, (2) to be imported by public enterprises only, (3) to be imported from specified countries or regions only and (4) to be imported with approval from relevant government or non-government units. Beside government agencies, producers or association of producers could apply for import controls to the relevant government agency such as the Industrial Development Board of the Ministry of Economic Affairs.[8]

The imposition of import controls, along with foreign exchange controls, led the domestic prices of imports or import substitutes to be substantially higher than the cost, insurance and freight (c.i.f.) costs of comparable imports. According to Lin (1973) in 1953, the differentials ranged from 41–84 per cent for wheat flour, powdered milk, etc., to 155–189 per cent for goods such as soybeans and toothpaste, to over 300 per cent for woolen yarn and soda ash. This means that the bulk of the rent from price increase in imports and import substitutes have gone into the pockets of powerful traders and protected domestic producers. As noted in the theoretical discussion, the income distribution effect of the import controls definitely worked against the poor.

As Taiwan began to accumulate budgetary surpluses in the 1960s and the trade account moved into black in 1971, changes in both tariff and non-tariff policies were in order. With respect to import controls, Table 7.1 shows that the share of permissible imports increased from 53.7 per cent in 1960, to 82.1 per cent in July 1972 and then to 97.7 per cent in February 1974; the share of controlled imports shrank from 40.5 to 17.9 per cent, and 2.3 per cent during the corresponding year. The prohibited imports were greatly reduced after 1972, to less than 1 per cent.

The trend towards liberalisation continued in the 1980s and the 1990s. With the exception of the agriculture sector, automobile and petroleum, all the principal import restrictions were eliminated during 1985–7. The share of total imports that could be freely imported reached 98.5 per cent by December 1988, though it declined to 96.9 per cent in January 1989 due to the adoption of the Harmonised Commodity Description and Coding System (HS system) of classification.

In an effort to apply for the membership of GATT, further liberalisation measures were introduced after 1990. By January 1992, the share of permissible imports rose to 97.4 per cent. Moreover, a 'negative list' of import restrictions was adopted in July 1994. Under this system, only the goods on the negative list have to obtain the import permit before importation, though some of those not on the list still subject to examination and approval by the customs authority.[9]

Table 7.1 The evolution of import controls in Taiwan

Year and month	Permissible imports		Controlled imports		Prohibited imports	
	No. of items	%	No. of items	%	No. of items	%
1953	280	55.2	185	36.5	28	5.5
1956	252	48.1	241	46.0	25	4.8
1960	506	53.7	381	40.5	33	3.5
1966	493	52.3	395	41.9	36	3.8
1968,12	5,451	57.9	3,770	40.1	191	2.3
1970,7	5,612	57.1	4,030	41.0	190	1.9
1972,7	10,860	82.1	2,365	17.9	5	0.04
1974,2	12,645	97.7	293	2.3	4	0.03
1975,1	12,688	97.5	318	2.4	4	0.03
1976,6	12,846	97.2	362	2.7	13	0.1
1978,7	15,773	97.6	375	2.3	17	0.1
1979,12	15,836	97.6	380	2.3	17	0.1
1980,12	15,818	97.4	410	2.5	21	0.1
1981,12	25,681	96.8	833	3.1	17	0.1
1982,12	25,657	96.5	904	3.4	17	0.1
1983,12	25,664	96.5	921	3.5	17	0.1
1984,12	25,972	97.1	744	2.8	14	0.1
1985,12	26,289	98.2	470	1.8	9	0.03
1986,12	26,443	98.4	421	1.6	8	0.03
1987,6	26,461	98.4	411	1.5	8	0.03
	Free imports		Restricted imports		Controlled imports	
	No. of items	%	No. of items	%	No. of items	%
Pre-1994,6	7,597	81.65	1,483	15.93	225	2.42
1994,7	7,835	84.09	1,239	13.30	243	2.61
1999,7	8,975	87.67	992	9.69	270	2.64

Sources: Chang 1986; Chen and Liu 1993 and Chen 1999.

For those who need the import permit, they are further classified into controlled and restricted imports. The controlled items, corresponding to the prohibited imports under the old system, are not allowed to be imported unless a special approval is issued by the Board of Foreign Trade, Ministry of Economic Affairs. While an import permit is required, the restricted items can in fact be imported rather easily. By July 1999, 87.7 per cent of the importable could be imported free of any administrative restrictions (Chen 1999).

Tariff reduction

Generally speaking, import tariffs were quite high during the import substitution phase, with an aim to protect infant industries and to raise revenue. In 1955, the average nominal tariff rate was around 45 per cent, while the share of imports subject to a tariff rate above 90 per cent (respectively between 60 and 90 per cent,

Table 7.2 Average effective tariff rate

Year	(1) Customs duties (NT$ million)	(2) Value of imports (NT$ million)	(3) Effective tariff rate =(1)/(2) (%)
1952	20	2,533	20.53
1953	513	2,754	18.63
1954	611	3,304	18.49
1955	658	3,146	20.92
1956	807	4,800	16.81
1957	978	5,259	18.60
1958	1,312	5,605	23.41
1959	1,316	8,420	15.63
1960	1,341	10,797	12.42
1961	1,655	12,894	12.84
1962	1,743	12,174	14.32
1963	2,046	14,483	14.13
1964	2,458	17,162	14.32
1965	3,302	22,296	14.81
1966	3,445	24,957	13.80
1967	4,291	32,314	13.28
1968	5,362	36,222	14.80
1969	6,134	48,629	12.61
1970	6,800	61,110	11.13
1971	8,373	73,942	11.32
1972	12,197	100,791	12.10
1973	17,687	145,079	12.19
1974	26,659	265,395	10.05
1975	25,717	226,460	11.36
1976	30,584	289,139	10.58
1977	35,090	323,839	10.84
1978	46,225	408,378	11.32
1979	56,467	532,928	10.60
1980	57,821	711,433	8.13
1981	57,988	778,633	7.45
1982	53,519	736,084	7.27
1983	62,818	813,904	7.72
1984	69,438	870,861	7.97
1985	62,094	801,847	7.74
1986	71,409	916,421	7.79
1987	78,154	1,113,871	7.02
1988	82,023	1,423,101	5.76
1989	87,061	1,385,720	6.28
1990	79,543	1,471,803	5.40
1991	84,121	1,690,772	4.98
1992	93,057	1,817,061	5.12
1993	101,587	2,034,746	4.99
1994	107,322	2,261,651	4.75
1995	115,681	2,742,851	4.22
1996	100,753	2,815,120	3.58
1997	111,564	3,276,094	3.41
1998	109,614	3,503,569	3.13
1999	100,868	3,576,416	2.82
2000	105,586	4,368,696	2.42

Sources: 1. Taiwan statistical data book (various years); 2. Yearbook of tax statistics, R.O.C, Ministry of Finance (various years).

between 30 and 60 per cent, below 30 per cent) was 11.3 per cent (respectively 7.4, 34.7 and 46.6 per cent). In the same year, the average effective tariff rate, defined as the ratio of total tariff revenue to total value of imports, reached 20.9 per cent (Table 7.2). Another salient feature of the tariff structure during the period was that the tariff rates governing important inputs and raw materials were much lower than those of the final consumer goods. This resulted in a rather high effective rate of protection for many processing or manufacturing activities (Lin 1973; Li 1995).[10]

Major changes in tariffs were made in 1959, 1965, 1971, 1973 and 1979 during the export promotion phase. Barring the change of 1979, no significant tariff reduction could be found in spite of the dramatic increase in Taiwan's exports. The average nominal tariff rate rose even after the revision of 1971. However, it would be a big mistake to suggest that the increase in the nominal tariff rate represented strengthening of protection. The fact was that the number of imports subject to import controls was significantly reduced at the same time. Consequently, the upward adjustment of tariff rates was part of the process of tariffication, namely substituting tariffs for quantitative restrictions, and should be regarded as an important step towards liberalization (Li 1995).

Under pressure from the USA, tariffs were cut sharply during the 1980s. The tariff schedule was revised eleven times between 1979 and 1992, with the ceiling tariff rate reduced to 50 per cent in 1988; tariff rates on 733 items were eliminated and on other 16,303 items were reduced. As a result, the average nominal tariff rate decreased to 8.9 per cent in 1991 from 31.0 per cent in 1982, and average effective rate decreased from 7.3 to 5.0 per cent over the same period (Chen 1999). While the pressure from the USA was the major driving force for the tariff reduction, it should be noted that the inflation pressure brought about by the swelling trade surplus and the ensuing increase in money supply in the second half of the 1980s actually deprived the government of other choices. While the adjustment in 1992 was mainly for the purpose of access to GATT, further tariff reduction was made in 1995 to implement the plan of the Asian Pacific Regional Operation Center.

Export promotion policies

It is well documented that various measures were adopted to promote exports in Taiwan's outward development efforts (Wade 1990; Li 1995). Among the measures, the duties rebate system was representative of the ones aiming at offsetting the distortions created during the import substitution phase. On the contrary, the establishment of the EPZs symbolised the overall effort in providing new incentives for exports. As will be detailed below, the operation of the EPZs is of particular relevance to poverty alleviation.

Duties rebate system

One of the popular measures to promote export is the rebates of customs duties and other indirect taxes on inputs used directly or indirectly to produce manufactured

Table 7.3 Tax rebates as a proportion of corresponding tax and total tax revenue

Period	(1) Customs duties	(2) Commodity tax	(1) and (2): Total tax revenue
1955–60	5.9	3.0	1.5
1961–5	25.2	17.8	8.6
1966–70	39.6	21.8	13.4
1971–5	67.3	35.7	24.2
1976–80	44.3	33.9	17.2
1981–5	33.7	8.8	7.9
1986–90	17.2	4.3	3.4
1991–4	4.4	0.1	0.4

Source: Kuo 1997: 60.

exports. A properly administered customs duties rebate system allows exporters duty-free access to imported raw materials and intermediates so that they could compete with firms from other countries at comparable costs. It is particularly effective in offsetting bias against exports when import substitution development strategy is adopted and high protective tariffs are imposed.

The customs duties rebate system in Taiwan dates back to 1951 when duties rebates were granted on imported raw materials for making straw hats for re-export. With the attainment of high rates of import substitution and the inception of manufacturing export, the Ministry of Finance extended the system to cover all export goods in 1954.[11] Although the scope of rebates included such taxes as defense surtax and harbour charge, they were applied mainly to customs duties and commodity taxes. The largest rebates of customs duties and commodity taxes on exports, in percentage terms, occurred during the period of 1971–5, accounting for 67.3 and 35.7 per cent of the corresponding taxes (Table 7.3).

According to Scott (1979), when an average was taken for all manufacturers of exports, in 1971 rebates of import duties, commodity tax and other indirect taxes amounted to three-quarters of the estimated value added, and twice their current surpluses. Among the manufacturers, those in the textile industry enjoyed the greatest advantages. At one time, half of the total rebates were granted to the textile industry. This explained why the customs duties rebate scheme was so important to the export-led growth in Taiwan, especially during the 1960s and the 1970s when textile industry was the leading goose.

As expected, the administrative work of processing tax rebate applications and preventing fraudulent claims became increasingly difficult when the volume and varieties of manufactured exports grew over time. In view of this, the Ministry of Finance proposed a revision of the Customs Duties Rebate Law in 1968 to simplify the duties rebate standards and the processing of duties rebates. Unfortunately, with as many as 20,000 different standards, and with a single final product sometimes involving as many as 1,000 different intermediate inputs, the administration of the system remained exceedingly complex. The situation was not improved until the 1980s when the Taiwanese economy was further liberalised. As import liberalisation was going on, the importance of tariffs in the

costs of manufacturing production decreased, and duties rebates began to lose their economic value. Table 7.3 shows that the rebates of customs duties (commodity tax) decreased to 4.4 per cent (0.1 per cent) of the corresponding tax in the early years of the 1990s. Together these rebates accounted for only 0.4 per cent of the total tax revenue in 1991–4, compared to 24.2 per cent in 1971–5 and 17.2 per cent in the second half of the 1970s.

Recognising that the trend towards liberalisation and globalisation is irreversible, as early as 1983 the government proposed to phase out the duties rebate system within five years (Li 1995). However, the system survives to date, though the number of exports qualified for the rebates has become very small. Producers still needing dutiable imports of intermediate inputs are urged to use bonded warehouse and bonded factory system.[12]

Export processing zones

Among the export promotion measures, the establishment of EPZs was particularly relevant to poverty reduction. An EPZ is an expansion of the free trade zone concept; it combines in one place the advantage of a free trade zone, an industrial estate and an integrated, simplified administration. By cutting the red tape, an EPZ was aiming at creating employment, earning foreign exchange and encouraging foreign investment. According to the Statute for Establishment and Management of Export Processing Zones enacted in 1965, plants in the zone could enjoy all of the tax benefits accorded to the export industries in addition to having ready access to well-developed plant sites or factory buildings, water and power supply and harbour and warehouse facilities at comparably low costs (Lin 1973).

In 1966, the first EPZ was formally opened in Kaohsiung (namely, KEPZ), with a target of hosting 120 firms. As applications for setting up firms in KEPZ quickly outgrew the space available, the government decided to set up two additional zones. Thus, Nantze EPZ and Taichung EPZ were opened in April 1971. The zones were open to both domestic and foreign firms. In fact, the bulk of the firms were joint ventures with foreign companies. By 1991, 241 firms were operating in the three zones and the cumulative investment reached US$ 886 million, more than thirty-eight times the initial expectation in 1966, and about 6 per cent of private foreign and overseas Chinese investment in Taiwan during 1966–91 (Li 1995). In spite of importing most of machinery and raw materials, the zones have exported far more than they imported since 1969. As shown in Table 7.4, total exports and imports of the three zones were US$ 3,991 million and US$ 1,916 in 1991, respectively, 64 and 35 times their 1969 levels. By 2000, the corresponding numbers reached US$ 8,705 and US$ 6,843, respectively.

Besides labour-intensive exports which contributed to economy-wide growth, the main benefits of the zones in terms of poverty alleviation came from the creation of employment, especially the employment of low-skilled labour force. Starting from 1,215 in 1966, the total employment quickly climbed to 75,557 in 1973, though it declined somewhat in the wake of energy crisis.[13] The peak was

Table 7.4 Basic data of the EPZs

Year	Values of trade (US$ 1,000)			Number of employment			Average age of workers			Educational attainment of workers (%)			
	Imports	Exports	Employees	Workers	Female workers	% of female workers	Total	Male	Female	Elementary	Junior high	Senior high/ vocational	College and above
1966	2,068	222	1,215	—	—	—	—	—	—	—	—	—	—
1967	11,596	7,970	5,625	—	—	—	19.29	—	—	—	—	—	—
1968	29,598	26,385	16,387	—	—	—	19.63	—	—	—	—	—	—
1969	54,380	62,181	27,881	—	—	—	19.84	—	—	—	—	—	—
1970	90,146	109,388	39,737	—	—	—	20.13	—	—	—	—	—	—
1971	110,349	163,475	47,173	—	—	—	20.13	—	—	—	—	—	—
1972	124,269	227,679	59,658	—	—	—	21.06	—	—	—	—	—	—
1973	239,681	375,462	75,557	—	—	—	21.44	—	—	—	—	—	—
1974	308,720	508,849	62,562	—	—	—	21.46	—	—	—	—	—	—
1975	255,770	453,125	66,115	58,897	49,246	83.61	21.46	—	—	—	—	—	—
1976	373,346	675,981	74,930	66,791	56,034	83.89	23.43	—	—	—	—	—	—
1977	390,944	750,488	70,814	62,550	52,515	83.96	23.01	—	—	—	—	—	—
1978	542,906	906,071	77,389	68,566	58,278	85.00	22.89	—	—	—	—	—	—
1979	610,056	1,204,732	80,166	70,971	60,497	85.24	23.02	—	—	—	—	—	—
1980	753,222	1,423,809	79,126	69,069	57,912	83.85	24.23	—	—	—	—	—	—
1981	799,415	1,589,187	77,826	67,166	56,894	84.71	24.14	—	—	—	—	—	—
1982	812,091	1,626,122	70,047	59,218	50,469	85.23	24.52	—	—	—	—	—	—
1983	864,607	1,620,840	78,526	67,661	57,542	85.04	24.17	—	—	23.10	42.97	32.27	1.66
1984	1,072,314	2,035,964	83,375	71,206	60,619	85.13	25.07	—	—	20.53	41.95	35.72	1.80
1985	945,783	1,872,123	72,931	61,491	52,381	85.18	26.02	29.70	25.37	21.14	40.92	35.85	2.09

Table 7.4 (Continued)

Year	Values of trade (US$ 1,000)			Number of employment			Average age of workers			Educational attainment of workers (%)			
	Imports	Exports	Employees	Workers	Female workers	% of female workers	Total	Male	Female	Elementary	Junior high	Senior high/ vocational	College and above
1986	1,231,739	2,402,736	89,023	76,256	64,230	84.23	25.79	28.66	25.25	16.88	40.82	40.29	2.01
1987	1,628,666	3,173,617	90,876	76,899	63,404	82.45	26.50	28.52	26.07	15.91	39.35	42.12	2.62
1988	1,784,131	3,766,339	83,599	70,199	57,415	81.79	27.26	28.84	26.90	15.69	40.52	40.28	3.51
1989	1,819,399	3,907,262	72,899	60,269	49,148	81.55	28.12	29.38	27.83	16.90	39.11	41.07	2.92
1990	1,616,831	3,525,148	67,667	55,297	45,098	81.56	28.94	29.82	28.74	16.37	38.94	40.34	4.35
1991	1,915,512	3,990,568	65,733	53,250	43,362	81.43	29.18	29.36	29.14	16.14	39.32	40.49	4.05
1992	2,118,807	4,315,095	57,215	45,259	37,303	82.42	30.17	31.35	29.92	17.23	39.14	41.32	2.31
1993	2,283,327	4,325,455	52,085	40,064	33,203	82.87	31.16	31.58	31.08	18.37	38.96	40.33	2.34
1994	2,800,633	4,780,210	53,212	40,971	33,634	82.09	31.56	31.05	31.67	15.88	37.36	42.71	4.05
1995	3,776,816	6,271,975	56,660	43,103	35,036	81.28	31.20	30.47	31.37	15.25	37.76	41.52	5.47
1996	3,987,053	6,897,065	55,495	41,695	33,883	81.26	31.29	30.89	31.39	14.08	35.60	43.83	6.49
1997	5,105,908	7,934,118	59,911	43,946	35,689	81.21	31.02	30.38	31.17	12.75	34.41	44.25	8.59
1998	5,169,025	7,332,904	59,355	42,264	34,213	80.95	31.60	31.00	31.74	11.76	31.49	46.60	10.15
1999	5,232,944	7,075,240	61,320	42,915	35,068	81.72	31.16	31.62	31.16	9.22	29.42	49.56	11.80
2000	6,843,199	8,704,822	70,364	49,410	40,327	81.62	30.41	29.92	30.52	7.76	23.22	55.49	13.53

Source: Ministry of Economic Affairs, *Essential Statistics* (various issues).

reached in 1987 with 90,876 employees, among them there were 76,899 work-ers; the corresponding numbers were 70,364 and 49,410 in 2000.[14] Unfortunately, no data are available to show whether or to what extent the workers in the zones were indeed from the poor families. It is therefore advisable to provide some indi-rect evidence by examining the characteristics of the workers in the zones.

The major characteristics of the EPZ workers can be learned from Table 7.4. Three salient features stand out, namely, a relatively low average age, a high proportion of female workers and a high but decreasing proportion of the less educated (with only elementary education or less). The average age was around twenty in the 1960s and early 1970s, increasing to thirty-one in the 1990s. An increase of eleven years in average age in thirty-four years implies that the zones tended to hire relatively young new entrants into the labour market, especially in the early years.[15] This in turn indicates that the workers were most likely to be the ones with relatively low educational attainment. The fact that around 85 per cent up to 1986 and over 80 per cent of the workers as of 2000 were females, which were twice that of the whole manufacturing sector in the corresponding years, might also attest this argument (Figure 7.2).

Even though there is no institutional discrimination against females, some traditional family and cultural factors worked against education for women in the early years, especially among the poor families (Tsay 1987). Due to poverty, the poor families could not afford to have their children go beyond the compulsory

Figure 7.2 Percentage of females among the employed in the manufacturing industry in Taiwan and among workers in EPZs.

Sources: Director General of Budget, *Yearbook of Manpower Survey Statistics* 1999; Director General of Budget, *Yearbook of Labour Statistics* 1984; Ministry of Economic Affairs, *Essential Statistics* (various issues).

education, which was extended to nine years of age in 1968. Instead, they expected the children to enter the job market and to help the whole family financially as early as possible. When a family had to make a choice of sending male or female children to school, the latter usually was the one to be sacrificed. There was a significant influence from the tradition of 'weighing more heavily on males than on females'. As a matter of fact, such a choice was almost the only rule among the poor families.

The information on educational attainment in Table 7.4 corroborates this inference. In 1983, sixteen years after the compulsory education was extended to nine years of age, 66 per cent of the workers in the zones had education at the primary or secondary level. Even as late as the 1990s, when the number of students in higher education as a percentage of population aged 18–21 exceeded 50 per cent, only around 10 per cent of the workers in the zones had educational attainment at college level or above. Figure 7.3 compares the earnings of the workers in the zones with those of the nationwide manufacturing workers. While not strictly comparable, the median wage rate of the workers in the zones clearly lags behind the average wage rate of the manufacturing sector in the whole country. Consequently, all the evidence points to the same conclusion that workers in

Figure 7.3 Average monthly earnings of employees in the manufacturing industry in Taiwan and median monthly wage of workers in EPZs.

Source: As per Figure 7.2.

the zones consist mainly of low educational attainment, low-skilled labour with limited human capital, satisfying the key features of the poor as observed in Tsai (2001). This finding is suggestive that the employment opportunities created in the EPZs could be extremely effective in terms of poverty alleviation.

It should be emphasised that the employment created in the EPZs might not be directly helpful to the poorest among the poor as officially defined. As pointed out in Tsai (2001), the officially defined poor families tend to be the ones with an aged single member, or the ones with most of their members being young dependents. In either case, it is very unlikely for them to take advantage of the working opportunities available in the zones. However, if the poor is interpreted to be the bottom quintile of the population as Dollar and Kraay (2000a, b) defined, it would be reasonable to claim that the establishment of the EPZs has been beneficial to poverty reduction in Taiwan.

Openness, growth and poverty alleviation: a quantitative assessment

We have discussed the theoretical underpinning of how trade policies could affect poverty through overall economic growth and through income distribution. It was also found that there has been a clear trend towards liberalising the economy in Taiwan; quantitative restrictions have been almost eliminated by the second half of the 1980s, and tariffs have also been linearly reduced. It is appropriate now to test quantitatively to see to what extent the Taiwanese experience bears out the theoretical prediction. The empirical exercise is on the lines of Dollar and Kraay (2000a, b) as well as Foster and Szekely (2001), though in a much smaller scale using only the time series data of Taiwan.

Due to the aforementioned defects of the official data on poverty incidence, we follow Dollar and Kraay (2000a, b) and define the poor as the bottom quintile of the population in Taiwan. The mean income of the poor (y^r) is calculated as the share of income earned by the bottom quintile times mean income (y), divided by 0.2. The model to be estimated is:

$$Ln(y^r)_t - \ln(y^r)_{t-1} = a + b(\ln(y)_t - \ln(y)_{t-1}) + c'(\ln(x)_t - \ln(x)_{t-1}) + e_t, \quad (7.1)$$

where $\ln(x)_t$ is a vector of control variables in logarithmic form at year t, and e_t is an error term. In estimating equation (7.1) the control variables other than mean income include a measure of openness defined as the sum of imports and exports as a share of GDP, the share of government consumption in GDP, the share of government spending on social security in government consumption and the share of exports from the EPZs in total exports. With the exception of openness, these variables are included because they are generally regarded as pro-poor policies. As for the effect of openness on poverty, while still under hot debate, it is widely regarded to be associated with higher growth and thus less poverty.

Since the growth of mean income is included, the effect of the other control variables that works through overall growth is already captured. The coefficient

for each of these control variables therefore captures the impact that it has on the income of the poor, or equivalently, on the share of income earned by the poor (Dollar and Kraay 2000a; Foster and Szekely 2001). Finally, while the trend towards overall liberalisation in Taiwan became clear in the early 1980s, the critical year in terms of liberalisation economically, socially and politically is 1987 (Chen 1999). To capture the likely impact of this structure change, we include a dummy variable (Dummy87) with value equal to one for all the years after and including 1987, and equal to zero otherwise.

The model is estimated by the ordinary least squares technique, using a data set with thirty-six observations, from 1964 to 2000.[16] We start with the basic specification with mean income and openness as the explanatory variables. We then add one by one, two by two and finally all the control variables to see how different combinations of these policy variables affect the results. The empirical results are reported in Table 7.5. In all cases, the condition number (not reported) indicates that there is no serious multicollinearity problem and the Durbin–Watson statistic indicates the absence of first-order autocorrelation.

Several findings stand out in Table 7.5. First, there is essentially no difference in explanatory power between different model specifications; all of them explain 86 or 87 per cent of the variation in the dependent variable. Second, only the

Table 7.5 Openness, growth and income of the poor: an econometric evidence[a]

Independent variable	Dependent variable: ln (per capital GDP of the first quintile)							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
ln (per capita GDP)	0.93	0.93	0.93	0.93	0.93	0.93	0.93	0.93
	(13.51)	(12.91)	(12.77)	(12.97)	(12.48)	(12.77)	(12.45)	(12.23)
Openness[b]	0.13	0.13	0.14	0.14	0.12	0.14	0.13	0.13
	(3.12)	(2.57)	(2.62)	(2.75)	(2.35)	(2.69)	(2.49)	(2.36)
Openness × Dummy87		0.01	−0.002	0.01	0.01	0.01	0.03	0.02
		(0.09)	(0.03)	(0.19)	(0.14)	(0.12)	(0.26)	(0.21)
Government consumption/GDP			0.02			0.01		0.003
			(0.65)			(0.34)		(0.11)
Expenditure on social security/ government consumption				−0.02		−0.02	−0.03	−0.03
				(−1.21)		(−1.05)	(−1.01)	(−0.81)
Exports of EPZs/ exports					0.002		0.01	0.01
					(0.24)		(0.65)	(0.55)
Number of observations	36	36	36	36	34	36	34	34
D–W statistics	2.30	2.29	2.22	2.14	2.32	2.11	2.14	2.14
$\bar{R}^2$	0.87	0.87	0.86	0.87	0.86	0.86	0.86	0.86

Notes
a All variables in changes of log values.
b Openness is (exports + imports)/GDP.
t-statistics are given in parenthesis.

coefficients of the two variables, mean income and openness, reach the conventional significant levels in each and every equation. Third, the estimated coefficients of mean income and openness are extremely stable, with that of the mean income always staying at 0.93 and that of openness varying between 0.12 and 0.14. Consequently, it might not be unreasonable to argue that the results are robust.

It is interesting to note that, while the *t*-values in Table 7.5 indicate that the estimated coefficient of mean income is statistically different from zero, it is not statistically different from one. Thus our empirical result from the time series data of Taiwan corroborates that of Dollar and Kraay (2000a, b) and Foster and Szekely (2001) that there is a one-to-one relationship between the growth of the income of the poor and the growth of mean income. In other words, the worry about the quality of growth on poverty might be overblown. Overall economic growth is definitely a 'must' if poverty reduction is the goal to be pursued. Of course, it is also likely that the 'quality of growth' in Taiwan is indeed good for the poor.

Contrary to the finding of Dollar and Kraay (2000a, b) and Foster and Szekely (2001), the estimated coefficient of openness is consistently positive and statistically significant at 1 per cent level in each equation. Thus our regression result suggests that in the case of Taiwan openness not only contributes to raising the mean income of the poor through economic growth, but through its impact on the share of income accruing to the poorest quintile. Every 1 per cent increase in the share of the sum of imports and exports in GDP leads to 0.13 per cent increase in the mean income of the poor on top of that brought about by economic growth. One possible explanation is that the export-led economic growth in Taiwan is unique in that it is based on thousands of small and medium-sized enterprises (SMEs). As pointed out in Tsai (2001), SMEs have always accounted for 60–80 per cent employment and 50–70 per cent of manufacturing exports in Taiwan. More importantly, the fact that SMEs have spread to essentially every corner of the island and made use of mostly simple, unskilled labour-intensive technology implies that they are particularly crucial in creating job opportunities in the backward poor areas. The non-farm opportunities and income emphasised so much by Chinn (1979) in alleviating rural poverty in Taiwan in the 1960s and early 1970s provide further evidence to this argument.

A popular impression in Taiwan is that the SME-based growth ran out of steam after the economy being greatly liberalised in the 1980s and as a consequence income distribution has been deteriorating since then. Is this impression correct? To answer the question, we add an interaction term between openness and Dummy87 in all the equation to see whether the coefficient of openness is different before and after 1987. As shown in Table 7.5 none of the estimated coefficients of the interaction term in the equations differs significantly from zero. Consequently, the suspicion that trade liberalisation has aggravated the income distribution, especially for the poorest quintile, is not supported by our empirical evidence.

Our empirical results, as those of Dollar and Kraay (2000a, b) and Foster and Szekely (2001), also show that none of the included policy variables has

significant impacts on the share of the income of the poorest quintile. However, it is probably worth noting that the share of social security spending in total government consumption tends to have negative impacts, though not statistically significant. This is at variance with the general conception that spending on social security is pro-poor. As pointed out by Dollar and Kraay (2000a), this could be due to ill-targeted spending of the social spending, or due to the fact that the simple share of government spending on social security is not a good measure of whether the policy is particularly pro-poor. Finally, the empirical result does not lent support to a significant impact of the EPZs on the income share of the poorest quintile, though all the estimated coefficients of the share of exports from EPZs are positively signed. This might be due to the fact that the share of exports from the EPZs is too small to exercise noticeable influence in a nationwide scale.

To sum up, the empirical evidence from the Taiwanese time-series data partly corroborates what observed in the cross-country studies and partly differs from them. On the one hand, as in most of the recent cross-country studies, it was found that economic growth generally benefits the poor as much as everyone else in Taiwan. On the other hand, being at variance with the findings of most large sample cross-countries studies, the empirical result indicates that an increase in openness further increases the mean incomes of the poor through raising the share of total income accruing to the bottom quintile of the population. This result holds even after mid-1980s when many people were concerned about the pernicious effect of accelerated liberalisation on income distribution. The Taiwanese experience suggests that an open trade regime could be conducive to both faster economic growth and successful poverty reduction, though it is certainly not the only thing needed to improve the lives of the poor.

Concluding remarks

Poverty reduction is one of the biggest challenges faced by the less-developed world to date. The success stories of some developing countries in the post-war period are overshadowed by the widespread poverty in others. Attacking poverty, therefore, remains an imperative work for many governments and international institutions in the foreseeable future. While still under hot debate, a consensus is emerging among researchers and policy makers that sustained economic growth is necessary for any successful fighting against poverty. This consensus, along with the widely accepted hypothesis that outward-oriented economies indeed grow more rapidly, implies that an open trade regime and integration into the global market is essential for poverty alleviation. As one of the exemplars of the export-led development with a relatively good record in poverty reduction, Taiwan is particularly relevant in terms of clarifying the trade/poverty nexus. The purpose of this paper is to provide the post-war experience of Taiwan in reorienting its economies towards liberalisation and the ensuing poverty reduction. It is hoped that the Taiwanese experience will shed some light on poverty reduction strategies in other countries.

This chapter begins with a description of the aggregate trend of poverty in Taiwan after 1965, using the official measure of poverty incidence. It then goes on to discuss the theoretical relationship between trade policies and poverty. In addition to the growth effect and income distribution effect, special attention is paid to the political economy of trade policy formulation and rent-seeking activities. The evolution of tariff and non-tariff barriers since the 1950s is presented to show that there has been a general, clear-cut trend in Taiwan's trade policies towards liberalisation, even though the rationale behind it is far from clear. The two measures, the customs duties rebate system and the EPZs, symbolising the export promotion development strategy in Taiwan are then discussed in some detail. Finally, a quantitative analysis is performed to assess how economic growth, openess, and other relevant policies could have contributed to poverty reduction in Taiwan during 1964–2000. The main findings are as follows.

First, the unequivocal poverty reduction in Taiwan came in the mid-1970s, more than a decade after the country veered towards outward-looking development strategy and attained sustained economic growth. The story might have been very different had the economic growth been interrupted for whatever reasons. This fact suggests that sustained economic growth is indeed a necessary condition for successful poverty reduction.

Second, the increasingly open trade regime not only brought about the remarkable economic growth in Taiwan but also worked to raise the income share of the poorest quintile. This result holds even after the economy was drastically liberalised in the 1980s and people increasingly concerned about the adverse income distribution effect of liberalisation. In contrast to the finding of most cross-country studies, trade liberalisation in Taiwan helps to alleviate poverty through both income and distribution effects.

Third, notwithstanding the above findings, the Taiwanese experience does not deny the importance of 'quality of growth' with respect to poverty alleviation. It is perfectly likely that the quality of economic growth in Taiwan during the past four decades has indeed been good for the poor. The fact that economic growth in Taiwan has been based on its comparative advantage and based on SMEs might be the most important feature of this good quality. Being the driving force of Taiwan's export-led growth, SMEs contribute to poverty alleviation indirectly through economic growth. They also directly help improve income distribution and reduce poverty by providing a great amount of low-skilled jobs. Their island-wide presence and tendency in employing low-skilled, labour-intensive technology are particularly helpful in raising the living standard in the backward, poor rural areas.

Fourth, the establishment of the EPZs has been quite successful in attracting foreign investment and earning foreign exchange. However, it has been less noticed that the EPZs are potentially very favourable to poverty alleviation. This is attested by the fact that the large majority of the workers employed in the zones are young females with relatively low human capital. As in many other countries, the low educational attainment, especially among the females, is one of the main characteristics of the poor in Taiwan. The job opportunities and

income made possible by the establishment of the EPZs have certainly improved the livelihood of those in the bottom quintile.

So what can be learned from the Taiwanese experience? The most obvious factor is that economic growth should not be compromised in whatsoever sense in the course of fighting against poverty. While not a sufficient condition, economic growth is doubtless a necessary one for poverty reduction as the Taiwanese experience clearly demonstrated. Second, as attested by the experience of most of the 'globalisers' including Taiwan, a freer trade regime is associated with higher rate of economic growth. To the extent that this relationship holds, the liberalisation of protective trade policies is an option worthy of serious consideration if poverty reduction is a target being pursued. Trade liberalisation has merits beyond enhancing economic growth when the political economy of trade policies and their implications for income distribution are taken into account. Third, given the fact that an overall, nationwide trade liberalisation is out of the possibility set, especially in developing countries, export promotion policies such as duties rebate system and EPZs might be useful as transitional measures. However, it needs to be cautioned that these measures should be consistent with a country's comparative advantage and should not be captured by powerful interest groups. Last but not least, while it might not be easy to emulate, the SME-based growth strategy should be taken into serious consideration. The experience in Taiwan shows that the SME-based growth could be extremely effective in improving income distribution and thus contribute to poverty reduction.

Acknowledgement

Notes

1 There are other policies or institutions, such as land reform, education and small and medium-sized businesses system, which also contributed to Taiwan's poverty reduction. For details, see Tsai (2001).
2 With the slogan 'Increase Wealth, Eliminate Poverty', the Well-To-Do program was launched by Governor Shieh Tong-Min of the Taiwan Providence under the instruction of Premier Chiang Ching-Kuo. For more details, see Tsai (2001).
3 This section draws heavily on Hoekman *et al.* (2001).
4 Winters (2000b) identifies six linkages existing between trade, trade policy and poverty. They are: (1) the price and availability of goods, (2) factor prices, income and employment, (3) government transfers influenced by changes in revenue from trade taxes, (4) the incentives for investment and innovation, (5) external shocks, especially changes in terms of trade and (6) short run risk and adjustment costs. Among these, (2) is generally regarded as having the greatest importance (Reimer 2002).
5 It is very likely that the higher growth might be just a transition effect rather than a shift to a different steady state growth rate. However, the transition might take a couple of decades or more that it is reasonable to speak of trade openness accelerating growth (Dollar and Kraay 2000b).

 6 Sometimes another phase called secondary import substitution (1972–80) is added (Tsai 1999).
 7 As mentioned above, foreign exchange control was imposed also. Since our focus is on trade policies, we will not get into measures concerning foreign exchange, though they were of critical importance during the 1950s and early 1960s.
 8 The requirements for applying for import controls have been revised from time to time. Once an application is approved, the import control will last for two years, but can be renewed if the reasons for the control still hold (Chang 1986).
 9 The share of these goods was quite small, accounting for 8.2 per cent and 7.9 per cent in July 1994 and July 1999, respectively (Chen 1999).
10 The effective rate of protection would be even higher if the duties rebates, to be discussed next, are taken into consideration.
11 According to the Bill for Rebating Customs Duties on Imported Raw Materials, export goods are eligible for duty rebates if: (1) they meet international standards for quality and packaging, (2) they have a large, or potentially large, export market, (3) there are no raw materials available domestically at prices comparable to those of the imported raw materials used in the production of the goods and (4) the imported raw materials account for a major portion of the cost of producing the exported goods, and customs duties for more than 2.5 per cent of the total value of production (Li 1995).
12 Under the bonded warehouse or bonded factory system, firms are allowed to bring in imported raw materials or intermediates for the production of export goods without paying import duties. The system operates under the supervision of customs authorities, who check the import and export containers going in between the port and the bonded factories or warehouses.
13 The other reason for the decrease in employment in the EPZs was the government's decision to stop giving tax holidays to labour-intensive investments after 1973.
14 The number of workers was separated from that of the total employees only after 1975.
15 Though not directly comparable, it is helpful to note that the median of the age of all employees in the manufacturing sector were 32.5 in the 1970s and 37.5 in the 1990s.
16 The sample size is determined exclusively by the availability of the data. The share of the income earned by the poorest quintile is the key variable delimiting the sample size. We have data on this variable from 1964 onward. However, before 1976 it was available only every two years. To avoid losing too many observations in a small time series data set, we interpolate the six years with missing value in between 1964 and 1976 with the mean of the shares before and after that particular year. When the share of exports from the EPZs is included in the estimation, the number of observations is reduced to thirty-four since the KEPZ started operation in 1966. The data on the exports from the EPZs are assembled from various sources published by the Economic Processing Zone Administration, Ministry of Economic Affairs. All other variables are available from various years' Taiwan Statistical Data Book published by the Council for Economic Planning and Development.

8 Trade policy reforms and poverty in Thailand

Isra Sarntisart and Paitoon Wiboonchutikula

Economic growth in Thailand has been marked by the growing dominance of the manufacturing sector. In the 1960s, manufacturing was dominated by import substituting industries, geared toward the domestic market. As the domestic market expanded by the early 1970s, the country pursued an outward-oriented development strategy, which contributed significantly, to the growth in export-oriented industries, and finance, insurance and the real estate (FIRE) sector. The share of agriculture, in both GDP and exports declined substantially since the 1970s.

Although industrialisation and openness are believed to be major factors behind Thailand's impressive growth record, its success in alleviating poverty and income inequality remains questionable. Since most manufacturing industries and FIRE sectors are highly concentrated in Bangkok and its surrounding provinces and regional centres, it appears that the benefits from greater outward-orientation and resulting industrialisation have not spread evenly across the country. This chapter examines the role of openness in employment intensive growth and poverty alleviation in Thailand.

An overview of the trade policy regime

Thailand has long been a relatively open economy. The openness index (trade per cent of GDP) was stable at about 50 per cent in the first half of the 1980s, which reached about 100 per cent by 1995. In the year before the financial crisis (when the export growth turned negative) and the year of the crisis (i.e. 1997) the ratio declined to about 90 per cent. In year 2000, the ratio increased again to over 110 per cent. However, it should be noted that the increase in the ratio after the crisis was not so much due to large trade expansion but rather, due to the shrinkage of GDP growth.

Trade policy in Thailand changed significantly after the crisis. From the 1960s to the early 1970s the policy was rather restrictive, under the import-substitution development strategy, where domestic production was protected against competing imports. From the mid-1970s, trade policy became more liberal as the development strategy began to shift towards export promotion. The policy of promoting exports from the 1970s to the early 1980s was aimed at generating

employment from the export sector, which mainly consisted of natural resource-based and labour-intensive goods. In the second half of the 1980s, Thailand adopted an active export-promotion policy. Both fiscal and financial incentives were provided to export-oriented industries with the expectation that these incentives would reduce a bias against exports caused by high tariffs and imperfect capital markets.

However, it was soon realised that fiscal and financial incentives were complex and inefficient. It was felt that a better policy for promoting trade would be to reduce trade impediments across the board. Thailand started to liberalise trade on a wider scale following a multiple-track approach, namely, unilateral liberalisation, under the GATT/WTO framework, liberalisation on the regional basis under the regional trade agreements (RTAs), and more recently, negotiations with individual countries to form bilateral free trade agreements. The following sections discuss the nature of trade policy regime in the various periods.

Trade policy before 1990

Thailand's trade policy regime was quite restrictive until the 1960s and the first half of the 1970s. During the mid-1970s and the early 1980s attempts were made to reduce tariff rates, but the rates remained high throughout the period. By the late 1980s, neither the average nominal tariff rate, nor the dispersion in the rates across industries, had reduced. In fact, the weighted average effective rate of protection in 1987 was 50 per cent higher than that of 1981. Also, the effective rates of protection for import-substitution industries were much higher than the exporting industries.[1] Thus, trade policy during this period showed a bias against exporting industries. Table 8.1 shows the structure of protection during 1981–97.

To reduce a bias against exports the Thai government introduced incentives in the form of both fiscal and financial credit. These incentives together with favourable world economic conditions had an impact on Thailand's unprecedented

Table 8.1 NRP and ERP rates in Thailand's manufacturing sector, 1981–97 (%)

Year	NRP		ERP	
	Mean	Dispersion	Mean	Dispersion
1981	22.80	11.79	18.83	30.37
1984	14.39	13.69	23.77	58.02
1987	17.73	17.54	28.86	55.93
1990	20.32	15.59	31.32	45.20
1992	18.99	14.77	28.07	35.70
1995	14.38	13.29	21.60	33.17
1997	10.31	7.61	13.30	15.06

Sources: The 1981, 1984 and 1987 figures are from Wiboonchutikula *et al.* 1989, and the 1990, 1992, 1995 and 1997 figures are from Meerod 1996.

growth in exports and GDP. Moreover, among all exports, those with the most rapid growth were manufactured exports such as canned foods, textiles and textile products, clothing, footwear, electrical and electronic goods and miscellaneous products, most of which were labour-intensive goods consistent with Thailand's factor endowment of abundant unskilled labour.[2] Although export growth generated employment and increased real wages, there was a considerable inefficiency in enterprises producing these goods.

Trade policy from 1990 to 1997

In the early 1990s, there were new attempts to liberalise the trade regime and reform the tax system for promoting growth and distributing the benefits to the wider community. First, the business tax system was changed to the value-added tax system in 1992 to eliminate the accumulation effects of the wage burden on producers. Most goods and services were subject to 7 per cent value-added tax but exports were exempted from the value-added tax in order to reduce a bias against exports. Second, the government implemented a comprehensive restructuring of the tariff schedule by reducing tariff rates and the number of tariff bands. However, this process took many years to complete. In fact, it was not until 1997 when the reform and the tariff rate categories were reduced from thirty-nine to six categories. The average applied rate was also reduced from 30 per cent in 1990 to 17 per cent in 1997. The newly reformed tariff rate structure follows the principle of value-added escalation, and the rates are the following: (i) zero for essential goods such as medical equipment and fertiliser, (ii) 1 per cent for raw materials, electronic parts and components, and vehicles for international transportation, (iii) 5 per cent for primary products and capital goods, (iv) 10 per cent for intermediate products, (v) 20 per cent for final products and (vi) 30 per cent for products needed special protection.[3]

Additionally, Thailand has also implemented its WTO commitments and accelerated its commitments under the ASEAN Free Trade Area (AFTA). It has also followed the Asia Pacific Economic Cooperation (APEC) liberalisation action plans to free trade and investment among member countries. As a result, both nominal and effective tariff rates fell throughout the 1990s (see Table 8.1).

Trade policy after the financial crisis

There was an initial concern that the financial crisis and the recession might lead Thailand to adopt protectionist policy to save foreign exchange and prevent worsening current account deficit. However, Thailand floated its currency after the crisis.[4] The Thai baht depreciated over 50 per cent in 1998 and the current account, with a deficit of 8 per cent of GDP for several years before the crisis, produced a surplus of about 12 per cent of GDP during 1997–9.

Immediately after the crisis there was a brief period when the government increased tariffs and surcharges to finance its spending that was badly needed to prevent a deepening recession. The increased revenue from tariff and taxation

was used to make up for the shortfall of government revenue during the period of negative GDP growth during 1997–99. In October 1997, the government increased tariffs substantially on many products some exceeding the WTO bound rates.[5] The argument for tariff increases and import surcharge imposition was that these measures were temporary only to finance the immediate increased expenditure of the government.

Growth, equity and poverty

Economic growth and structural change

The Thai economy has grown rapidly during the past three decades. Real GDP grew at about 8 per cent in the 1960s, and 7 per cent in the 1970s. During the first half of the 1980s, the growth rate fell slightly to about 6 per cent, but rose dramatically to 9 per cent in the second half. The growth rates of GDP in the beginning of the 1990s were well above 8 per cent. However, they dropped to about 6 per cent in 1996 and recorded a decline of −1.75 per cent for the first time in 1997. After the onset of the 1997 economic crisis, the economy has tended to recover, although at a slower growth rate (see Table 8.2).

Over the years, the structure of the Thai economy has been changing from a labour-intensive agricultural base to a capital-intensive manufacturing base. The share of agriculture in GDP dropped sharply from nearly 40 per cent in 1960 to about 11 per cent by the mid-1990s. These reductions were accompanied by a rapid expansion in the manufacturing sector whose share in GDP grew from 12.5 per cent in 1960 to 60 per cent by the mid-1990s, although it declined marginally after the crisis. Within manufacturing, the shares of food, beverages, tobacco and snuff fell, while the shares of petroleum refining, electrical machinery, and wearing apparel, leather and textiles rose sharply.

Table 8.2 Growth of GDP in Thailand at 1988 prices, 1961–2000ᴾ (%)

Sector	1961–4	1965–9	1970–4	1975–9	1980–4	1985–9	1990–4
GDP	7.08	8.86	6.27	7.98	5.56	9.04	9.02
Agriculture	5.16	6.44	1.72	4.67	3.28	5.02	2.27
Manufacture	10.48	12.53	7.48	10.89	6.43	11.44	11.73
Others	7.17	8.93	8.72	7.90	6.01	8.85	8.90
	1995	1996	1997	1998	1999ᴾ	2000ᴾ	
GDP	9.31	5.88	−1.45	−10.77	4.22	4.40	
Agriculture	4.15	4.05	−0.4	−3.10	2.71	2.67	
Manufacture	11.88	6.52	1.42	−11.44	11.51	5.89	
Others	8.79	5.83	−3.23	−11.83	0.15	3.74	

Sources: National Income of Thailand (various issues), Office of the National Economic and Social Development Board.

Notes
The 1961–87 data from the old series of national income were adjusted to 1988 prices.
p Provisional.

These structural changes brought about by an outward-oriented policy have changed the structure of employment in the Thai economy. Over the years, manufacturing labour force expanded at a much faster rate than agricultural labour, but the latter remains a major source of employment. The share of agricultural labour in total labour force declined from about 82 per cent in 1960 to about 42 per cent by the late 1990s. During the same period, the share of manufacturing labour rose from 3 to 1 per cent, while the share of other sectors jumped from 14 to 16 per cent.

There has been a major change in the structure of Thai's exports. A shift in trade and investment policy together with a favourable trading environment in the 1990s led to an expansion in labour-intensive exports. By the early 2000 the share of manufactured exports in total exports reached 75 per cent. The export sectors that grew at the highest rates were computer parts and components, telecommunications equipment, electrical and electronic products, auto parts and certain miscellaneous consumer goods. Thailand's major traditional exports such as textiles, clothing and footwear grew at much lower rates and their shares in total exports declined steadily throughout the decade (see Table 8.3). A note should be made that the production of electrical and electronic products in Thailand involved many assembly activities, which were quite labour-intensive. The growth in production of these items, which were mainly exported to the US and the EU, generated substantial employment particularly for the female workers. With regard to agriculture and processed food exports, there have been a decline since the mid-1990s which appears to be linked with the rising non-tariff barriers in developed countries for certain foods and labour-intensive exports (such as seafood, sugar, tapioca products and textiles).

Income disparities

During the past four decades, regional income disparities have been widening in Thailand. The gap in per capita gross regional products between Bangkok and the Northeast has reduced, while that between the Central region and the Northeast increased even after the implementation of outward-oriented reforms. The gap between the North and the Northeast remained constant.

The causes of regional income disparities are difficult to identify. They can be attributed to many factors, that is, spatial immobility of labour, transportation costs, the endowment of natural resources and productivity differences. Because of the differences in industrial mix across regions, productivity differences can also be regarded as a determinant of regional income disparities. A region with a large proportion of high productivity sectors, for example, manufacturing and highly processed industries, has high average productivity and income. Conversely, a region with a large proportion of low productivity sectors, for example, agriculture and simple processed industries, has low income.

The differences in industrial mix between Bangkok and surrounding provinces, and other regions, have been increasing. During the past three decades, the rapid expansion of the manufacturing sector, mostly located in Bangkok and the Central region,

Table 8.3 Thailand's export structural changes, 1990–2000 (%)

Export category	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000
Agriculture and processed foods	33.83	31.59	30.58	25.84	25.64	24.68	25.18	22.41	21.50	20.13	17.80
Food and processed foods	28.73	27.05	26.08	21.85	21.06	19.29	19.78	18.40	18.09	17.08	14.46
Non-food	5.10	4.54	4.49	3.99	4.58	5.39	5.39	4.01	3.41	3.06	3.34
Manufactured goods	63.11	65.51	66.75	71.04	72.28	73.02	71.25	70.72	73.41	73.85	75.25
Machinery and transport equipment	21.90	23.84	26.45	29.66	33.31	33.64	37.86	38.30	40.83	41.94	43.66
Chemical and chemical products	2.01	2.55	2.57	2.86	2.83	4.39	3.44	4.26	4.53	5.10	5.93
Other semi-manufactures	8.35	7.71	7.22	7.54	7.50	7.23	7.37	6.87	6.90	7.05	6.99
Textiles	4.02	3.96	3.89	3.68	3.64	3.43	3.40	3.47	3.28	3.11	2.85
Clothing	12.24	12.96	11.60	11.26	9.98	8.88	6.70	6.33	6.61	5.91	5.46
Miscellaneous consumer goods	14.01	13.90	14.52	15.42	14.43	14.60	11.65	10.63	10.21	9.72	9.06
Others	3.06	2.90	2.68	3.12	2.07	2.30	3.58	6.87	5.09	6.02	6.95
Total	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00	100.00

has characterised the high growth rates of the regions. Between 1960 and 1988, the share of Bangkok and the Central region in total manufacturing products increased from 68 to about 90 per cent. By the early 1990s, nearly 90 per cent of gross manufacturing products was still in Bangkok, the East and the Central region.

The bias in favour of manufacturing industries benefited Bangkok and the Central region. Before 1972, the systems of protection discriminated against the processed food activities and construction materials. For example, in the 1980s, protection for industries using agricultural raw materials was mostly negative. Also, protection for food industries was relatively lower than protection for other manufacturing industries. In 1960, more than 50 per cent of the products of the processed food industry originated from outside Bangkok and the Central region. Conversely, except for rubber products, the highly protected industries – intermediate products, consumer goods, machinery and transport equipment – were mostly located in Bangkok and the Central region. In the 1970s and the 1980s, these highly protected manufacturing industries still agglomerated in Bangkok and surrounding provinces. Since the beginning of the 1990s, because of the development of labour-intensive manufacture in Laem Chabang industrial estate and that of heavy industry in Map Ta Phut industrial estate, both in the Eastern Seaboard Area, the biases of the protective system toward Bangkok and surrounding provinces was reduced and the benefits of industrial protection has been shared by the East.

It is also well known that manufacturing in Bangkok and the surrounding provinces are more capital intensive than manufacturing in other parts of Thailand. Thus, productivity and income of manufacturing labour in Bangkok and the surrounding provinces is also higher. This fact, together with the conglomeration of manufacturing in Bangkok and surrounding provinces, partly explain the widening regional income disparities before and during the 1990s. Since the Northeast and the North supplied much of the manufacturing labour force in these regions, this should have indirectly reduced the incidence of poverty in the two poorest regions.

Trends in poverty

The most comprehensive study of poverty in Thailand is by Meesuk (1979). His study found significant reductions in poverty in Thailand between 1962/3 and 1975/6. Reductions were at both the national and regional levels. In 1962/3, around 57 per cent of urban Thais were in poverty, while in 1975/6, the figure dropped to 33 per cent. By 1980/1, poverty in most parts of Thailand was less than that in 1975/6, apart from the Central region where poverty increased, especially in sanitary districts and municipal areas. Although, the incidence of poverty rose in the first half of the 1980s due to high crop prices, it fell from the second half of the 1980s. A declining trend in poverty continued until Thailand experienced the economic crisis in 1997. The percentage of poor in the total population was around 32 per cent in 1990 which fell to around 27, 20 and 14 per cent in 1992, 1994 and 1996, respectively. Except between 1990 and 1992

Table 8.4 Percentage of poor in total population for selected years

Areas	1988	1990	1992	1994	1996	1998	2000
Whole kingdom	36.5	31.6	27.1	20.3	14.3	15.5	17.8
By community							
Municipal areas	5.1	4.2	3.6	2.4	1.0	1.4	1.5
Sanitary districts	24.0	21.9	12.8	9.6	7.6	7.5	8.4
Villages	44.8	39.0	29.7	21.2	18.5	17.3	19.1
By region							
North	35.0	26.9	27.7	19.4	13.6	13.8	19.4
Northeast	53.1	49.9	44.1	33.4	23.5	24.9	30.9
Central	25.8	22.4	14.2	10.2	7.9	8.0	6.6
South	34.1	30.1	23.7	20.9	14.0	18.5	16.3
Bangkok	2.2	1.6	0.9	0.6	0.1	0.4	0.1
Vicinity	7.7	2.6	2.3	2.6	1.3	0.7	0.5

Source: Calculated from SES.

Note
Based on the average NESDB poverty lines which were 473, 522, 600, 636, 737, 878 and 882 baht per person per year in 1988, 1990, 1992, 1994, 1996, 1998 and 2000, respectively.

in which poverty increased slightly in the North and between 1992 and 1994 in which poverty increased insignificantly in the vicinity of Bangkok, the decreases in poverty were uniform across regions and areas. Poverty reduction until the mid-1990s was recognised widely and was said to be quite successful.

The economic crisis that began in 1997 raised concerns over the sustainability of development policies and further reductions in poverty in Thailand. The percentage of poor in the total population increased slightly from around 14 per cent in 1996 to about 16 per cent in 1998, and rose dramatically to nearly 18 per cent in 2000 (Table 8.4). The increase between 1996 and 1998 occurred in almost all regions except the vicinity of Bangkok. Between 1998 and 2000, the overall increase in poverty was dominated by sharp increases in poverty in the poorest areas, especially the Northeast and the North, while poverty in other regions decreased slightly. Poverty tended to increase more in rural areas than in urban areas.

Although changes in poverty over the past four decades have been very impressive, it is remarkable that, for almost the whole period prior to the 1997 crisis, Bangkok has been insulated from poverty deterioration, while the Northeast has kept its record as the poorest region of the country. High incidence of poverty in the Northeast is attributed to the poor land quality and the low percentage of irrigated farmland. The rapid expansion in export-oriented industries in Bangkok and vicinity is the main reason for the low level of poverty in these areas.

Concluding remarks

Export-led growth has been a key factor in reducing poverty in Thailand. For almost the whole period prior to the 1997 crisis, poverty was in a decreasing trend. Despite industrial protection that increased in the pre-1990s period and

decreased after 1990, poverty tended to be reduced. While the Northeast has kept its record as the poorest region of the country, Bangkok and its vicinity have been well insulated from poverty deterioration. Overall, the incidence of poverty has been declining in Thailand, although poverty rose marginally after the onset of the 1997 economic crisis due to the impact of economic recession. Thailand's experience suggests that openness is a key to employment creation and poverty reduction, but the future could be different. The proliferating non-tariff barriers (e.g. anti-dumping standards and technicalities, regulations and trade-distorting subsidies, etc.) in the developed countries could prevent the poor in Thailand from benefitting from the country's increasing openness. This issue is very crucial and has important implications for all developing countries.

Acknowledgments

Notes

1 For further discussion of Thailand's trade policy in the 1980s see Akrasanee and Wiboonchutikula (1994).
2 Akrasanee and Wiboonchutikula (1994).
3 Due to the slow progress in tariff reform Thailand continued to rely on the system of import protection and at the same time gave import duty reduction and exemptions to exporters for promoting industrial production throughout the 1990s. The major agencies that provided these incentive measures are the BOI and the export processing zones (EPZs) under the Industrial Estate Authority of Thailand. However, it is important to note that in the late 1980s to 1992 the BOI granted tax and non-tax incentives primarily to local and foreign investors who produced goods for export. From the early 1990s to 1997 the BOI incentives shifted to the priority industries located in remote provinces for the purpose of industrial decentralisation. It clearly shows that the importance of export promotion was reduced as emphasis was put on relocating industries to provinces in the remote area.
4 See a discussion of Thailand's economic crisis in Warr (1999).
5 See World Trade Organisation (1999).

9   Transition from planning to market economy and poverty alleviation in Vietnam

Pham Lan Huong and Vo Tri Thanh

Vietnam was among the world's forty poorest countries with seven out of ten Vietnamese living in poverty by the mid-1980s. As a centrally planned economy, its production, distribution and consumption decisions were made by the government, with a very limited role of private sector. This substantially discouraged the growth prospect and resulted in higher poverty. However, this scenario has changed substantially with the opening of the economy in the late 1980s. The Vietnamese economy has experienced an unprecedented growth and poverty reduction in recent years and is seen as an example of a successful transition from a centrally planned to a market-oriented economy. This chapter presents the Vietnamese experience with market reforms and poverty alleviation.

Policy in the past and recent changes

Background

Prior to the 1980s, the Vietnamese economy was a traditional centrally planned economy. Its main features included state or collective ownership of factor of production, government control over physical inputs, outputs and prices, and very limited role of private sector. In general, the economy was characterised by serious distortion of resource allocation, poor incentives, and poor information flows. By the late 1970s, the Vietnamese economy suffered from low economic growth, stagnation in industrial production and a decline in food production due to poor agriculture productivity, forcing Vietnam to import large amounts of rice.

To reverse deteriorating conditions, some microeconomic reforms were introduced in the early 1980s. These included some degree of autonomy to industrial enterprises and farmers through market forces. In an attempt to stabilise the economy financial reform was also introduced in 1985 which resulted in a cut in government subsidies and gave greater autonomy to the SOEs. Also, emphasis was placed on increasing real wages, while stabilising the economy. However, these reforms failed to solve the fundamental problems of the country as they were implemented within the framework of the centrally planned economy.

By the mid-1980s, declining agricultural productivity and unfavourable weather condition caused real hardship in some areas. Food shortage in the North led to

starvation in twenty-one provinces and cities in the early 1988, hurting 9.3 million people (39.7 per cent of the total farming households), of which 3.6 million people were subject to serious starvation (Nguyen and Quang 1996). These, combined with the expectation of the drying up of aid from the former Soviet Union had created the strongest pressure for reforms.

The first significant policy changes were made during the Sixth Communist Party Congress in December 1986 when it approved the Renovation (*Doimoi*) Programme. The *Doimoi* Programme recognised the importance of a multi-ownership structure of Vietnam's economy. It also emphasised the importance of expanding opportunities for the people and by the people to promote growth and raise living standards. In March 1989, Vietnam adopted a radical reform package aimed at stabilising the economy, enhancing the role of private sector in trade and investment and encouraging competition. It was thought that a comprehensive reform package would sustain growth and alleviate growing poverty. Key reforms undertaken since 1989 are discussed below.

Macroeconomic stabilisation

In an attempt to stabilise the economy, several measures have been taken since the late 1980s. These included controlling growth in credit and government expenditures. Money printing to finance the budget deficits was replaced by issuing bonds and borrowing abroad. Interest rates were increased to positive levels in real terms. The government subsidies to SOEs were diminished and consumption subsidies were eliminated. Military demobilisation and public investment cutback also helped reduce government spending. Also, tight monetary and fiscal policy brought inflation down to a manageable level, from 775 per cent in 1986 to 5 per cent by 1993.

Macroeconomic stabilisation was successful in conjunction with price liberalisation. For instance, artificially low price setting by the government for most goods and services were abolished, which created incentives for manufacturers and farmers to produce, and at the same time relieved the fiscal burden. Other factors that contributed to overall price stabilisation included a large devaluation and unification of the multiple exchange rates.[1]

Private sector development and reform in SOEs

The government has taken several measures to increase private sector participation in production and distribution. These include recognition and encouragement of the private sector and creation of legal framework for the operation of private businesses including FDI. A legal framework for the corporate sector has gradually been created through promulgation and amendment of business-related laws and regulations. Rapid growth in services and construction in recent years mainly came from the quick response of the private entrepreneurs. In an attempt to make the operation of SOEs viable, the government has substantially reduced subsidies to these enterprises and given greater autonomy. Also, loss making and unfeasible enterprises have been liquidated. For instance, during

1990–4, the number of SOEs fell from 12 to 6.3 thousand and 1.5 million state workers (out of the 4.05 million total SOE employees) retired or reduced to part-time work (Fahey 1995). These reforms have already shown some positive improvements in growth performance of the SOE sector in the first half of 1990s. Further reforms have taken place in the early 2000 through asset sales and leasing out of the SOE sector to reduce the government participation.

Trade, investment and banking sector reform

Vietnam has substantially liberalised its trade, investment and banking sector since the late 1980s. In an attempt to integrate its economy with the rest of the world, Vietnam has entered into trade agreements with about sixty countries and has trade relations with some 150 countries. It has preferential trade agreement with the European Union (1992) and is the member of the Association of South East Asian Nations (ASEAN) (since June 1995) and the Asia Pacific Economic Cooperation (APEC) (since 1998). Furthermore, it has signed an US–Vietnam bilateral trade agreement (2000) and has been negotiating for WTO membership. Liberalisation of investment climate has resulted in a rapid growth in foreign investment between 1993 and 1997. The country has received foreign investment from some sixty countries.

To facilitate trade and investment, the government has also introduced reforms in the banking sector. In 1988, the mono-banking system, was replaced by a two-tier system where functions of a central bank and commercial banks were separated. However, the two-tier system could function only in 1990, when the laws on banking authorised the State Bank of Vietnam to assume traditional central bank functions such as the conduct of monetary policy and the supervision of the financial system. Also, sectoral restrictions on the specialised banking activities and the entry barriers were abolished. At present, in addition to the six state-owned commercial banks, a number of joint-stock banks, credit cooperatives/funds, joint-venture banks and foreign banks are in operation in the country.

Agricultural sector reform

Vietnam reform agenda also included agriculture sector reform which formally recognised the farming households as basic economic units in the rural economy and granted the long-term land use right. Reform also entitled farmers to purchase, sell and transfer factor of production in the market, which was banned previously. They were also allowed to sell surplus outputs after fulfilling obligations to the government. Agriculture sector reform was essential to poverty reduction as it is the largest sector of the economy and provides income to some three quarters of the population.

Labour market reform

The existence of labour market and its role in economic development was formally recognised for the first time in the 1992 Constitution. It was further

emphasised in the Labour Code passed in 1994. The 1994 Labour Code formally allows employment of a Vietnamese worker and defines ringing and firing provisions. The Labour Code also regulates other labour-market issues, such as labour contract, legal rights and obligations of employees, employers and intermediators, minimum wage, superannuation obligations and medical insurance. These developments in labour market promoted labour mobility and created employment opportunities in the private sector. The Labour Code has legalised the labour income, creating incentive to be productive. As consumption subsidies were removed, wages and salaries in the public sector have been adjusted, keeping in view the qualifications, working efforts and responsibilities.

Growth and poverty outcomes of policy reforms

Macroeconomic performance during the 1990s

With the introduction of reforms, the country has grown rapidly. During 1989–2000, the average annual growth in GDP was 7.1 per cent, accompanied by a continuous rise in per capita income and domestic savings. Per capita GDP increased by 1.8 times and the ratio of domestic savings to GDP rose by 3.2 times. All sectors grew although at different rates. Inflation was kept under control. Industry grew at the average annual rate of 9.6 per cent, enhancing entrepreneurs' income and creating employment opportunities for unskilled labour. The services sector performed well and the quality of services has improved dramatically to support growing private sector. For example, from 1991 to 2000, the value of financial services increased by 3.2 times, education and training services rose by 2.2 times, health and related social services increased by 1.7 times, transport, storage and communication increased by 1.8 times (Socialist Republic of Vietnam (SRV) 2002). With a change in the structure of the economy, the employment shares of industry and services have increased while that of agriculture has fallen. This reflects a common pattern of development when the labour force gradually moves out of agriculture to industry and services where it can earn more. Although the importance of agricultural sector in terms of GDP has been declining, it has made impressive progress with an average annual growth rate of 5.6 per cent over the 1990s. Since 1989, Vietnam has not only ensured food security at the national level, but has also turned from a net food importer into one of the largest exporters of rice, coffee and cashew nut.

   The maintenance of the real exchange rates combined with a gradual removal of trade barriers has boosted Vietnam's exports. It rose from US$ 854 million in 1987 to US$ 14.5 billion by 2000 with a substantial shift from the former trade blocks of socialist countries to the rest of the world. Vietnam's openness is high in terms of the ratio of total trade values to GDP. Although the country did not receive much financial support from the international organisations during the adjustment period, rapid growth in export earnings made it possible to finance increasing imports and the government spending.

Poverty reduction

Vietnam has made substantial progress in poverty alleviation.[2] A broad-based
growth pattern has lifted several households out of poverty. Dollar and Litvack
(1998) found that the decline in poverty since the mid-1980s has been remark-
able. Whether we use *the total poverty line* or *the food poverty line*, there has been a
sharp fall in both rural and urban poverty in the post-reform period (Figure 9.1).
For example, the total poverty line shows a decline in poverty from 58 per cent in
1993 to 37 per cent by 1989.[3] The number of households categorised as poor has
further declined from 37 per cent in 1998 to 32 per cent in 2000 (Poverty
Working Group 1999). In recent years, except for China and Indonesia in the
1980s, almost no other country has recorded such a sharp decline in poverty.

   Available studies suggest a decline in poverty in Vietnam as reflected by rising
household per capita expenditures due to an increase in real income during the
1990s. According to the Vietnam Living Standard Survey (VLSS)[4] the average
household per capita expenditures rose by 41 per cent between 1993 and 1998,
indicating an improvement in living standards. During this period the average
annual growth in GDP was about 7.2 per cent, which was much faster than
the average annual growth in population, which grew at 2 per cent, implying
5.2 per cent annual growth in per capita income in aggregate.

   Non-monetary measures of poverty also show an improvement during the
1990s. Access to public health centres, clean water, electricity and roads has
substantially improved between 1993 and 1998, indicating that the poor have
benefited after the liberalisation reforms (Table 9.1). Improved access to health
services and clean water has improved the life expectancy at birth and the adult
literacy rate. By 2000, Vietnam has achieved universalisation of primary educa-
tion. Child malnutrition also declined dramatically from about half the popula-
tion to a third between 1993 and 1998. The under-five child mortality rate fell
from 81 to 42 per cent, and maternal mortality rate declined from 110 to 100
per 100,000 live infants over the last ten years (SRV 2002). Vietnam's

Figure 9.1 Incidence of poverty in Vietnam, 1993 and 1998 (%).

Source: Adapted from Poverty Working Group (1999).

Table 9.1 Access to infrastructure in Vietnam, 1993 and 1998

Indicator	1993	1998
% of rural population with access to public health centre within the community	93	97
% of rural population with access to clean water*	17	29
% of urban population with access to clean water*	60	75
% of population using electricity as a main source of lighting	48	77

Source: Poverty Working Group (1999).

Note
* Clean water is defined to include piped water, deep wells with pumps and rainwater.

Table 9.2 Vietnam's human development index, 1992–9

Year	1992	1993	1994	1995	1997	1998	1999
Life expectancy at birth (years)	65.2	65.5	66.0	66.4	67.4	67.8	67.8
Adult literacy (%)	91.9	92.5	93	93.7	91.9	92.9	93.1
Combined enrollment rate (%)	49	51	55	55	62	63	67
Real GDP per capita (PPP US$)	1,010	1,040	1,208	1,236	1,630	1,689	1,860
HDI (value)	0.611	0.618	0.634	0.639	0.666	0.671	0.682
HDI (rank)	120	121	121	122	110	108	101

Source: National Centre for Social Sciences and Humanities (NCSSH) 2001.

Human Development Index (HDI) has shown a remarkable improvement since the early 1990s, increasing from 0.611 in 1992 to 0.682 in 1999.

Studies conducted by Action Aid Vietnam (1999), Mountain Rural Development Program (1999), Oxfam Great Britain (1999) and Save the Children UK (1999), reveal that poor households in Vietnam feel more confident about their livelihoods in recent years. With the introduction of market-oriented reforms, the poor are able to obtain higher prices for goods and services, leading to an improvement in their living standards. They have reported reduced stress, fewer domestic and community disputes as life was getting better and easier. The gains from reforms appear to have been widespread as all regions and groups have experienced a fall in poverty, although at different rates (Table 9.3).

The rates of poverty reduction among the regions has been unequal, and the income disparity increased rapidly over the 1990s, when the economic reforms began to take effect. Generally, poorer regions, usually the mountainous and remote ones, have tended to gain less from growth than richer regions. For example, the Red River Delta showed the largest reduction in poverty, whereas the pace was lowest in the Mekong River Delta. Regions with the highest concentration of the poor are Northern Uplands (28 per cent); Mekong Delta (21 per cent); and the North Central Coast (18 per cent), which together accounted for about 70 per cent of Vietnam's poverty. Nevertheless, compared with other developing

Table 9.3 Poverty in Vietnam by region, 1993 and 1998 (%)

Region	Share of population in 1998	Contribution to total poverty		Head count index		Poverty gap index		Poverty gap squared index	
		1993	*1998*	*1993*	*1998*	*1993*	*1998*	*1993*	*1998*
By urban region									
Rural	78	90	90	66	45	21	12	9	4
Urban	22	10	10	25	9	6	2	2	0.5
By region									
Northern Uplands	18	21	28	79	59	27	17	12	6
Red River Delta	20	23	15	63	29	19	6	7	2
North Central	14	16	18	75	48	25	12	11	4
Central Coast	11	10	10	50	35	17	11	8	5
Central Highlands	4	4	5	70	52	26	19	14	10
South East	13	7	3	33	8	9	1	4	0
Mekong Delta	21	18	21	47	37	14	8	6	3
All Vietnam	100	100	100	58	37	19	10	8	4

Source: Poverty Working Group 1999.

Table 9.4 Employment growth rates in Vietnam, 1993–8 (%)

	Farm self-employment	Non-farm self-employment	Wage employment	Total employment
All Vietnam	0.4	5.4	3.5	1.8
Rural	0.8	6.7	3.3	1.7
Urban	−8.7	3.9	3.7	2.0

countries, Vietnam is a good performer in terms of income equality that has not deteriorated quickly over the reform period. This outcome is attributed to quite equitable initial asset distribution, particularly land distribution among households, and widespread basic education resulting in high literacy (Dollar and Glewwe 1998; Wiens 1998).

Although poverty has fallen, there appears to be a rise in inequality (measured by Gini coefficient) and the gap between the rich and the poor appears to have widened nationwide.

How did growth influence poverty?

As the growth has been high and broad-based, poverty reduction has been widespread and substantial. Since Vietnam is a labour abundant country, the growth affects poverty reduction chiefly through employment creation and changes in income levels coming from more efficient use of existing factors. Among the major sources of employment, self-employed non-farm employment grew fastest during 1993–8 (Table 9.4), with a much higher growth in rural areas than in urban areas. Wage employment grew as well, but in contrast with self-employed non-farm employment, the growth in cities was higher than in the countryside.

Although growth in rural farm self-employment was not large (0.8 per cent), living standards of rural households improved substantially between 1993 and 1998. This is primarily due to an improvement in agricultural productivity coming from intensification and diversification away from low-value outputs (staple crops) to higher ones (livestock, aquaculture, perennial crops and fruits) and high export orientation. The real revenues from rice cultivation have increased by about 21 per cent and from livestock and aquaculture rose by 53 per cent (Poverty Working Group 1999). These figures confirm the crucial impact that the agricultural reform and the 1993 Land Law have had on patterns of agricultural production.

The reforms also raised the relative price of agricultural products. Favourable agricultural terms of trade at the time Vietnam opened up its economy further reinforced the gains. Between 1992 and 1998, Vietnam's rice export price increased on average by 9.2 per cent per year in nominal terms (Poverty Working Group 1999). Most rural households responded to the improved price incentives. As a result, agricultural export earnings rose by 14.3 per cent per annum over 1990–8 (General Statistical Office 2000), more than fourfold from US$ 1 billion in 1990 to US$ 4.3 billion in 2000 (SRV 2002). Consequently, rural agricultural income grew by 60.6 per cent between 1993 and 1998. Since most of the poor rely on agriculture for their living, a rise in income significantly increased their purchasing power.

The broad-based growth brought about by reform has reduced underemployment and unemployment in the 1990s. The VLSS indicates a fall in underemployment in the 1990s, from 66 per cent of total employees in 1993 to 57 per cent in 1998.[5] Unemployment also declined from 3.7 to 2.2 per cent in the same period. The redundant workers from the SOEs have found jobs relatively easy in the private sector that grew rapidly in response to strengthened property rights and a more supportive environment.

Rapid growth in output and export earnings raised the government revenues and increased its spending on infrastructure, education and health, which are essential for creating economic opportunities for the poor and reducing their vulnerability to escape poverty. During the 1990s, the road network has improved considerably and a large number of modern bridges have been built replacing old ones. Many ferry landings and wharves have been upgraded and expanded for meeting transportation demand in the last few years. Post and telecommunications services also have expanded rapidly and the domestic telecommunications network has been modernised. By 2000, 82 per cent of the communes had access to electricity and 94 per cent were accessible by car (Poverty Task Force 2001).

Poverty reduction has been the highest priorities of the government. Along with reforms to sustain economic growth, the government has made special financial resources for a national programme for poverty reduction since 1992 and a separate programme to develop basic infrastructure in remote and disadvantaged communes since 1998, despite budget constraints. The Bank for the Poor has been established to provide concessional credit with the total amount of funds lent to them reaching VN$ 5,500 billion. In addition, the government provided considerable support to ethnic minorities, fixed cultivation, sedentarisation and resettlement. Local people have made contribution to infrastructure

development projects by cash and in-kind that valued at tens of billion of VN$ (Central Committee for Ethnic Minorities and Mountainous Areas 2001).

Concluding remarks

The Vietnam experience so far suggests that market-oriented reforms do not hurt the poor, instead help the poor by increasing the demand for goods and services that they sell. The broad-based growth brought about by reforms has in fact increased opportunities for the poor and reduced poverty in the 1990s. However, these achievements may not be sustained unless another round of deeper reforms is introduced. There appears to be very low labour productivity, especially in agriculture as a whole, resulting in the widening income gap between rural and urban population. Also, rural underemployment and urban unemployment has been an issue. A large proportion of workers has low skills, and the employment generation in the manufacturing sector for unskilled labour has not been rapid. Product marketing and export expansion have been difficult due to over-supply of some goods, or high trade barriers in importing countries. Vietnam has to put tremendous efforts in changing the way of thoughts and institutions that lingers from the central planning time. There is a need for further reform in the SOEs and banking sector. Also, the existing education and training system needs to be reformed to make Vietnam competitive in the next century.

Notes

1 In 1989, the official exchange rate was devaluated from VN$ 900 to VN$ 5,000 per US dollar, the rate that prevailed in the black market (Dollar and Litvack 1998).
2 The poverty line mentioned in this chapter includes both the *food poverty line* (lower poverty line), and the *total poverty line*. The *food poverty line* refers to the level of per capita expenditures required to consume 2,100 Kcal per person a day, but makes no allowance for essential non-food expenditures. However, *total poverty line* makes an allowance for essential non-food consumption (such as clothing and housing) in defining the poverty line. Households on or above the *total poverty line* therefore have per capita expenditures sufficient to cover nutritional needs and basic non-food needs.
3 During the same period, the indicator of poverty based on the food poverty line suggests that the number of poor household has fallen from 25 to 15 per cent.
4 The 1993 and 1998 Living Standards Surveys were conducted by the General Statistical Office with funding from Swedish International Development Agency and United Nation Development Programme, and technical assistance from the World Bank. These nationally representative sample surveys provide data on a wide range of topics, including: expenditures and incomes; education; health, fertility and nutrition; employment; migration; housing; agricultural activities; small household businesses, credit and savings. In addition to the household questionnaires, the surveys also included commune questionnaires (for rural areas only), price questionnaires and, for 1998, modules on school and health facilities. Some 4,800 households were included in the first VLSS and about 6,000 households were covered in the most recent survey. Approximately, 4,300 households were included in both the first and second survey, providing a large panel of households useful for analysing how living standards have changed over time.
5 Those who work less than forty hours per week are classified as underemployed.

10 Poverty reduction and sectoral growth in Southeast Asia

Peter G. Warr

Economic booms were enjoyed by most of the countries of Southeast Asia since the late 1980s. During this protracted boom, great progress had been made in poverty reduction in all the countries that had experienced rapid growth. But by the late 1990s these same countries were experiencing deep recessions. Economic hardship was being felt at all levels of the income distribution in these countries but the implications for the poorest people has rightly been a concern in popular discussion and in the planning of international aid community. The present chapter attempts to contribute to this discussion. It focuses on four large countries of Southeast Asia, all of which have been badly affected by the economic crisis: Thailand, the first to succumb; Indonesia, which has proven to be the most severely affected; Malaysia, where the crisis had produced the most radical macro-economic policy responses; and the Philippines, where the pre-crisis boom had been least significant but where the crisis itself was nevertheless a serious event.

In each of these countries, the restoration of economic growth is a policy priority, but not just *any* growth. A lesson which has been drawn from reflection on the boom period and the crisis which followed it is that the quality of growth is important and not just the rate. But what is 'quality' growth? One criterion for determining the quality of growth, though certainly not the only one is its effects on the poor. What kinds of growth are most (and least) beneficial for the poor? Much of the development economics literature has dealt with is the manner in which the distribution of income is affected by the rate and composition of economic growth. How do relative inequality, on the one hand, and absolute poverty, on the other, change with economic growth and how do these effects depend on the characteristics of that growth, such as its sectoral composition? This chapter attempts to explore these issues in the context of Southeast Asia.

Poverty incidence in Southeast Asia

Available data on poverty incidence in the four Southeast Asian countries (Thailand, Indonesia, Malaysia and the Philippines) are summarised in Table 10.1a–d. The data are presented as aggregate poverty incidence and its rural and urban components. Poverty incidence and its changes over time obviously depends on many factors, of which economic variables are only part of the story and among the economic variables many issues aside from simply the overall rate

Table 10.1a Poverty incidence in Thailand, 1962–96 (%)

	Aggregate poverty (P)	Rural poverty (P^R)	Urban poverty (P^U)
1962	57	61	38
1969	40.73	44	26
1975	31.41	36.2	12.5
1981	22.98	27.3	7.5
1986	29.02	35.8	5.9
1988	21.05	25.5	6.1
1990	16.97	20.5	5.3
1992	12.38	15.5	2.4
1994	8.8	11.0	1.9
1996	6.15	7.73	1.4
1999	8.58	11.16	1.82

Source: National statistical data from government sources.

Note
Aggregate poverty is the percentage of the total population whose incomes fall below a poverty line held constant over time in real terms; rural poverty is the percentage of the rural population whose incomes fall below a poverty line held constant over time in real terms, and so forth.

Table 10.1b Poverty incidence in Indonesia, 1970–96 (%)

	Aggregate poverty (P)	Rural poverty (P^R)	Urban poverty (P^U)
1970	57.2	58.5	50.7
1976	50.18	54.5	31.5
1978	48.5	54.0	25.7
1980	39.2	44.6	19.7
1984	33.0	39.4	12.8
1987	21.6	26.8	7.3
1990	19.3	23.3	10.6
1993	17.3	21.3	9.0
1996	13.5	19.0	6.5
1998	20.7	29.0	10.1

Source and note: As in Table 10.1a.

of growth will be relevant. Changes in commodity prices will play a role, along with tax and public expenditure policies. The sectoral composition of growth may also be important. If so, this is important information.

Economic policies, including trade policies and industrial policies, influence the sectoral composition of growth. If poverty reduction is a priority, as the rhetoric of most governments clearly suggests, then the way in which economic policies may indirectly affect poverty incidence is important. The sectoral composition of growth may play a role, but casual perusal of the data suggest that the overall rate of growth may be an important part of the story. Large reductions in poverty have been achieved in each of the four countries but the rate of reduction was lowest in the Philippines, where the average rate of growth was also lowest.

Table 10.1c Poverty incidence in Malaysia, 1970–95 (%)

	Aggregate poverty (P)	Rural poverty (P^R)	Urban poverty (P^U)
1970	49.3	58.6	25.5
1976	39.6	47.8	17.9
1984	18.4	24.7	8.2
1990	17.1	21.08	7.5
1993	13.5	18.6	5.3
1995	9.6	16.1	4.1

Source and note: As in Table 10.1a.

Table 10.1d Poverty incidence in the Philippines, 1961–97 (%)

	Aggregate poverty (P)	Rural poverty (P^R)	Urban poverty (P^U)
1961	75.02	80.19	65
1965	67.08	71.15	57.43
1971	61.63	66.08	51.32
1985	59.65	63.3	51.18
1988	54.16	61	43.01
1991	55.77	64.5	47.08
1994	49.06	56.74	42.28
1997	42.1	43.15	32.6

Source and note: As in Table 10.1a.

To what extent does the overall rate of growth matter, and to what extent is its sectoral composition important in determining its effect on poverty incidence?

The literature has emphasised the sectoral composition of growth as a possible determinant of its distributional implications, although this emphasis has been based primarily on a priori theorising, rather than empirical analysis. The obvious argument is that in most poor countries a majority of the poor live in rural areas and are employed in agriculture. From this it has seemed probable that growth of agriculture is more important for poverty reduction than growth of industry or services. Many authors in the development economics field have taken this view, but the conclusion does not necessarily follow. Sectoral growth rates may not be independent. Expansion of capacity in one sector – say, food processing – may stimulate output growth elsewhere – say, fruit and vegetables. More important, people are potentially mobile; given sufficient time, even poor people can presumably move to whichever sector is generating the growth. Rural poverty may therefore be reduced by urban-based growth, drawing the poor away from rural areas at a rate which depends on the degree of labour mobility (Fields 1980). When these issues of sectoral interdependence and intersectoral factor mobility are taken into account, it is not obvious that the sectoral composition of growth is important for poverty reduction.

Even if labour was fully and instantaneously mobile, poverty incidence could still be affected by the sectoral composition of growth. To a first order of approximation,

the level of absolute poverty presumably depends on the demand for the factors of production owned by the poor – especially unskilled labour and, to a lesser extent, agricultural land. Growth in different sectors has differential effects on the demands for these factors, depending on these sectors' factor intensities, and may therefore have different effects on poverty, inequality or both. Finally, we should note that the distinction rural/urban is not synonymous with the distinction agriculture/non-agriculture. Much agricultural production may occur in full or part-time farming on the fringes of urban areas and much industrial and services activity may actually occur in rural areas.

The limited availability of data which may support statistical analysis has been an impediment to the systematic study of poverty incidence. Some recent studies have attempted to explore the relationships involved by analysing cross sectional data sets across countries, or across regions or households for individual countries, while others have attempted to assemble long-term time series data sets on poverty incidence for individual countries. The time series approach is generally preferable, in that it makes possible a direct study of the determinants of changes in poverty at an aggregate level.

Unfortunately, in most developing countries, the consumer expenditure surveys on which studies of poverty incidence must be based are conducted only intermittently. Data are thus available at most only with intervals of several years between observations. This is true of all of the countries of Southeast Asia. Even when all time series observations on poverty incidence at a national level are assembled for Thailand, the number of observations is only twelve. For Indonesia the number is ten for the Philippines eight and for Malaysia six. The number of observations is insufficient to sustain formal statistical analysis for any one of these countries, but when all four countries are pooled, the total number of observations is thirty-six. The present study thus attempts to pool the data for these four countries, while still recognising the possible differences between them.

Since the meaning of the poverty lines is different in each of the countries and also since the structure of the economies is different, we should not expect that the same relationship between poverty incidence and aggregate growth will exist in all these countries. We therefore experimented with intercept dummy variables for three of the four countries and with slope dummies. Data were assembled for the dependent variables $d \ln P$, $s^R d \ln P^R$ and $s^U d \ln P^U$. Each interval between the data points indicated in Table 10.1 is used to construct the values of these dependent variables, with the calculated value divided by the number of years corresponding to that time interval, giving an annual rate of change for the variable concerned. These annualised rates of change then become the variables used in the regression analysis described below.

Theoretical framework

Aggregate, rural and urban poverty incidence

We shall review first the relationship between aggregate, rural and urban poverty incidence and then turn to the manner in which each of these measures is affected

by economic growth. Changes in aggregate poverty incidence may be decomposed into rural and urban components, as follows. We shall write N, N^R and N^U for the total, rural and urban populations, respectively, where $N = N^R + N^U$. We write $\alpha^R = N^R/N$ and $\alpha^U = N^U/N$ for the rural and urban shares of the total population, respectively, where $\alpha^R + \alpha^U = 1$. The total number of people in poverty is given by $N_P = N_P^R + N_P^U$, where N_P^R and N_P^U denote the number in poverty in rural and urban areas, respectively. Aggregate poverty incidence is given by

$$P = N_P/N = (N_P^R + N_P^U)/N = \alpha^R P^R + \alpha^U P^U \tag{10.1}$$

where $P^R = N_P^R/N^R$ denotes the proportion of the rural population that is in poverty and $P^U = N_P^U/N^U$ the corresponding incidence of poverty in urban areas. Now, differentiating equation (10.1) totally, we obtain a key relationship,

$$dP = \alpha^R\, dP^R + \alpha^U\, dP^U + (P^R - P^U)d\alpha^R \tag{10.2}$$

From equation (10.2), the change in poverty incidence may be decomposed into three parts: (i) the change in rural poverty incidence, weighted by the rural population share, (ii) the change in urban poverty incidence weighted by the urban population share and (iii) the movement of populations from rural to urban areas weighted by the difference in poverty incidence between these two areas.

   The last of these terms is described by Anand and Kanbur (1985) and by Ravallion and Datt (1996) as the 'Kuznets effect'. As the population moves from rural to urban areas, a change in aggregate poverty incidence will occur even at constant levels of rural and urban poverty incidence, provided that the levels of poverty incidence in these two sectors is different. In growing economies, we expect to find that the rural population share is falling ($d\alpha^R < 0$) and that the incidence of poverty in rural areas typically exceeds that in urban areas ($(P^R - P^U) > 0$). Thus, the expected sign of $(P^R - P^U)d\alpha^R$ is negative. How important the Kuznets effect is as a determinant of overall poverty reduction is, of course, an empirical matter.

Poverty and aggregate growth

We now turn to the manner in which poverty incidence is affected by economic growth and, for simplicity, we hypothesise initially that the total number of households in poverty, N_P, depends on the aggregate level of real income, Y, and the size of the population, N. Thus

$$N_P = \varphi(Y, N) \tag{10.3}$$

The incidence of poverty is defined as

$$P = N_P/N = \varphi(Y, N)/N \tag{10.4}$$

Totally differentiating this equation,

$$dP = (\varphi_Y Y/N)y + (\varphi_N - \varphi/N)n \tag{10.5}$$

where lower case Roman letters represent the proportional changes of variables represented in levels by upper case Roman letters. Thus $y = dY/Y$ and $n = dN/N$ are the growth rates of aggregate real income and of population, respectively. In the special case where the function $\varphi(\cdot)$ is homogeneous of degree one in Y and N, equation (10.3) may be written $N_P = \varphi_Y Y + \varphi_N N$ and equation (10.5) reduces to

$$dP = (\varphi_Y Y/N)(y - n) \tag{10.6}$$

In this case the change in poverty incidence depends on the growth of per capita income. We shall not be imposing this assumption of linear homogeneity, but shall instead estimate relationships of the kind

$$dP = a^1 + b^1 y + c^1 n \tag{10.7}$$

and test whether the coefficient b^1 is significantly greater than zero. We shall also test whether $b^1 = -c^1$, that is, whether the growth of per capita income is the determinant of the change in poverty incidence, as in equation (10.6), or whether population growth affects the reduction in poverty incidence in some other way.

We wish to study the way economic growth affects each of the components of the change in aggregate poverty incidence, as given by equation (10.2). Ravallion and Datt (1996) apply an ingenious method for estimating decomposed equations systems of this kind. We have a four equation system, consisting of equation (10.7) and

$$\alpha^R dP^R = a^2 + b^2 y + c^2 n \tag{10.8}$$

$$\alpha^U dP^U = a^3 + b^3 y + c^3 n \tag{10.9}$$

$$(P^R - P^U)d\alpha^R = a^4 + b^4 y + c^4 n \tag{10.10}$$

But from the identity given by equation (10.2), these equations are linearly dependent. Equation (10.7) is identically the sum of equations (10.8), (10.9) and (10.10). Of these four equations, only three need to be estimated. The parameters of the fourth can be computed from equation (10.2). We shall estimate equations (10.7), (10.8) and (10.9) and infer the parameters of (10.10) from the identities $a^4 = a^1 - a^2 - a^3$, $b^4 = b^1 - b^2 - b^3$ and $c^4 = c^1 - c^2 - c^3$.

Poverty and sectoral growth

Whether the sectoral composition of economic growth affects poverty reduction can be investigated as follows. The level of real GDP is given by $Y = Y_a + Y_i + Y_s$, where Y_a, Y_i and Y_s denote value-added (contribution to GDP) at constant prices in agriculture, industry and services, respectively. The overall rate of growth can be decomposed into its sectoral components from

$$y = H_a y_a + H_i y_i + H_s y_s \tag{10.11}$$

where $H_k = Y_k/Y$, $k = (a, i, s)$, denotes the share of sector k in GDP. By estimating the equation

$$dP = a^1 + b_a^1 H_a y_a + b_i^1 H_i y_i + b_s^1 H_s y_s \tag{10.12}$$

and testing whether $b_a^1 = b_i^1 = b_s^1$, we may test directly whether the sectoral composition of growth affects the rate of poverty reduction.

An alternative way of viewing this relationship is to decompose equation (10.12) into a component depending on the aggregate rate of growth and a component depending on changes in its composition. Noting that $Y_a = (Y_a/Y)Y = H_aY$,

$$y_a = y + h_a \tag{10.13}$$

where $h_a = dH_a/H_a$ denotes the proportional change in agriculture's sectoral share of GDP. It follows that

$$b_a^1 H_a y_a + b_i^1 H_i y_i + b_s^1 H_s y_s = (b_a^1 H_a + b_i^1 H_i + b_s^1 H_s)y + b_a^1 H_a h_a + b_i^1 H_i h_i + b_s^1 H_s h_s \tag{10.14}$$

The reduction in poverty depends on the rate of aggregate growth (the coefficient in parentheses) and changes in its composition (the final three terms). Clearly, this expression reduces to a term in y alone if and only if the final three terms sum to zero. Now, by differentiating the identity $H_a + H_i + H_s = 1$, we see that

$$H_a h_a + H_i h_i + H_s h_s = 0 \tag{10.15}$$

Therefore, a sufficient condition for the final three terms of equation (10.14) to vanish is that $b_1 = b_2 = b_3$, as discussed in relation to equation (10.12). Clearly, to apply this decomposition, no additional econometrics is necessary beyond the estimation of equations like equation (10.12). Estimation of the parameters of (10.12) is sufficient to support the decomposition represented by equation (10.14).

Applying the method of equations (10.7), (10.8) and (10.9) above, we estimate the system

$$dP = a^1 + b_a^1 H_a y_a + b_i^1 H_i y_i + b_s^1 H_s y_s + c^1 n \tag{10.16}$$

$$\alpha^R dP^R = a^2 + b_a^2 H_a y_a + b_i^2 H_i y_i + b_s^2 H_s y_s + c^2 n \tag{10.17}$$

$$\alpha^U dP^U = a^3 + b_a^3 H_a y_a + b_i^3 H_i y_i + b_s^3 H_s y_s + c^3 n \tag{10.18}$$

The parameters of the fourth equation of the system

$$(P^R + P^U)d\alpha^R = a^4 + b_a^4 H_a y_a + b_i^4 H_i y_i + b_s^4 H_s y_s + c^4 n \tag{10.19}$$

are then computed using identities derived from equation (10.2) as before $a^4 = a^1 - a^2 - a^3$, $b_a^4 = b_a^1 - b_a^2 - b_a^3$, and so forth.

Results

The theoretical discussion above suggests the use of the absolute change of poverty incidence as the dependent variable, whereas some earlier studies have used the proportional change. Arguments can be mounted in support of either

version. To see whether this issue was important, the analysis was conducted for both. The results proved to be far superior for the absolute change version and the discussion will therefore concentrate on it.

Decomposition of changes in poverty incidence

First, we discuss the decomposition of the data on poverty incidence themselves. Table 10.2 shows the results of this decomposition.

All results shown in Table 10.2 are evaluated at the mean values of the data set. For example, the mean annual change in the aggregate level of poverty incidence for Thailand was −1.75 percentage points per year (i.e. an annual reduction, on average, from numbers like 20 per cent to numbers like 18.25 per cent). Equation (10.2), above, is an identity and must apply at all points in the data set. It must therefore apply at the means of the data. The equation shows that this mean aggregate change in poverty incidence can be decomposed into three components: average poverty reduction in urban areas, average poverty reduction in rural areas, and the average movement of population between these two areas.

The second half of the table normalises the decomposition by dividing all values by this mean change in aggregate poverty (−1.75 for Thailand, for example) and multiplying by 100. For Thailand reductions in rural poverty accounted for 88 per cent of the overall reduction in poverty, reduced urban poverty for 9.7 per cent and migration for 2.2 per cent. Migration effects were more important for Malaysia and Indonesia, but for all four countries reductions in rural poverty account for more than half of the total reduction in poverty that occurred and for all except the Philippines the proportion is more than two-thirds. The above calculations are, of course, merely descriptions of the data. We now turn to the question of what caused these observed changes in poverty incidence to occur.

Table 10.2 Data decomposition

Mean	Thailand	Indonesia	Malaysia	Philippines
Actual				
Aggregate	−1.969	−1.106	−1.528	−1.294
Urban	−0.323	−0.188	−0.290	−0.554
Rural	−1.676	−0.416	−0.934	−0.584
Migration	0.030	−0.502	−0.304	−0.156
Normalized (aggregate = 100)				
Aggregate	100	100	100	100
Urban	16	17	19	43
Rural	85	38	61	45
Migration	−2	45	20	12

Source and note: As in Table 10.1a.

Effects of sectoral growth on poverty incidence

All regression results are summarised in Tables 10.3a and b. If sectoral economic growth and population growth affect poverty reduction jointly through their effects on *per capita* sectoral growth, equation (10.16) can be re-written

$$dP = a^1 + b_a^1 H_a(y_a - n) + b_i^1 H_i(y_i - n) + b_s^1 H_s(y_s - n) \tag{10.20}$$

and similarly for equations (10.17)–(10.19). That is, equations (10.16)–(10.19) would each satisfy the restriction that $b_a^j H_a + b_i^j H_i + b_s^j H_s = c^j$, $j = (1, \ldots, 4)$. When this restriction was imposed on the estimates of equations (10.16)–(10.18) it was rejected at the 95 per cent level of significance in the case of equations (10.16) and (10.17) – total and rural poverty – but not in the case of equation (10.18) – urban poverty – which performed poorly in general. We therefore concentrate on Table 10.3b.

In the equation for aggregate poverty incidence, the estimated coefficients for agricultural growth and services growth were negative (growth of each of these sectors was associated with poverty reduction) and significantly different from zero, at the 95 per cent confidence level for agriculture and at the 99 per cent level for services. Growth of agriculture and services was associated with reductions in poverty. The absolute value of the estimated coefficient for agriculture was substantially smaller than the coefficients for services. The coefficient for industry was not significantly different from zero. The hypothesis that the true coefficients on agriculture, industry and services were equal to one another was rejected for the equations for total and rural poverty but could not be rejected for urban poverty. The equations for total and rural poverty produced high values and the F-test for the significance of the regressions is highly satisfactory in both cases. The regression results for urban poverty were unsatisfactory.

Table 10.4a–d shows the implications of the coefficients reported in Table 10.3b for the respective contributions of growth in agriculture, industry and services to the overall rate of poverty reduction which was achieved. For example, in Thailand, of the annual rate of poverty reduction which occurred (almost 2 per cent points per year) most was due to a reduction in rural poverty, rather than reductions in urban poverty or migration. However, the results indicate that it would be a mistake to attribute this reduction in rural poverty to growth of agriculture. Growth of services was far more important to the reduction in rural poverty and the reduction in overall poverty incidence. This pattern was repeated in each of the countries of the other three countries studied except Malaysia, where the contribution of agricultural growth outweighed services.

Finally, Table 10.5a–d decomposes the reductions in poverty incidence which occurred into two components: a 'growth effect' – the reduction in poverty that would have occurred if all sectors had grown at the rate of growth of GDP; and a 'compositional effect' – the reduction in poverty that resulted from deviations from uniform sectoral growth rates. In all countries, the growth effect dominates. According to these results, the sectoral composition of growth matters for poverty reduction, but the aggregate rate of growth is even more important.

Table 10.3a Regression results: sectoral growth rates per capita

	Change in total poverty		Change in rural poverty		Change in urban poverty	
	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic
Variable Constant	−0.3770	−1.674*	0.0635	0.307	−0.2861	0.307
Agriculture growth per capita	−0.1188	−0.328	−0.3613	−1.084	−0.086	−0.679
Industry growth per capita	0.2931	1.959**	0.2776	2.02**	−0.0377	−0.722
Services growth per capita	−1.334	−7.591***	−1.2825	−7.937***	−0.1144	−1.86*
Intercept dummy						
Thailand	0.4422	1.319	0.3511	1.140	0.1629	1.390
Indonesia	0.7147	1.942**	0.9633	2.847***	0.3134	2.435**
Malaysia	0.3992	1.047	0.4683	1.336*	0.2952	2.214**
R-squared		0.514		0.5593		0.161
Adjusted R-squared		0.489		0.5371		0.119
F-statistic		20.97***		25.18***		3.80**

Significant levels are: *** = 1 per cent; ** = 5 per cent; * = 10 per cent.

Table 10.3b Regression results: population growth as a separate variable

	Change in total poverty		Change in rural poverty		Change in urban poverty	
	Coefficient	t-statistic	Coefficient	t-statistic	Coefficient	t-statistic
Variable Constant	1.5894	4.226	2.0058	5.860***	0.1502	0.996
Agriculture growth	−0.5430	−2.283**	−0.7295	−3.369***	−0.1742	−1.826*
Industry growth	0.0578	0.476	0.0064	0.057	−0.0525	−1.078
Services growth	−1.1863	−8.621***	−1.0941	−8.376***	−0.1196	−2.167**
Population growth	−0.071	−0.631	−0.0361	−0.353	−0.03672	−0.815
Intercept dummy						
Thailand	1.050	3.627***	0.8851	2.408**	0.2317	1.997***
Indonesia	0.4119	1.355	0.6663	2.408***	0.2398	1.968
Malaysia	0.6291	1.956**	0.7117	2.431**	0.3376	2.618***
R-squared		0.672		0.708		0.2554
Adjusted R-squared		0.652		0.691		0.2112
F-statistic		34.50***		40.9***		5.78***
Test: $haya = hiyi = hsys$ (F-statistic)		13.71***		14.38***		
Test: $haya + hiyi + hsys = −n$ (F-statistic)		57.59***		78.64***		

Significant levels are: *** = 1 per cent; ** = 5 per cent; * = 10 per cent.

Table 10.4a Thailand: poverty reduction and sectoral growth – decomposition

	Constant	Agriculture	Industry	Service	Pop
Estimated (per cent points change per year)					
Aggregate	−1.969	2.43	−0.36	0.19	−4.06	−0.17
Urban	−0.323	0.46	−0.12	−0.17	−0.41	−0.09
Rural	−1.676	2.62	−0.49	0.02	−3.75	−0.08
Migration	0.030	−0.65	0.24	0.34	0.09	0.00
Normalised (aggregate = 100)					
Aggregate	100	−124	18	−10	206	8
Urban	16	−23	6	9	21	4
Rural	85	−133	25	−1	190	4
Migration	−2	33	−12	−17	−5	0

Table 10.4b Indonesia: poverty reduction and sectoral growth – decomposition

	Constant	Agriculture	Industry	Service	Pop
Estimated (per cent points change per year)					
Aggregate	−1.106	2.01	−0.46	0.14	−2.65	−0.14
Urban	−0.188	0.43	−0.15	−0.13	−0.27	−0.07
Rural	−0.416	2.71	−0.62	0.02	−2.45	−0.07
Migration	−0.502	−1.13	0.31	0.26	0.06	0.00
Normalised (aggregate = 100)					
Aggregate	100	−182	42	−13	240	13
Urban	17	−39	13	12	24	7
Rural	38	−245	56	−1	221	7
Migration	45	102	−28	−23	−6	0

Table 10.4c Malaysia: poverty reduction and sectoral growth – decomposition

	Constant	Agriculture	Industry	Service	Pop
Estimated (per cent points change per year)					
Aggregate	−1.528	−2.18	−0.94	0.08	−0.35	−0.02
Urban	−0.290	−0.48	0.30	−0.07	−0.03	−0.01
Rural	−0.934	−1.88	1.27	0.01	−0.32	−0.01
Migration	−0.304	0.18	−0.63	0.14	0.01	0.00
Normalised (aggregate = 100)					
Aggregate	100	143	−62	−5	23	1
Urban	19	31	−20	4	2	1
Rural	61	123	−83	−1	21	1
Migration	20	−12	41	−9	−1	−0.03

Table 10.4d Philippines: poverty reduction and sectoral growth – decomposition

	Constant	Agriculture	Industry	Service	Pop
Estimated (per cent points change per year)					
Aggregate	−1.294	1.36	−0.39	0.09	−2.16	−0.19
Urban	−0.554	−0.03	−0.13	−0.08	−0.22	−0.10
Rural	−0.584	2.02	−0.53	0.01	−1.99	−0.10
Migration	−0.156	−0.631	0.261	0.160	0.050	0.005
Normalised (aggregate = 100)					
Aggregate	100	−105	30	−7	167	15
Urban	43	2	10	6	17	8
Rural	45	−156	41	−1	154	8
Migration	12	49	−20	−12	−4	−0.4

Table 10.5a Thailand: decomposition of poverty reduction into aggregate growth effect and composition effect

	Constant	Growth	Composition
Estimated (per cent points change per year)			
Aggregate	−1.969	2.43	−4.24	−0.17
Urban	−0.323	0.46	−0.70	−0.09
Rural	−1.676	2.62	−4.21	−0.08
Migration	0.030	−0.65	0.67	0.00
Normalised (aggregate = 100)			
Aggregate	100	−124	215	8
Urban	16	−23	35	4
Rural	85	−133	214	4
Migration	−2	37	−38	0

Table 10.5b Indonesia: decomposition of poverty reduction into aggregate growth effect and composition effect

	Constant	Growth	Composition
Estimated (per cent points change per year)			
Aggregate	−1.106	2.010	−2.973	−0.143
Urban	−0.188	0.432	−0.547	−0.074
Rural	−0.416	2.710	−3.054	−0.072
Migration	−0.502	−1.133	0.627	0.004
Normalised (aggregate = 100)			
Aggregate	100	−182	269	13
Urban	17	−39	49	7
Rural	38	−245	276	7
Migration	45	102	−57	0

Table 10.5c Malaysia: decomposition of poverty reduction into aggregate growth effect and composition effect

	Constant	Growth	Composition
Estimated (per cent points change per year)			
Aggregate −1.528	−2.18	−5.59	2.25
Urban −0.290	−1.13	−0.68	1.52
Rural −0.934	−1.24	−5.68	1.98
Migration −0.304	0.18	0.77	−1.25
Normalised (aggregate = 100)			
Aggregate 100	143	235	−78
Urban 19	74	45	−99
Rural 61	81	241	−161
Migration 20	−12	−50	82

Table 10.5d Philippines: decomposition of poverty reduction into aggregate growth effect and composition effect

	Constant	Growth	Composition
Estimated (per cent points change per year)			
Aggregate −1.294	1.36	−2.46	−0.19
Urban −0.554	−0.03	−0.42	−0.10
Rural −0.584	2.02	−2.51	−0.10
Migration −0.156	−0.63	0.47	0.00
Normalised (aggregate = 100)			
Aggregate 100	−105	190	15
Urban 43	2	33	8
Rural 45	−156	194	8
Migration 12	49	−36	0

Conclusions

Our results confirm that poverty reduction was related to growth of agriculture and services but not to growth of industry. Growth of industrial output was very weakly associated with increases in poverty. Similar results have been obtained using data for India, except that the negative effects of industry growth were stronger. Results for Taiwan (Warr and Wen-thuan 1999) showed that growth of industry was strongly associated with poverty reduction. The differences may be due to the role of industry policy. Taiwan's more outward-oriented trade policy apparently induced a pattern of industrialisation which was conducive to a massive reduction of poverty incidence, occurring in both rural and urban areas. In Southeast Asia, as in India, heavy protection of industry led to a capital intensive, import substitution-led pattern of industrial development which did not

serve the interests of the poorest groups. If this hypothesis is correct, it presumably reflects the greater contribution of agricultural and services growth to the demand for unskilled labour – the principal resource owned by poor people.

Acknowledgement

Part III
The South Asian experience

11 Market-oriented reforms and poverty in Bangladesh

Clem Tisdell and Mohammad Alauddin

Bangladesh has experienced rising per capita income and increasing GDP since the 1960s and the direction of this growth has been sustained since it commenced market-oriented reforms in the early 1980s. For the first time in its history Bangladesh has achieved foodgrain sufficiency. It is important to remember that this is a significant achievement against the background of the fact that the goal of foodgrain self-sufficiency *albeit* in a narrow sense has eluded Bangladesh for nearly three decades. In the second half of the 1990s the annual growth rate in GDP has consistently topped the 5 per cent level and has broken the 4 per cent syndrome that has epitomised Bangladesh's growth in the preceding twenty-five years. Bangladesh has significantly reduced the rate of population growth to about 1.5 per cent, about half the rate thirty years ago and that of contemporary Pakistan. This is the second lowest in South Asia after Sri Lanka. Literacy rate has more than doubled over the last three decades. Bangladesh has made very slow but steady progress in addressing gender issues. Bangladesh has also come out of the shadow of famine and proved capable of managing crises like the flood of 1998, the most devastating in living memory (Alauddin and Tisdell 1998; Alauddin and Hossain 2001).

Significant changes have taken place in the occupational structure and composition of the labour force with an increasing number of women being employed in the formal sector, notably the ready-made garments industry. The sectoral composition of GDP has undergone significant changes. The contribution of agriculture to GDP has declined from more than 50 per cent in the late 1970s to around 30 per cent in the late 1990s while at the same time the contribution of the industrial sector to GDP has shown very little increase. One noteworthy feature of the sectoral composition GDP is that the share of the manufacturing sector has changed very little during the last two decades hovering about the 10–11 per cent mark. The services sector enjoys a disproportionately high importance accounting for more than 50 per cent of GDP.

There have been noticeable changes in the structure of foreign trade with a discernible trend away from Bangladesh's traditional dependence on jute-based items. Readymade garments constitute the single-most important foreign exchange earner. Despite a momentous decline in the share of primary exports, there has been a substantial growth of processed primary goods through the exports of

frozen fish and shrimps and leather products especially footwear. However, there does not seem to have been any significant diversification in Bangladesh's foreign trade in that a few commodities dominate it. For example, only four commodities account for nearly 80 per cent of export earnings (Alauddin 1999). The Gini–Hirschman (G–H) indices for Bangladesh's exports in terms of both its commodity composition as well as market destination show a trend toward increasing degree of concentration over time. Based on IMF International Trade Statistics Yearbook, Hossain and Alauddin (2002) report that the value of the G–H index has increased from 0.65 in 1975 to 0.76 in 1998. A characteristic feature of the time path of the G–H index is that it shows a U-shaped pattern, dropping over time to 0.45 in 1985 before increasing to 0.49 in 1990 and to 0.60 in 1995. Hossain and Alauddin (2002) further report that the four-country market concentration index has increased consistently from 0.17 in 1975 to 0.29 in 1998.

   While those economists convinced of the virtues of free market systems might be inclined to attribute Bangladesh's economic growth in the second half of the twentieth century to its market reforms, its 'take-off' into economic growth (Rostow 1960) seems to be mostly attributable to its adoption of Green Revolution technologies commencing in the second half of the 1960s and accelerating in the 1970s (Alauddin and Tisdell 1991). Its market-oriented reform began in the early 1980s, and proceeded fairly slowly and did not become relatively far reaching until the early 1990s.

   International political pressure was placed on Bangladesh via the Washington consensus to commence and accelerate its market-oriented reforms. Arguably, without such reforms, its economic growth would have suffered. But as is well known, growth in GDP per capita can be a poor indicator of human welfare. It may, for example, be associated with an increasing incidence of poverty or other indicators of declining well-being overall.

   In this chapter, the nature of the international political pressures on Bangladesh to undertake market reforms are briefly outlined and the pattern of Bangladesh's pro-market reforms and their balance of payments consequences are considered. This is followed by a general discussion of the impacts of Bangladesh's economic reform on welfare in Bangladesh, using various welfare indicators and paying some attention to income distribution considerations. This leads on to specific examination of Bangladesh's market reforms on the incidence of poverty and to a general discussion and conclusions.

International pressures for reforms

Like most developing countries, Bangladesh was placed under increasing international political pressure beginning in the 1970s to adopt market-oriented reforms and undertake structural adjustment policies to reduce the size of its public sector and make its economy more open by lowering trade protection for its domestic industries and by reducing restrictions on foreign direct investment. In Bangladesh, like its South Asian neighbours, attempts at reform began in the

1970s and 1980s but were piecemeal and had little impact as elsewhere in the region, except in India in the 1980s when the average growth rate rose above 5 per cent. Sri Lanka, however, is the exception in the group which went into reform mode as early as 1977 (Shand 1999). Nonetheless, it has been claimed that Bangladesh started earlier than most South Asian countries in integrating its economy into the global one and had, in fact, gone further than most of these nations in dismantling its import-substitution and protectionist trade regime by the end of the twentieth century. For example, India, despite opening up to the outside world, is still characterised by a more protectionist trade policy regime than Bangladesh which is constantly struggling to gain access to the Indian market.

Bodies such as the IMF and World Bank appear to have become convinced, possibly as early as the 1960s, on the basis of neoclassical theory, of the economic virtues of free markets and trade. Since the headquarters of these organisations were in Washington the general type of policies that they recommended were dubbed the Washington consensus. This consensus was further endorsed and reinforced by GATT, and subsequently WTO, as well as many other international aid and economic policy bodies. However, the speed of reforms has varied widely. While Bangladesh, for example, has instituted most reforms proposed by the IMF and World Bank, it has been slow in privatising public enterprises including its financial intermediaries. However, it moved quite quickly to adopt the macroeconomic stability policies recommended in the Washington consensus (Hossain and Chowdhury 1999).

In many cases, developing countries have had little alternative but to adopt structural adjustment policies. In general, foreign and concessional loans to developing countries were reduced during the last two decades of the twentieth century. Increasingly, aid and concessional loans have been made conditional on the adoption of structural adjustment programmes by the recipients. Furthermore, the economic failure of centrally planned economics became quite evident by the end of the 1980s and seemed to clinch the argument in favour of *laissez-faire* type market economies.

The World Bank (2000: 64) appears to reaffirm its original position, but with greater qualification than originally, in the following terms:

> In summary, market-oriented reforms have been widespread but uneven through the developing world. On average, they have delivered lower inflation and higher growth, both powerful forces for reducing income poverty. But reforms can also go awry, with painful consequences for poor people. Lack of supporting institutions, mistakes in sequencing reforms, or the capture of the reform process by powerful individuals or groups lie at the bottom of most failed reforms.

Sequence and pattern of reforms and their consequences

Bangladesh commenced its economic reforms around 1983. It concentrated initially on the imposition of macroeconomic discipline (fiscal and monetary restraint)

and there was some corporatisation of public enterprises in the 1980s but little privatisation of these. Macroeconomic reforms were followed by international trade reforms (liberalisation of international trade and currency exchange) and this gained momentum in the 1990s and was accompanied by price reforms in the 1990s. Despite the privatisation of some government-owned financial institutions and industrial enterprises, the Government of Bangladesh reported that by the beginning of the twenty-first century that a large number of government-owned enterprises remained and their losses continue to burden government finance (Government of Bangladesh 2001). While, by the end of the 1980s, little microeconomic reform (but significant macroeconomic reform) had occurred by the end of the 1990s substantial microeconomic reform was evident. By then, possibly Bangladesh had done more than any other South Asian nation to liberalise its economy and integrate it with the global economy (Khan 2002).

Protection of both agricultural and non-agricultural industry declined significantly in the 1990s. For example, the Government of Bangladesh (2001: 11) reports that under donor persuasion and the dictates of the Structural Adjustment Programmes, Bangladesh has brought down its level of public support to agriculture to an absolute minimum. Recent estimates of aggregate measure of support (AMS) to agriculture put this at around 1 per cent of agricultural output although the permissible level of such support under the Agreement on Agriculture of the WTO is 10 per cent. Furthermore, tariff protection fell in the 1990s from an average nominal rate of protection of 89 per cent in 1990–1 to 25 per cent in 1995–6. In addition, Bangladesh moved ahead with full exchange convertibility in the 1990s and with measures to encourage foreign direct investment. Consequently, despite its tardiness in the privatisation of a significant proportion of its public enterprises, Bangladesh had gone far by the beginning of the twenty-first century in implementing the policy recommendation of the Washington consensus.

There are at least three queries raised by the process of Bangladesh's market-oriented reforms. These are: was their timing and sequencing appropriate? How should one measure the extent of such reforms? What has been the impact of Bangladesh's economic growth, on economic welfare and poverty?

Bangladesh's reforms were evolutionary in character. This and the nature of their sequencing appears to have been politically desirable. There is generally less political opposition to macroeconomic reforms than to microeconomic because the latter often reduce the economic rents of cohesive interest groups. Therefore, progress with a structural adjustment programme is liable to be politically derailed if microeconomic reform is introduced early and on a wide front. Furthermore, from a political point of view, there can also be something to be said for delaying privatisation of public enterprises, as Bangladesh has done. Although these enterprises are often inefficient, in some developing countries, they play an important income support role for needy families.

It is difficult to obtain a precise measure of Bangladesh's progress with its market-oriented reforms. However, indicators of its trade openness constitute one such measure. However, whether Bangladesh's volume of exports plus its

volume of imports as a percentage of its GDP constitutes the best measure is unclear. This measure has trended upwards with fluctuations from around 22 per cent in the period 1979–82 to around 26 per cent in the period 1996–8. This indicates a rise in openness but not an extraordinary one after the reforms. However, Bangladesh's trade deficits were quite unsustainable in the period leading up to 1983. In 1982 for example, Bangladesh's imports were almost three times the value of its exports. However, with some lag, the ratio began to decline. By 1990, this ratio was about 2 : 1 and by 1997 about 1.4 : 1. Whereas Bangladesh's trade deficit was 10.71 per cent of its GDP in 1982, this had fallen to 8.06 per cent by 1990 and to 4.34 per cent in 1998. Given the initial disequilibrium in Bangladesh's balance of trade it may be appropriate to use its value of exports as a percentage of its GDP as an indicator of its openness and the progress of its economic reforms. Using this indicator, 'openness' increased slowly form 1983 onwards in the 1980s (from 1983, 6.74 to 7.15 per cent in 1989) but accelerated in the 1990s going from 7.72 per cent in 1990 to 111.18 per cent in 1998.

Bangladesh has been able to maintain a growth rate of GDP broadly in the range of 4–5 per cent since 1973 (Government of Bangladesh 2001: 2). There was not any significant increase in this growth rate in the early reform years. In fact, it seems likely that Bangladesh's economic growth in the period 1973–80 averaged 4.9 per cent per annum but was slower in the 1980s and early 1990s but still in excess of 4 per cent on average. However, in the second half of the 1990s, Bangladesh's average rate of growth of GDP was slightly in excess of 5 per cent per annum. By this time, its economic reforms were widely established. Furthermore, as time passed, its growth rate became more sustainable in view of its declining relative trade deficit.

Social welfare consequences

The social welfare consequences of economic change are often difficult to determine. This is partly so for philosophical reasons and because statistical information is often inadequate, especially in developing countries. In particular, increases in per capita income can be an inadequate indicator of increased social welfare. Such increases may be associated with rising income inequality or a growing incidence of poverty such that for some Bergson-type social welfare functions (Burk [Bergson] 1938), social welfare declines. This decline can be very well marked if Brawl's principle of distributive justice is applied (Rawls 1971).

It might be thought that the Human Development Index (HDI) would provide a satisfactory measure of human welfare. HDI is calculated by placing a one-third weight on an income index plus a longevity index plus an education index. But it fails to take adequate account within a country of inequality in income, and inequalities in longevity and access to education (Neumayer 2001). It is also subject to several other inadequacies as a social welfare indicator (Doessel and Gounder 1994; Sager and Najam 1998; Neumayer 2001), as are UNDPs gender inequality indices (Tisdell *et al.* 2001).

There is clear evidence that personal income inequality in Bangladesh has increased during the market reform period. While very recent evidence is not yet available, between 1991/2 and 1995/6 household expenditure surveys indicate rising income inequality. This is attributed to a large extent to rising differences between urban and rural incomes (Khan and Sen 2001). Khan and Sen (2001) also found that income inequality is much greater in urban areas than in rural areas and that urban incomes and consumption have shown a greater rate of increase in inequality during Bangladesh's market reform period. Given this urban–rural difference, urban migration (as has been occurring in Bangladesh) might be expected to add to overall income inequality. This trend contrasts with that in the mid-1970s to the early 1980s as far as income inequality is concerned. Rahman and Haque (1988) found that, in this period, growing per capita income was accompanied by a relatively stable distribution of income and consequently a declining incidence of poverty (Wodon 1995). However, in the reform period, income inequality has risen and there are 'mixed' consequences for the incidence of poverty, as outlined below.

Further, research is needed to determine trends in inequality in access to education in Bangladesh and in longevity. Nevertheless, bearing in mind that there are serious limitations to HDI as an indicator of social welfare, how has it altered as Bangladesh's market reforms have progressed and its economy has become more open?

As can be seen from Table 11.1, by the end of the 1990s, Bangladesh's HDI was on average only a little higher than in 1990, even though it was considerably higher than in 1992. If, however, Bangladesh's imports as a percentage of its GDP are used as an indicator of its degree of openness and the extent of its market-based reforms, the relationship between the two variables does not appear to be highly significant. Of course, it might have been that Bangladesh's

Table 11.1 Bangladesh's human development index (HDI) in comparison to openness (exports as a percentage of its GDP) in the 1990s

Year	HDI	Openness
1990	0.412	7.72
1991	0.364	8.94
1992	0.309	7.04
1993	0.365	7.29
1994	0.368	8.98
1995	0.371	8.68
1997	0.400	11.46
1998	0.461	11.18
1999	0.440	18.20

Source: BBS (1998).

HDI would have been lower if Bangladesh had not proceeded with its market reforms. However, testing this hypothesis may be impossible.

The ordinary least squares regression line for the data shown in Table 11.1 is

$$HDI = 0.3008 + 0.0037 OPENNESS \qquad (11.1)$$
$$(2.3344)$$

$$R^2 = 0.4377, \quad \text{adjusted } R^2 = 0.3574.$$

The figure in the parenthesis is the *t*-ratio. OPENNESS is Bangladesh's exports as a percentage of its GDP. This reveals that the relationship is not statistically significant at the 5 per cent level. Moreover, the absolute value of the slope is very small implying that a 1 per cent increase in the degree of openness would increase the value of the HDI by a negligible 0.0037. Thus there is insufficient evidence to prove that Bangladesh's market reforms and the increasing openness of its economy were significant and major factors in raising its HDI in the 1990s. Nevertheless, for most of the period there was a slight upward trend in its HDI.

Trends in the occurrence of poverty

There are many different ways to measure the occurrence of poverty and several different conceptions of poverty itself. Furthermore, it is being increasingly stressed that poverty is best assessed as a phenomenon involving multiple attributes (World Bank 2000). While there is much to be said for that point of view conceptually, it does add to the difficulty of assessing the occurrence of poverty, which in many cases has both a physical or biological dimension as well as a social dimension. Because of the social dimension (which in most cases reflects deprivation in well-being of individuals based on their resource-endowments relative to other members of society), poverty lines and the nationally perceived incidence of poverty are likely to vary from country to country.

Rather than, however, engaging in extensive discussion about appropriate ways to measure poverty, trends in two measurements will be considered here, namely the human poverty index (HPI) for Bangladesh and its national poverty lines as applied to urban and rural areas.

Whereas HPI measures average achievements in terms of life expectancy, educational attainment and adjusted GDP per capita, HPI is a measure of *average* human deprivation in relation to selected attributes. These attributes are the average probability at birth of not surviving to forty years of age, the adult illiteracy rate and a third component. This third component is the unweighted average of the population not using improved water resources, the percentage of children under five who are underweight plus (where available) a measure of average access to health services. In some ways, however, HPI is quite deceptive as an indicator of the extent of deprivation. For example, it does not take

account of the extent and distribution of deprivation below its thresholds. For example, of all children who are underweight, most may be just below the cut-off point for being underweight or considerably below it or distributed in a way that creates extra concern about the deprivation. It is necessary, therefore, to be aware of such issues when using HPI as a poverty indicator.

Few observations are available for HPI for Bangladesh. As can be seen from Table 11.2, it was, on average, lower in 1997 and 1998 than in 1994 and 1995 and during that time exports as a percentage of GDP also rose in Bangladesh. However, the number of observations are very few and while some positive association may exist between falling HPI and rising openness in Bangladesh's case, there is no indication that it is a causal relationship. In any case, if there is a causal mechanism, it would need to be explained. While there could conceivably be some influence of openness on some components of HDI, such as life expectancy, if nutrition improves, impacts on adult illiteracy would be long term and may not be closely related to openness.

In Bangladesh, the incidence of poverty (using official poverty lines) is much higher in rural areas than in urban areas. As can be seen from Table 11.3, the incidence of poverty in rural areas in Bangladesh was almost double that in rural

Table 11.2 Bangladesh's human poverty index (HPI) for available years in the 1990s compared with openness

Year	Poverty (HPI)	Openness
1994	48.3	8.98
1995	46.5	8.68
1997	44.4	11.46
1998	43.6	11.18

Source: BBS (1998).

Table 11.3 Percentage of rural and urban population in poverty in Bangladesh according to official statistics for available years compared with openness

Year	Rural	Urban	Openness
1973–4	47.7	32.3	4.26
1976–7	62.3	37.4	5.96
1983–4	53.8	40.9	6.74
1985–6	45.9	30.8	5.52
1988–9	49.7	35.9	6.69
1991–2	52.9	33.6	8.94
1995–6	51.1	26.3	8.69

Source: BBS (1998).

areas in 1995–6. Furthermore, as can be observed from Table 11.2, there has not been a significant downward trend in the incidence of poverty in rural Bangladesh. Furthermore, the incidence of poverty in rural areas *relative* to that in urban areas was at a higher level in 1995–6 compared to earlier years in the table. This suggests that as far as poverty reduction is concerned. An urban-bias has arisen from Bangladesh's market reforms and increased openness to international trade. However, the urban-bias in overall income growth resulting from the market reforms may be even stronger.

The number of observations on the incidence of poverty in Table 11.3 are relatively small. Great caution is required in drawing inferences from so few observations. While the incidence of rural poverty has shown no persistent downward trend during Bangladesh's reform period, arguably, the incidence of urban poverty does fall even though the significance of the relationship is open to question. This is particularly so because there is now some indications that the incidence of urban poverty has begun to rise since 1995–6 (Personal communication, Rehman Sobhan, February 2002).

Fitting ordinary least squares regression lines to the data in Table 11.3, the following linear relationships emerge:

$$\text{RURAL POVERTY} = 47.801 + 0.615 \text{OPENNESS} \tag{11.2}$$
$$(0.439)$$

$$R^2 = 0.0371, \quad \text{adjusted } R^2 = -0.1554$$

The figure in the parenthesis is the *t*-ratio

$$\text{URBAN POVERTY} = 38.072 - 0.626 \text{OPENNESS} \tag{11.3}$$
$$(-0.507)$$

$$R^2 = 0.0489, \quad \text{adjusted } R^2 = -0.1413$$

The figure in the parenthesis is the *t*-ratio. In both equations, the coefficients are not statistically significant.

It is also pertinent to note that in rural areas the incidence of poverty is positively associated with the degree to which rural residents have a limited amount of land. As can be seen from Table 11.4, the incidence of poverty is highest amongst the rural ladders and, in general, the smaller the landholding of rural dwellers, the higher is their likelihood of being in poverty.

It is also interesting to note that, while the average daily per capita calorie intake of Bangladeshis has shown a slight increase in the market reform period, protein intake has shown no such increase and indeed seems to have declined slightly (see Table 11.5). On average, the nutritiousness of food intake has not improved. In particular, the poor are most likely to suffer from protein deficiency and it seems possible that they are being increasingly crowded out of quality protein rich food by those on higher incomes as income inequality in Bangladesh

Table 11.4 Percentage share of population below poverty line by size of owned land (acres) in rural Bangladesh

Size of owned land in acres	Absolute poverty (2,122 kcal/day/person)		Hard core poverty (1,805 kcal/day/person)	
	1995–6	1991–2	1995–6	1991–2
Landless	66.0	69.7	44.3	54.5
0.01–0.49	58.0	59.4	32.2	36.8
0.50–1.49	40.8	43.6	20.4	23.9
1.50–2.49	33.7	37.4	14.9	19.0
2.50–7.49	32.1	33.0	113.2	17.7
7.50 +	20.5	19.5	7.1	9.7
All groups	47.1	47.6	24.6	28.3

Source: BBS (1998).

Table 11.5 Food, calorie and protein intakes of the people of Bangladesh

Types of intake	1985–6	1991–2	1995–6	2000
Per capita daily food intake (grams)		886.2	913.8	893.1
Per capita daily fish intake (grams)		34.5	43.8	38.45
Per capita daily calorie intake (kcal)	2,196	2,266	2,244	2,240
Per capita daily protein intake (grams)	63.50	62.72	64.96	62.50

Source: BBS (1998, 2001).

magnifies. This view is supported by a recent study by Jahan and Hossain (1998).

Thus, it can be concluded that Bangladesh's market-oriented reforms have not been associated with a reduction in the incidence of rural poverty. At the same time, however, there may have been a reduction in the incidence of urban poverty. Nevertheless, there is really only one observation in Table 11.3 that provides any reasonable support for this view. If the incidence of urban poverty has risen again as suggested by some observers (Personal communication, Rehman Sobhan, February 2002), it is possible that the market reforms have not even been very effective in reducing the incidence of urban poverty. Furthermore, even if a reduction in the incidence of urban poverty happened to be associated closely with the increasing openness of Bangladesh's economy, it would be necessary to specify the nature of the association, that is, to what extent a causal relationship exists and the nature of the causal connection, if any. It cannot be emphasised too often, that association does not imply causality, although causality may be present when an association between variables exists.

Discussion and conclusion

Supporters of the Washington consensus sometimes appear to promise economic miracles if their *laissez-faire* market policies are adopted, and amongst these promised claims is a significant reduction in the incidence of poverty. The basic

argument runs as follows: Reforms to create free markets and international trade openness and reduce government involvement in the economy will stimulate economic growth. Economic growth will be effective in raising living standards and reducing the incidence of poverty. This chapter is essentially a revisit of the trickle-down mechanism of the 1960s and early 1970s.

Because market reforms are risky from a national political view and electors have a relatively short-term perspective, it is politically important to detect or claim significant economic benefits from such policies as quickly as possible. Arguably, the IMF and the World Bank as well as other similar institutions, have been striving to support these claims. While this is advisable in some respects, it should be kept in mind that in such circumstances political imperatives can crowd out scientific analysis, for example, favourable political conclusions may be drawn from selected samples and from an insufficient number of observations. The latter is a particular problem in developing countries because available statistical data are often limited, may be subject to significant observational errors, and only infrequently available or available with significant delay. For instance, in early 2002 the latest available comprehensive official figures on the incidence of poverty in Bangladesh were for 1995–6. This means that there is a considerable lag in knowing what the changing incidence of poverty is in Bangladesh. However, preliminary figures for 2000 became available in 2001 (BBS 2001), so the lag is declining.

It is also pertinent to note that the effects of *laissez-faire* policies on indicators of human well-being and on poverty depend on the length of time such policies have been in operation. Changes on human capital, for instance, tend to be more of a long-term nature than a short-term one, and they alter the long-term human structure of societies. These effects are not, for example, fully apparent from HDI or HPI figures considered even for a whole decade. Yet there seems to be an increasing tendency for international organisations to draw significant conclusion about human development and well-being from short time-series of data. Therefore, it is difficult to escape the conclusion that 'quick results' may be required for political reason. This may be to show the policy-value of the organisation, or to provide support for its policy proposals or to justify funding for new research by it or for formulation of new policy proposals by it. Of necessity, international economic-policy organisations have a political agenda. Their reports, publications and pronouncements usually need to be assessed in this context.

While claims are often qualified (and as is well known qualification sometimes increases support for an argument), the basic thrust of the argument of those supporting the Washington consensus that market reforms result in economic growth and this in turn translate as a rule into poverty reduction, not only of income poverty but often also of non-income poverty. See, for example, the World Bank (2000: 64) statement quoted earlier in this chapter.

As mentioned above, there is an increasing tendency to consider poverty as a multi-dimensional concept. As a result, attributes of poverty additional to income deprivation are considered such as lack of access to educational opportunities and to medical care. In addition, one could add to this other types of deprivation experienced by the poor such as lack of resources to take advantage

of their legal and democratic rights. These features may, however, be conse-
quences mainly of income deprivation.

In addition, poverty has a dynamic dimension that is not in itself necessarily
associated closely with current income deprivation. Poverty has a much broader
connotation beyond the 'criterion of individual physical survival to satisfying a
full social existence' than income deprivation (Chambers 1988; Bernstein 1992:
16; Sen 2000) or the implicit acknowledgement of the notion of relative poverty
or deprivation in the World Bank (1990) discussion of poverty (Sen 1983). It is
the risk of becoming poor or suffering a significant reduction in economic well-
being. This risk can rise in economies that become increasingly market-oriented.
It can create serious problems in developing countries when traditional social
safety nets are eroded by growing 'commodification' and market expansion and
not replaced by government-supported safety nets. While the incidence of
income poverty, for example, is lower in urban than rural Bangladesh, it is possi-
ble that households in the urban areas show more variation in rising and falling
above the poverty line, and that this variation will increase with market reforms.
Consequently, the long-term or permanent income of the poor in urban areas
could be much lower than appears to be so from an annual snapshot. The extent
to which household income can be sustained and how surely it can be sustained
has important implications for the occurrence and measurement of poverty.
Economic insecurity can significantly reduce human well-being. There is a con-
siderable body of evidence which suggests that with rapid population growth,
depletion of natural resources and greater penetration of technological and mar-
ket forces, the cushioning effect of the access to natural resources especially, in
adverse circumstances, on the rural poor has become more limited and their
income security has been undermined (see, e.g. Hossain 1987; Alauddin and
Tisdell 1998). Furthermore, a seminal work on Great Bengal Famine of 1943 and
Bangladesh Famine of 1974 by Sen (1981) clearly demonstrates that adequate
aggregate supply of food does not necessarily avert starvation and famine.

Market-oriented economies can, especially if they are very open to interna-
tional trade, generate considerable income insecurity. Market reforms tend to pro-
mote economic specialisation and this can add to economic insecurity and in
some cases lack of economic sustainability (Tisdell and Fairbairn 1984). At the
same time as Bangladesh's exports have increased, it has become more specialised
in the exports of garments and textiles. This makes it more vulnerable to global
changes in the market for these products. This apart, shrimp farming has experi-
enced a phenomenal growth in Bangladesh over the entire period of reforms. This
is in response to rising global demand for farmed shrimp. While shrimp farming
has generated significant employment and foreign exchange, the process has
engendered high environmental costs. The livelihoods of many could be under
serious threat. Moreover, with money and muscle power being the dominant
force, the social environment is highly 'polluted' (Alauddin and Hamid 1999).

To conclude, although economic growth continued in Bangladesh throughout
its reform period, it has been accompanied by increasing income inequality and
no apparent reduction in the incidence of rural poverty. It is even debatable

whether there has been a significant reduction in the incidence of urban poverty in this period, particularly if all dimensions of poverty are taken into account. It seems that an economic miracle as a result of Bangladesh's reforms has yet to be realized. Proponents of the effectiveness of *laissez-faire* policies to reduce poverty could, however, argue that this is mainly because Bangladesh's reforms have not yet been in place for long enough or are not as yet, sufficiently far sweeping, for example, too may state enterprises remain. Or the following counterfactual argument could also be put forward, namely that without market reforms the incidence of poverty in Bangladesh would be far higher than it is now. These are all plausible possibilities. However, without adequate proof, these views have little scientific substance. All that can be safely concluded at present is that there is insufficient proof to show that Bangladesh's market-oriented reforms have resulted in a significant lasting reduction in its incidence of poverty and a sustainable increase in the well-being of its citizens.

Acknowledgement

12 How have the disadvantaged fared in India after the economic reforms?

J. V. Meenakshi and Ranjan Ray

India has recently completed a decade of economic reforms which began in June 1991. While the immediate stimulus for the reforms was the serious balance of payments situation facing the country in the second half of 1991, the reforms process, started by the then Finance Minister, Manmohan Singh, was designed to bring about far reaching structural changes to the Indian economy. The sequence of measures, that has been referred to as the 'process of liberalisation', has generated a vigorous debate on the desirability and effectiveness of these changes. Much of the discussion has been conducted at the level of macro aggregates such as growth rates, trade figures, output levels, etc., and relatively little at the household level. The principal reason for this is that household level statistics, unlike macro aggregates, are available only with a lag. Consequently, an assessment of the impact of the changes on household welfare has not taken place until now.

As the country starts the process of 'second generation reforms', it is important to look back at the 1990s and analyse the changes in poverty and inequality in the past decade. That is the principal motivation of this study. To keep the calculations manageable and to focus attention, the study concentrates exclusively on rural India. This study comes in the wake of a flurry of recent articles on poverty in India in the 1990s in the context of economic reforms. Examples include Sen (1996), Jha (2000), Lal *et al.* (2000) and Palmer-Jones and Sen (2001). With the recent release of the large sample survey data on consumer expenditure (55th round) by the National Sample Survey Organisation (NSS) relating to the period July, 1999 to June, 2000, it is now possible to compare the picture on poverty and inequality at the end of the 1990s with that in 1993/4 yielded by the consumer expenditure data from the 50th round.

Some significant changes in the scope and methodology of these surveys[1] (see Government of India (2001)) imply that the rounds are not strictly comparable. Indeed, Sen (2000) contends that the use of the mixed reference period renders the 55th round data completely non-comparable with the earlier large sample survey in the 50th round. It is important to note, also, that the NSS data is not without other limitations (see, e.g. Bhalla (2000)) and, consequently, some (e.g. Lal *et al.* (2000)) have relied on other data sets to provide evidence on this issue. However, the NSS data set is still the most comprehensive in its design and

coverage, and remains the primary data base used for poverty and inequality calculations in India.

The debate on methodological comparability across rounds assumes significance in light of the precipitous decline in head count ratios of poverty between 1993/4 and 1999/2000, leading to fears that this decline is merely a statistical arteifact, arising out of a comparison between non-comparable surveys. This has led researchers to attempt to suitably modify poverty estimates in order to bring a measure of comparability. While a detailed discussion of this work is beyond the scope of the present study, the consensus appears to be that adjustments do imply a lower magnitude of decline in poverty.

In this study, we abstain from these methodological considerations and instead focus attention on several issues that have not been addressed in most previous analyses. Apart from providing comparative evidence on poverty and inequality in India at the all India and the State levels between the two large scale NSS consumer expenditure surveys (50th and 55th rounds), the present study has the following features.

i   The study pays special attention to two disadvantaged groups in India, namely, the backward classes, that is, the scheduled castes and tribes (SC/ST) and female-headed households, and examines how these groups have fared in the 1990s in relation to the others.

ii The sensitivity of the poverty and inequality estimates to alternative treatments of household size and composition is examined. Since the expenditure data is provided at the household rather than the individual level, this is an important measurement issue and, as we report later, the incorporation of household composition has quite a significant impact on the poverty and inequality estimates.

iii The chapter compares poverty estimates, based on the concept of 'absolute poverty', that is, using information on State specific and all India poverty lines, with those based on 'relative poverty' that defines the poverty line as a fraction (2/3 in this study) of the sample median of per equivalent adult household expenditures. In addition, the chapter proposes and uses an alternative poverty measure that defines a household to be 'poor' if the expenditure share of cereals in its budget exceeds a priori set cut offs (0.35, 0.40). Since there is nothing sacrosanct about using a particular poverty concept, the sensitivity of the poverty estimate to the alternative measures is of some policy interest.

iv The study decomposes the changes in poverty in India over the period 1993/4 and 1999/2000 between the 'growth' and 'redistribution' components. There is now a significant literature that provides evidence on such decomposition for India and other countries – see, for example, Jain and Tendulkar (1990), Datt and Ravallion (1992) and Kakwani and Pernia (2000). We follow the methodology of the last study in providing evidence on this decomposition, not only at the all India level but, also, for each State and, separately, for the SC/ST and female-headed household groups.

The issue of sensitivity of poverty estimates to the treatment of household size, which is investigated here, has recently attracted considerable attention (e.g. Buhmann *et al.* (1988), Coulter *et al.* (1992), Dreze and Srinivasan (1997), Lancaster *et al.* (1999) and Meenakshi and Ray (2001)). Much of the interest in these studies has focused on the impact of allowing economies of household size on the poverty calculations. Poverty studies on India have tended to ignore the question of household composition and economies of household size in consumption (see, e.g. Dreze and Srinivasan (1996), Dubey and Gangopadhyay (1998) and Datt and Ravallion (1998)). Traditional analyses of poverty and welfare are conducted on a per capita basis, wherein households whose per capita incomes fall below a pre specified norm are identified as being poor. This ignores the fact that adults need more resources than children. Further, larger households may be able to take advantage of bulk discounts associated with larger purchases of a given commodity, say, cereals and thereby achieve a greater level of utility than that by a smaller household. While the importance of incorporating household size and composition in welfare analysis has long been recognised, empirical work on Indian data has been relatively scarce. The present study adds to the limited literature on this issue in the context of poverty in India (Dreze and Srinivasan (1997) and Meenakshi and Ray (2001)), and extends it to include evidence in the context of inequality.

Methodology

The estimates of economies of household size and of adult equivalence scales were obtained by estimating the following Engel curves expressed in budget share terms, w_i:

$$w_i = \alpha_i + \beta_i \left[\log\left(\frac{Y}{N^*}\right) \right] + \gamma_i \left[\log\left(\frac{Y}{N^*}\right) \right] + \delta_{i1}D_1 + \delta_{i2}D_2 + \delta_{i3}L + u_i \quad i = 1,\ldots,n$$

(12.1)

where Y is aggregate household expenditure, $N^* = (n_a + \rho n_c)^\theta$ is the economies of scale and equivalence scale adjusted measure of household size. n_a, n_c denote the number of adults, children, respectively, in the household and θ, ρ are the demographic parameters. D_1, D_2 are dummy variables corresponding to households belonging to SC/ST and female-headed households respectively. L is the size of landholdings owned by the household, and u_i is the stochastic error term. The estimates of θ, ρ, that have been reported for each State in Meenakshi and Ray (2001, table 3), are significant and well determined and show wide variation between the various regions. The State specific estimates, almost always, reject the hypothesis, $\theta = \rho = 1$, that is implicit in the use of the unadjusted household size as the expenditure deflator in the conventional use of per capita expenditure figures in the poverty calculations in India. The two sets of poverty estimates, namely, those corresponding to the use of N^* (adjusted household size)

and N (unadjusted household size) are referred to below as OPL1, OPL2 respectively.

In contrast to the above poverty measures, which are based on the official poverty line (OPL), the study also estimates poverty based on alternative definitions of the poverty line. These include the concept of 'relative poverty' with the poverty line defined as two-thirds of the sample median expenditure. In addition, we report poverty estimates using a 'behaviourally determined' (BD) poverty measure where a household is considered 'poor' if the cereal share of its budget exceeds 0.35, 0.40. These will be denoted as BD1, BD2, respectively. The basis for this poverty measure, also used by, for example, Rao (1981) and Lancaster *et al.* (1999), is Engel's law which states that the share of food (cereals, in our case) is inversely related to household welfare. The behaviourally determined poverty measure has the advantage of not requiring knowledge of subsistence expenditure or poverty line. Consequently, in the context of intertemporal poverty comparisons, while information on prices relevant to the poor are needed by the conventional measures to construct year specific poverty lines, such information is not required in case of the behaviourally determined poverty measure. However, the principal disadvantage of the latter is the arbitrariness involved in the choice of any particular value as the cut off for the cereal share. Consequently, the evidence on the sensitivity of the poverty estimate to the cut off used, that is presented later, is of some policy interest.

The decomposition of the temporal change in poverty between the 'pure growth' and the 'inequality components' is made as follows. Following Kakwani and Pernia (2000), suppose η is the proportional change in poverty when there is a positive growth rate of 1 per cent. This can be decomposed into two components, η_g and η_1 as follows:

$$\eta = \eta_g + \eta_1 \tag{12.2}$$

where η_g is the pure growth effect and η_1 is the inequality effect. η_g is the percentage change in poverty when the distribution of income does not change, while η_1 is the change in poverty when inequality changes in the absence of growth. The degree of pro-poor growth is measured by the index:

$$\phi = \frac{\eta}{\eta_g} \tag{12.3}$$

Three cases can now be distinguished.

Case 1: $\phi > 1$ which implies that growth is 'pro-poor', that is, the poor benefit proportionally more than the non poor.

Case 2: $0 < \phi < 1$ which implies that growth is not strictly pro-poor even though it still reduces poverty incidence.

Case 3: $\phi < 0$ which implies that economic growth actually leads to an increase in poverty.

Data and its principal features

The data for this study is provided by the unit record data on consumer expenditure in the rural areas collected for each of the States in India in the 50th round (1993/4) and the 55th round (1999/2000) of the NSS. In the 55th round, 71,385 households in over 6,000 villages were surveyed; the corresponding figure for the 50th round is 69,206 households across nearly 7,000 villages.[2] In both rounds, special efforts were made to canvass affluent households, typically believed to be under-represented in these consumer expenditure surveys. We also make use of net state domestic product figures made available to us from the National Accounts Statistics.

Notwithstanding some significant methodological differences in the measurement of consumer expenditure between the 55th round and the earlier large sample survey, some of which were noted earlier, the 50th and 55th rounds are considered broadly comparable given the focus of this study. For example, the change in the methodology regarding the change in reference period for the measurement of durable consumer goods may not be significant given the relative unimportance of durables in the poor household's basket of consumption; see, however, the contrary opinion expressed in Sen (2000). Note that though the 55th round reports expenditures on both seven-day and thirty-day recall, we use only the latter for comparability with the earlier round. We need to however keep in mind that the thirty-day estimate for poverty rate in 1999–2000 may not be fully comparable with the earlier estimate.

Since the poverty calculations were carried out for each State in rural India and at the all India level, we require the State specific and all India poverty lines in rural India for NSS rounds 50 (1993/4) and 55 (1999/2000). The former have been reported by Dubey and Gangopadhyay (1998: 56) and the latter in the Government of India (2001, table 1) press release. To keep the calculations manageable, we excluded Union territories from our analysis. The list of twenty-five States, considered here, appears in Table 12.1. As already mentioned, the estimates of the equivalence scale parameters θ, ρ used in calculating the expenditure deflator, N^*, to arrive at the poverty rates, OPL1, were the State specific parameter estimates obtained and reported in our earlier study (Meenakshi and Ray (2001, table 3)).

Table 12.1 presents the summary statistics in NSS round 55 (1999/2000) of some of the principal variables of interest in this study.[3] This table also contains the corresponding information on the SC/ST and female-headed households in each State. Household size and cereal share, in particular, vary considerably between States. The rich States of Punjab and Haryana have low average Cereal shares (0.12) while in the poorer States of Bihar and Orissa the average Cereal share rises to around 0.40. These figures are quite similar to the summary statistics from the NSS 50th round reported in Meenakshi and Ray (2001, table 1). While, not surprisingly, the percentage of households who belong to SC/ST groups varies widely between the various States, it is interesting to note that this is also true of the female-headed households. Kerala has the highest percentage

Table 12.1 Summary statistics of key variables[a] in NSS 55th round, 1999/2000

State	Sample size	All households				SC/ST households					Female-headed households				
	No of households	Per capita total expenditure (RS)	Household size	No. of children per household	Cereal share	% Living in SC/ST households	Per capita total expenditure (RS)	Household size	No of children per household	Cereal share	% Living in female-headed households	Per capita total expenditure (RS)	Household size	No of children per household	Cereal share
Andhra Pradesh	5,181	495.76	4.09	1.34	0.26	28.99	408.37	4.16	1.5	0.29	12.59	536.75	2.47	0.67	0.25
Arunachal Pradesh	827	761.99	4.98	1.97	0.26	73.21	786.68	5.2	2.04	0.26	5.68	854.62	3.7	1.41	0.23
Assam	3,488	449.23	5.49	2.01	0.33	26.39	446.21	5.61	2.01	0.35	7.88	478.66	4.33	1.33	0.31
Bihar	7,261	409.18	5.29	2.2	0.34	30.64	359.4	4.86	2.03	0.37	9.29	430.31	3.64	1.76	0.33
Goa	192	1,005.19	4.79	1.06	0.17	1.99	1,908.32	2.13	0	0.1	18.7	1,142.77	3.69	0.73	0.17
Gujarat	2,479	598.1	4.97	1.65	0.16	1.49	492.69	4.77	1.64	0.18	6.24	635.28	2.66	0.76	0.15
Haryana	1,132	74,4052	5.56	2.1	0.12	24.39	654.47	5.6	2.17	0.15	8.24	952.2	4.03	1.65	0.11
Himachal Pradesh	1,634	781.04	4.62	1.51	0.19	26.71	652.7	4.73	1.68	0.21	21.9	840.53	3.76	1.33	0.17
Jammu and Kashmir	1,440	727.21	5.21	1.63	0.21	9.19	585.13	5.22	2.06	0.22	5.9	891.34	3.07	1.1	0.17
Karnataka	2,750	537.54	4.89	1.61	0.21	28.37	445.94	4.71	1.72	0.21	12.99	516.61	3.47	0.88	0.22
Kerala	2,604	848.36	4.56	1.18	0.16	11.7	675.23	4.5	1.11	0.18	24.42	859.41	4.23	1.2	0.16
Madhya Pradesh	5,118	428.44	5.34	2.09	0.28	45.05	367.25	5.04	2.05	0.31	6.45	453.47	3.07	1.15	0.28
Maharashtra	4,107	541.89	4.73	1.64	0.19	30.43	440.42	4.6	1.74	0.21	9.32	582.4	2.79	0.85	0.19
Manipur	726	554.58	5.2	1.72	0.4	51.38	540.78	5.06	1.59	0.41	10.09	549.03	4.3	1.24	0.39
Meghalaya	933	595.24	5.08	1.97	0.24	93.31	593.92	5.1	1.97	0.24	23.04	620.24	4.55	1.52	0.23
Mizoram	426	785.43	5.22	1.89	0.2	94.81	788.39	5.23	1.88	0.2	7.72	929.18	4.05	1.16	0.17
Nagaland	480	1,015.23	5.03	1.64	0.23	92.75	1,002.53	5.16	1.7	0.23	11.68	1,052.26	3.46	0.91	0.23
Orissa	3,381	393.85	4.63	1.54	0.39	49.37	337.9	4.41	1.56	0.42	9.49	419.04	3.1	1.09	0.37
Punjab	2,138	788.3	5.45	1.79	0.11	41.19	632.97	5.22	1.95	0.13	8.1	893.31	4.21	1.54	0.11
Rajasthan	3,229	596.53	5.72	2.34	0.19	37.56	535.47	5.5	2.38	0.21	7.82	614.06	3.79	1.74	0.18
Sikkim	1,056	607.78	4.63	1.58	0.18	33.91	615.94	4.35	1.51	0.18	9.54	648.9	4.03	0.96	0.18
Tamil Nadu	4,137	548.49	4.04	1.14	0.2	30.39	457.44	4.19	1.28	0.21	15.05	543.2	2.85	0.66	0.2

Note
a The figures denote sample means; the per capita total expenditure figures relate to expenditure over thirty days.

of female-headed households in the sample (24.42 per cent) and Arunachal Pradesh the lowest (5.68 per cent). In per capita terms, the female-headed households enjoy, in most States, higher aggregate expenditure than the others. However, as we report later, this picture of relative affluence of such households changes drastically if we allow size economies of scale and non-identical consumption needs between adults and children. The female-headed households are smaller sized and have less children than others.

Results

In view of space constraints, we have reported the results selectively in this chapter. While the tables are reported in detail in Meenakshi and Ray (2002), the salient empirical features are described here. There is evidence on the sensitivity of the headcount measures of household poverty to the alternative poverty measures. The incorporation of adult/child relativities and economies of household size in the expenditure deflator leads to an increase in the headcount poverty rates in case of some, though not all, States, over the conventional measures based on per capita expenditure. The increase is quite large for the more populous States, for example, Bihar (51–61.8 per cent), Madhya Pradesh (44.9–50.9 per cent), Uttar Pradesh (37.1–41.3 per cent) and West Bengal (33.5–35.7 per cent). It is important to recognise, however, that the demographic adjustment leads to a reverse movement in the headcount poverty rates of several other States. However, the All India figures, reflecting the upward movement for the larger States, show a fairly significant increase in the poverty rates, thus, pointing to the importance of demographic adjustment in the poverty calculations. The cereal share based poverty estimates of the States are completely out of line with the poverty line based estimates. However, one ought to treat these estimates with caution since the budget share of cereals reflects, besides household welfare, sharp taste differences between the different regions in India.[4] The relative poverty rates, implied by the use of two-thirds sample median as the poverty line, lead to a large fall in the poverty rates in case of several States (e.g. Bihar, Uttar Pradesh and West Bengal) from the conventional measures (OPL1, OPL2), and this is reflected in the All India figures.

Meenakshi and Ray (2002) present the Statewide estimates of the headcount poverty rates, using the alternative expenditure deflators, for the SC/ST and female-headed households.[5] While the use of equivalent scales as the expenditure deflator leads to an increase in the poverty rates in the large States such as Bihar, Uttar Pradesh and West Bengal, the increase is particularly marked and, for nearly all the States, in case of female-headed households. This is reflected in a 50 per cent increase in the household poverty rate of female-headed households at the all India level. The smaller size of such households and the general absence of children in them prevents such households from exploiting the adult child relativities and economies of household size. Consequently, the poverty rate of female-headed households increases, almost always and quite sharply, in the presence of household size and composition. Also, both disadvantaged household

groups register higher poverty rates than the general population. Between these two groups, the SC/ST households register higher poverty rates than the female-headed households on the basis of the per capita (i.e. unadjusted) figures. However, the difference narrows and, in some cases, reverses its sign on the incorporation of adult/child relativities and economies of household size in the poverty calculations.

To highlight these contrasts, head count ratios for four States are compared graphically in Figure 12.1. The use of unadjusted head count ratios indicates that female-headed households have a lower incidence of poverty than all households, as one might expect given the higher per capita expenditures in female-headed households. However, when their smaller household size is taken into account, not only do relative differences shrink, but female-headed households are seen to be considerably *worse-off* as compared to all households in States such as Madhya Pradesh and West Bengal. Similarly, while unadjusted head count ratios of poverty are higher among SC/ST than all households in most States, the magnitude of difference widens when size and composition adjusted figures are used.

Meenakshi and Ray (2002, table 5) present the Gini coefficients of expenditure inequality, for each State, in the 55th round, using the alternative expenditure deflators. Almost without exception, the incorporation of household composition differences and economies of household size leads to a decline in expenditure inequality. This is reflected in the decline in inequality at the All

Figure 12.1 Comparison of adjusted and unadjusted head count ratios by social group, 55th round, 1999/2000, selected States.

India level which contrasts with the rise in household poverty mentioned above. The female-headed households exhibit higher inequality, and the SC/ST households record lower inequality than the rest of the population. The lack of employment opportunities explains the equalisation of incomes among the backward classes, even though it is accompanied by higher poverty rates in them than the other groups in society.

Tables 12.2 and 12.3 provide evidence on the changes to poverty and inequality, respectively, during the reforms period by presenting the corresponding estimates in NSS rounds 50 and 55. The decline in household poverty between 1993/4 and 1999/2000 is true for nearly every State and for all household groups. However, as noted earlier, a part of this decline may well be merely statistical rather than real reflecting a change in the methodologies used between NSS

Table 12.2 Comparison of household poverty[a] between round 50 (1993/4) and round 55 (1999/2000)

State	All households		SC/ST		Female-headed households	
	Round 50	Round 55	Round 50	Round 55	Round 50	Round 55
Andhra Pradesh	30.0	10.8	43.8	14.9	56.4	29.2
Arunachal Pradesh	45.1	15.2	47.5	15.7	76.9	4.7
Assam	58.8	38.6	58.9	38.4	76.0	49.4
Bihar	65.4	44.6	79.3	61.8	74.9	57.1
Goa	7.4	0.0	0.0	0.0	15.5	0.0
Gujarat	27.1	10.1	37.3	17.9	35.9	18.6
Haryana	24.8	6.3	40.9	15.3	17.7	3.1
Himachal Pradesh	27.4	4.8	39.4	5.6	21.3	4.0
Jammu and Kashmir	13.9	2.1	18.1	9.2	12.0	3.1
Karnataka	33.1	14.0	46.4	20.8	44.6	24.7
Kerala	28.6	6.7	44.1	13.0	33.1	13.5
Madhya Pradesh	36.8	37.1	48.2	50.9	55.5	57.2
Maharashtra	50.9	20.0	65.0	32.7	56.8	27.7
Manipur	33.6	18.1	43.2	26.6	40.9	31.3
Meghalaya	27.8	4.4	28.1	4.2	12.7	4.4
Mizoram	9.9	3.6	10.1	3.5	7.9	8.8
Nagaland	3.5	0.6	3.7	0.4	7.2	3.9
Orissa	55.1	47.5	66.3	63.1	53.7	48.5
Punjab	13.0	3.7	22.8	7.	13.3	4.8
Rajasthan	24.0	10.2	38.7	17.7	33.2	20.8
Sikkim	36.8	21.2	42.3	17.2	38.6	19.8
Tamil Nadu	42.2	18.3	54.8	24.7	62.1	39.9
Tripura	30.7	15.2	40.4	18.7	58.5	40.5
Uttar Pradesh	41.4	29.0	57.9	41.3	53.4	39.9
West Bengal	52.1	28.4	62.6	35.7	68.0	36.30
All India	41.8	24.5	54.6	35.80	52.9	30.10

Note
a The inequality estimates are 'adjusted', that is, based on per adult equivalent expenditure figures.

rounds 50 and 55. The magnitude of the decline in poverty varies widely between the various States. It should be noted that the head count ratios based on two-thirds median income, as well as those based on the behaviourally determined cereal shares BD1 and BD2, also indicate a decline in poverty, although the magnitude of decrease is not as great (results not presented for reasons of space).

However, notwithstanding the decade of reforms, the SC/ST and female-headed households continue to register higher poverty rates than the general population. Consequently, in 1999/2000, these disadvantaged groups experienced high poverty levels that are comparable to that experienced by the others at the beginning of the reforms period. Table 12.3 shows that the reforms period was characterised by a general decline in expenditure inequality for all the

Table 12.3 Comparison of Gini inequality[a] between round 50 (1993/4) and round 55 (1999/2000)

State	All households		SC/ST		Female-headed households	
	Round 50	Round 55	Round 50	Round 55	Round 50	Round 55
Andhra Pradesh	0.290	0.231	0.264	0.204	0.302	0.271
Arunachal Pradesh	0.304	0.290	0.302	0.305	0.281	0.268
Assam	0.177	0.195	0.147	0.190	0.233	0.217
Bihar	0.227	0.204	0.216	0.170	0.250	0.219
Goa	0.311	0.249	0.213	0.042	0.288	0.270
Gujarat	0.224	0.226	0.198	0.202	0.206	0.232
Haryana	0.312	0.242	0.258	0.206	0.332	0.285
Himachal Pradesh	0.282	0.233	0.250	0.200	0.297	0.233
Jammu and Kashmir	0.239	0.190	0.211	0.196	0.226	0.199
Karnataka	0.257	0.234	0.229	0.188	0.238	0.220
Kerala	0.291	0.281	0.212	0.231	0.334	0.335
Madhya Pradesh	0.281	0.240	0.232	0.205	0.291	0.248
Maharashtra	0.297	0.252	0.257	0.230	0.289	0.250
Manipur	0.160	0.199	0.169	0.218	0.189	0.199
Meghalaya	0.244	0.147	0.243	0.145	0.165	0.123
Mizoram	0.166	0.184	0.167	0.187	0.172	0.164
Nagaland	0.150	0.190	0.152	0.188	0.141	0.179
Orissa	0.244	0.241	0.218	0.213	0.244	0.255
Punjab	0.276	0.241	0.258	0.194	0.402	0.260
Rajasthan	0.260	0.203	0.282	0.201	0.279	0.244
Sikkim	0.322	0.332	0.360	0.337	0.336	0.350
Tamil Nadu	0.308	0.276	0.250	0.244	0.332	0.302
Tripura	0.240	0.184	0.242	0.187	0.251	0.181
Uttar Pradesh	0.283	0.243	0.259	0.218	0.329	0.246
West Bengal	0.249	0.215	0.200	0.216	0.279	0.230
All India	0.282	0.250	0.252	0.229	0.312	0.281

Note
a The inequality estimates are 'adjusted', that is, based on per adult equivalent expenditure figures.

household groups. However, at the end of the 1990s, female-headed households continue to register sharply higher inequality than the other groups in society.

Finally, Table 12.4 presents estimates of poverty decomposition (η and ϕ) as proposed by Kakwani and Pernia (2000). In calculating these parameters, we use State-specific growth rates in real per capita State domestic product, so as to account for differential growth patterns among States. However, since these growth rates are not available separately for rural and urban areas, we use the aggregate net SDP growth rate per capita. The evidence indicates that growth between 1993/4 and 1999/2000 has been strictly pro-poor (with $\phi > 1$) in about half the States. Kakwani and Pernia propose a slight relaxation of the cut off used to determine whether growth has been pro-poor and suggest using $\phi > 0.66$ as

Table 12.4 Poverty decomposition between round 50 (1993/4) and round 55 (1999/2000)

State	Based on unadjusted poverty calculations		Based on size-composition adjusted poverty calculations	
	η	ϕ	η	ϕ
Andhra Pradesh	−4.3	1.2	−4.0	1.2
Arunachal Pradesh	−11.2	3.7	−12.7	5.0
Assam	−9.7	3.8	−10.0	3.8
Bihar	−3.6	2.0	−3.1	2.0
Goa	−18.6	6.6	a	a
Gujarat	−2.9	0.8	−2.9	0.7
Haryana	−6.0	1.7	−6.2	1.7
Himachal Pradesh	−4.5	1.3	−5.1	1.4
Jammu and Kashmir	−9.8	2.0	−11.7	2.4
Karnataka	−2.3	0.8	−2.3	0.8
Kerala	−4.7	1.7	−4.9	1.7
Madhya Pradesh	0.1	0.0	0.1	0.0
Maharashtra	−4.0	2.1	−4.3	2.0
Manipur	−3.9	0.7	−2.9	0.6
Meghalaya	−7.2	1.8	−7.3	1.6
Mizoram	−5.5	1.0	−4.5	0.9
Nagaland	b	b	b	b
Orissa	−1.4	0.6	−1.3	0.6
Punjab	−6.3	1.3	−7.3	1.6
Rajasthan	−2.4	0.7	−2.9	0.7
Sikkim	−1.9	0.5	−1.7	0.5
Tamil Nadu	−2.2	0.8	−2.2	0.9
Tripura	−1.7	0.5	−1.9	0.6
Uttar Pradesh	−1.7	0.7	−1.7	0.8
West Bengal	−1.6	0.5	−1.7	0.6
All India	−2.4	1.0	−2.4	1.0

Notes
a There was no poverty in Goa using the adjusted head count ratio in 1999/2000.
b Poverty declined in Nagaland, although there was no appreciable change in the income growth rate.

being indicative of pro-poor growth. With this weaker criterion, about two-thirds of the States had pro-poor growth. At the all-India level, growth has pro-poor, irrespective of whether unadjusted or adjusted head count ratios are used as the poverty measure. It is important to note and stress, however, that, on the strict definition ($\phi \leq 1$), growth in the 1990s has *not* been 'pro-poor' in several of the larger States, for example, Karnataka, Madhya Pradesh, Uttar Pradesh and West Bengal.

Conclusions

While our results point to a general decline in poverty and inequality in India in the 1990s, it is important to note that economic growth during the period of reforms has *not* been 'pro-poor' in several States, including some of the most populous ones. Moreover, at the end of the 1990s, several regions and groups continue to experience high levels of poverty and relative deprivation. There exist distinctly disadvantaged social groups in the country – the SC/ST and female-headed households, who continue to fare worse than other households, despite an improvement in their standards of living as well. These disparities are highlighted when the distinct demographic composition of such households is taken into account. Indeed, in the case of female-headed households, it is only when their distinct demographic composition is taken into account, that the fact that they are worse off than other households becomes apparent in many States. The persistence of these disparities suggests that anti-poverty programmes should target these vulnerable households.

Acknowledgements

Notes

1 The most significant changes are with respect to the use of two different reference periods, and the use of an abridged schedule for some items. A good discussion of the impact of different recall periods is contained in the report of the NSSO's Expert Group on Non-Sampling Errors (2001).
2 In both rounds, well over 100,000 households were surveyed in both rural and urban areas.
3 In this and the tables that follow, we use household-specific sampling weights (rather than per capita weights) in calculating averages, head count ratios, and so on.
4 See Meenakshi and Ray (1999) for detailed evidence on such regional variation in consumer preferences.
5 Note that given the small percentage of such households in many States, the poverty and inequality calculations are often based on extremely small sample sizes, and should best be used as indicative of trends.

13 Trade policy regimes, growth and poverty

The Nepalese experience

Binod K. Karmacharya and Kishor Sharma

The debate over liberalisation, growth and poverty has produced a large number of studies in developing countries, although empirical findings are inconclusive. The evidence from East Asia suggests that rapid growth brought about by openness has substantially reduced poverty and inequality in these countries. However, their experience is less relevant to a least developed country (LDC) like Nepal, which lacks human capital, efficient infrastructure and institutions. There is a widespread perception that liberalisation has in fact increased poverty in LDCs (UNCTAD 2002). For example, measures to achieve the fiscal balance (as a part of market-oriented reforms) have resulted in contraction of infrastructure budget and social expenditure, making the access to basic services difficult for the poor. Also, deregulation of financial markets has resulted in the closure of banks in many rural areas, making the cost of borrowing high for the poor. Furthermore, contraction of public sector and privatisation of public enterprises, in the absence of well-developed private sector, has further aggravated poverty in LDCs.

In this chapter we shed light on this debate by examining the experience of Nepal which is a LDC. Nepal has one of the lowest per capita incomes. Agriculture is the backbone of its economy, which employs about 80 per cent of the population and contributes over 40 per cent to GDP. Despite heavy emphasis on industrialisation over the years, manufacturing contributes about 10 per cent to GDP and employs less than 5 per cent of the workforce. There is no doubt that following liberalisation in the mid-1980s, several new industries have come into operation and exports of manufactured goods have increased substantially. Also, agricultural sector has experienced a marginal growth in output. However, despite this poverty remains a major development challenge in Nepal (see Preface of this book). This chapter examines the growth and poverty outcomes of policy liberalisation in Nepal.

Nature and extent of liberalisation

Background

Ever since Nepal embarked on the periodic development planning exercise in 1956, it followed restrictive trade policies with respect to the rest of the world while maintaining relatively open trade relation with its large neighbour, India.

To attain its economic development goals, Nepal followed inward-looking, import-substituting industrialisation (ISI) with public sector planning and regulation of the private sector. One of the major consequences of ISI was that it generated a highly distorted incentive structure resulting in severe allocative and productive inefficiency, which not only inhibited the growth prospects but also led to an 'anti-export' bias, thus undermining the potential for employment-intensive growth. With serious macroeconomic imbalances, Nepal initiated a series of market-oriented reforms in the mid-1980s.

Nepal's initiation of liberalisation reforms has been shaped by its situation of *de facto* integration with India. Several factors have put Nepal in this situation of *de facto* integration with India. First, the high cost of access to the markets of the rest of the world. The nearest port for access to world economy, other than immediate neighbours, is more than 900 km away from Nepal's border. The access to ports has been expensive and time consuming due to undeveloped infrastructure in neighbouring India and Bangladesh. Second, Nepal has a long open border with India and is surrounded by it on three sides. For access to ports in Bangladesh, it is necessary to transit through a strip of Indian territory. Furthermore, Nepal has granted almost free access to Indian goods ever since its first agreement on trade and transit with British India in 1923. The treaties with independent India was first signed in 1950 which were then subsequently renewed with the latest being in March 2002. But more than formal provisions of trade treaties, the open border with India and the high cost of access to the markets of the rest of the world have been decisive factors in putting Nepal in this situation of *de facto* integration with India.

While providing opportunities for increased exports and industrial growth which remain to be fully exploited, the *de facto* integration with India was of dubious benefit to Nepal because: (i) it has been subject to adverse spill-over effects of widespread and arbitrary protection system in India creating a great deal of inefficiency in its structure of production and trade; and (ii) it could not resort to traditional methods of protecting its legitimate infant industries from competition from Indian producers. Accordingly, the situation of *de facto* integration with India constrained policy choices for Nepal by compelling it to adopt a protection and incentive structure similar to that of former. Any attempt to create trading relations with the rest of the world through standard instruments of trade policy would be thwarted by unofficial and unrecorded movement of goods and services across the open border with India.[1] Lower tariff structure in Nepal provides incentive for trade deflection to India of the goods imported by it from the rest of the world causing drain in its foreign exchange reserves. If Nepal provides export incentive Indian goods would be re-exported causing a fiscal drain. Thus, Nepal's ability to integrate its economy with the rest of the world is limited.

Initiation of liberalisation reforms

Nepal embarked on liberalisation reforms under the Structural Adjustment Programme in 1986, although significant reforms took place only in the early 1990s when India vigorously perused economic reforms. The principal elements

of market-oriented reforms that Nepal has initiated since the early 1990s are discussed below.[2]

Trade policy reform

Customs tariff has undergone a major rationalisation and simplification since the early 1990. The peak tariff rates fell from 245 per cent in fiscal year 1991/2 to 110 per cent in July 1994 and then down to 80 per cent in 1997/8. However, customs tariff increased to 130 per cent in 1998/9. Besides, the tariff rate structure has been considerably simplified. The number of tariff slabs (categories) fell from more than 100 in 1980s to 5 in the fiscal year 1995/6 and then to 7 in 1998/9. The prevailing tariff structure includes five basic standard rates (5, 10, 15, 25, 40), with the largest number of import items coming within the custom duty of 10–20 per cent and having a significant number of tariff lines with zero duty.[3] These measures led to a decline in tariff protection. Both the trade weighted nominal rate of protection (NRP) as well as the effective rate of protection (ERP) fell substantially. The trade weighted NRP fell from about 80 per cent in the early 1980s to about 31 per cent in 1993/4 (Sharma 1997). Similarly, the average ERP has declined from about 111 per cent in late 1980s to about 9 per cent in 1996.

There has also been a substantial liberalisation in non-tariff barriers. These include elimination of quantitative restrictions on imports and phasing out import licence auctions and replacing them with appropriate tariffs.[4] The move toward partial convertibility of the Nepalese Rupee in trade accounts in March 1992 and then again toward full convertibility in February 1993 fundamentally altered the mechanism of QRs on imports.

In an attempt to reduce the anti-export bias, the export duty-drawback scheme and the bonded warehouse facilities were introduced. The export service fee was also reduced to 0.5 per cent of the export value from 2 per cent in 1993/4. The Government has also gradually reformed the export floor price system.

Exchange rate reform

Nepalese currency (rupees) is pegged to the Indian rupee.[5] There have been a number of reforms since the early 1990s. For example, the partial convertibility of Nepalese rupees was introduced for trade account purposes in March 1992 following India's announcement of doing the same. Further reform took place in February 1993 when the government announced the full convertibility of the Nepalese rupees for all trade account transactions. Subsequent reform measures, among others, included facilities for opening convertible currency accounts for all foreign exchange earners, provisions for imports from India through dollar payments, and permission to commercial banks to extend credit on convertible currencies.

Industrial sector reform

The Government announced radical changes in the licensing requirement in the New Industrial Policy in June 1992, which was subsequently enacted as the

Industrial Enterprise Act, 1992. Under the new Act, industries are no longer required to obtain licences, unless the establishment concerned falls within the category of industries related to defence, public health and environmental hazards as specified in the Act. The Government simplified the procedure for registration of industries by drastically curtailing the information requirements.

Nepal also took a number of steps to attract foreign direct investment (FDI) and other forms of private foreign investment. The enactment of Foreign Investment and Technology Transfer Act (FITTA), 1992, which was amended in January 1996, along with Industrial Enterprise Act 1992 formalised these measures. FDI is welcome in the form of share (equity), reinvestment of earnings from foreign investment and loan or loan facilities. The Government is encouraging FDI in Nepal by providing attractive incentives and facilities within a liberal and open economic policy. FDI with 100 per cent foreign ownership is permitted in all industries with the exception of industries of strategic, public health and environmental importance. Repatriation of dividend and principal in convertible currencies is guaranteed. Industries with foreign participation are also entitled to all the facilities and incentives, provided to the domestic investors. All formalities regarding incentives and infrastructure acquisition are completed under the one window system for industries to be established with foreign investment. The Government has also made attempts to privatise public enterprises, but progress towards privatisation of the Nepal Electricity Authority, Royal Nepal Air Corporation and Nepal Telecommunication Corporation has been very slow.

Agricultural sector reform

Although reforms in the agriculture sector began in the early 1990s, a more comprehensive reform programme was implemented only during the 1998–2001 period. Key aspects of the reform were: (i) liberalisation of both agricultural inputs and outputs by allowing them to be priced more according to market forces; and (ii) institutional reform of state-owned Agricultural Input Corporation (AIC) and Nepal Food Corporation (NFC). In 1998, government deregulated fertiliser trade by (i) removing the monopoly of AIC and allowing the private sector to import and distribute fertilisers; (ii) decontrolling wholesale and retail prices of fertilisers and (iii) phasing out fertiliser subsidies. The government also discontinued the transport subsidy for AIC to deliver fertilisers to remote regions. In the agricultural output market, the role of the state-owned NFC is being modified to promote competitive agricultural produce markets by eliminating unnecessary market distortions including the withdrawal of subsidised food grain distribution to urban and accessible areas and phasing out of subsidised food grain distribution. Other key aspects of reform was the reduction of irrigation subsidy. In October 1999, subsidy for individual shallow tube-wells (STWs) was eliminated altogether while that for group STWs was also completely removed by July 2000. The government has also introduced reforms to strengthen agricultural research, extension and training systems.

Financial sector reform

Financial sector reform began in 1980s when the Central Bank (Nepal Rastra Bank) eased entry restrictions with an amendment of the Commercial Bank Act. However, it was only in 1992, after the Nepal Rastra Bank adopted a liberal attitude in permitting foreign commercial banks to open up, that the financial sector liberalisation really took off. As a result, the number of commercial banks has gone up from five in 1990 to fourteen in 2000. Similarly, development banks have increased from two in 1990 to nine in 2000. To assist commercial banks to become competitive, the Nepal Rastra Bank eliminated the Statutory Liquidity Ratio (SLR) in July 1993.[6] In 1989/90, interest rates were also deregulated which allowed commercial banks to set their own rates.

Labour market

Labour market in Nepal is highly regulated despite substantial liberalisation in other areas. Liberalisation of trade, payment and investment regime requires flexibility in labour market. In the absence of such flexibility, firms are unable to adjust their production in response to market demand, which might discourage the use of labour. Under the Labour Act 1992 hiring and firing of a worker is extremely difficult.

Economic growth and poverty outcomes

Economic growth

The effect of policy reforms on growth and poverty is not easy to establish given that growth and poverty depend on several factors including the level of physical and human capital, and the quality of governance and institutions. However, an attempt is made to assess the growth and poverty outcomes of policy reforms in Nepal. Nepal's growth performance improved during the post-reform period (1985/6–1998/9) as compared to the earlier period (1974/5–1984/5). This was mainly brought about by growth in non-agriculture sector, which recorded over 6 per cent annual growth during 1985/6–1998/9 period (Table 13.1). Within non-agriculture sector manufacturing, trade and services, and finance are the major players, which are mainly located in urban areas. However, the average annual growth of about 5 per cent over the last few years could not make a dent on poverty, particularly in the rural areas. Lacklustre performance of agricultural sector and lack of alternative economic activity appear to have increased the incidence of rural poverty.

There has been a rise in export intensity (defined as merchandise exports as a percentage of GDP) in the post-liberalisation period (Table 13.1). Export intensity rose from about 5 per cent per annum (p.a.) in the earlier period to 8 per cent p.a. in the latter period mainly due to increase in carpet and garments exports under the GSP scheme rather than an improvement in the country's competitiveness. However, the current pattern is highly vulnerable due to the narrow export base

Table 13.1 Economic and social indicators and performance, Nepal

Indicators	1974/5–1984/5	1985/6–1998/9
Indicators		
Real GDP growth	3.5	4.8
Real agriculture GDP growth	2.6	2.9
Real non-agriculture GDP growth	5.8	6.4
Population growth*	2.6	2.3
Per capita income growth	−0.5	2.9
Contribution to GDP (%)		
Contribution of agriculture	62.0	45.5
Contribution of manufacturing	4.9	7.6
Exports % of GDP	5.4	8.3
Share in export earnings		
Share of agriculture	49.2	19.0
Share of manufacturing	27.2	68.0
Government expenditure		
Regular expenditure % of total budget	35.3	43.3
Development expenditure % of total budget	64.6	56.6
Education expenditure % of development expenditure	10.6	9.9
Health expenditure % of development expenditure	5.4	4.9
Roads and bridges exp. % of development expenditure	21.5	13.1
Investment % of GDP		
Education % of GDP	1.02	1.05
Health % of GDP	0.5	0.5
Roads and bridges % of GDP	1.6	1.3

Source: Sharma (2002).

Notes
Period average is based on the first and the last years data.
* Per capita income and population growth figures are for 1971–80 and 1991–6 periods respectively and taken from *UNDP*, 1998, table 7.1.

and excessive reliance on limited items, namely carpet and garments which together account for about 70 per cent share in total export earnings. There has already been a decline in carpets and garments exports by 2000. This phenomenon is a reflection of an absolute fall in their exports rather than an increased diversification in the exportable goods. In fact, a decline in the exports of carpets and readymade garments (which are labour-intensive) was partly due to the concern of the OECD countries over the exploitation of child labour and poor environmental standard and partly due to the supply bottlenecks. Hence, in the absence of rapid export growth, Nepal has failed to create employment opportunities for its unskilled workforce even after the policy reforms. The rigidity in labour market and inadequate infrastructure appears to have substantially discouraged employment-intensive exports.[7]

There has been a sharp fall in exports of agricultural products (particularly rice, jute and jute products) over the years and this has further declined in the post-liberalisation period. The share of agriculture exports in GDP fell from

Table 13.2 Use of chemical fertilisers, improved seeds and extension of additional irrigation facilities, Nepal

	1974/5	1984/5	1998/9
Chemical fertilisers (MT)	12,658	42,829	45,669
Improved seeds (MT)	1,934	2,116	1,794
Additional land with irrigation facilities (Hectares)	6,720	40,477	49,015
Total arable land ('000 hectares)*	1,567	2,287.5	2,323.4

Note

* Total arable land figures are for 1971/2, 1981/2 and 1991/2 respectively and obtained from the CBS (1998). Rest of the data are from His Majesty's Government of Nepal (2000).

49 per cent in the pre-liberalisation period to 19 per cent in the post-liberalisation period (Table 13.1). Since agricultural exports come from rural areas, it can be argued that the real income of the poor, most of whom rely on agriculture, has further declined after the policy reforms (Sharma 2002). Furthermore, no new products, based on agriculture, have emerged while the exports of handicraft have shown a declining trend, the item in which Nepal has traditional skills and hence comparative advantage.

A marginal improvement in growth performance of agriculture sector in the post-liberalisation period (2.6 per cent p.a. vs 2.9 per cent p.a.) appears to be linked with several factors, including increased access to imported inputs, extension of irrigation facilities and a rise in arable land (Table 13.2). As the access to basic agricultural inputs increased, the use of agricultural input rose despite higher prices resulting from the elimination of subsidies.[8] However, the access to improved seeds (particularly for food grains) is still limited. Input driven growth in agricultural output (2.9 per cent p.a.) without significant improvements in productivity could not make a dent in rural poverty in the presence of about 2.3 per cent annual growth in population. Several factors seem to be responsible for the lacklustre performance of agriculture sector. Since most of the agriculture in Nepal is rain-fed, weather is one of the critical factors of agriculture performance. However, a regression analysis of agricultural GDP over rainfall indicates that factors other than weather are even more important in explaining the performance of agriculture (NASPR 2002).[9] These factors could be related to policies, institutions and investments, both by private and public.

Poverty

In this section, using data from 1976/7 and 1995/6 surveys, we examine trends in poverty and place these trends within the broader economic policy framework of the mid-1980s and onward. To address the problems resulting from incomparability of the results between the surveys, poverty estimates are recalculated using a common definition to the 1995/6 data. This is reported in Table 13.3.

Table 13.3 Incidence of poverty in Nepal

	Comparison between[a]			Comparison between[b]	
	1976/7	1995/6	2000/1	1984/5	1995/6
Rural areas	33.0	44.0	39.0	43.1	46.6
Urban areas	22.0	20.0	NA	19.2	17.8
Nepal	33.0	42.0	NA	41.1	44.6

Sources: The World Bank 1998 and NASPR 2002.

Notes
a Based on the definition of 1976/7 estimates.
b Based on the definition of 1984/5 estimates.

New evidence of rural poverty in Nepal, for 2000/1, is also reported in the last column of Table 13.3. The following conclusions can be drawn about changes in the incidence of poverty in Nepal between years for which detailed household surveys are available after careful perusal of all available evidence (World Bank 1998; Bajracharya *et al.* 1999; NASPR 2002): (i) There is no evidence of a decline in poverty for Nepal as a whole between 1976/7 and 1995/6; (ii) There is also no evidence of a decline in poverty for Nepal as a whole between 1984/5 and 1995/6, while there is at least some weak evidence to suggest that poverty in Nepal increased during this period; (iii) There is evidence to inspire greater confidence in the proposition that poverty in rural Nepal increased over both the time periods; (iv) New evidence also suggests that incidence of rural poverty in 2000/1 is still higher than that in 1976/97 although it has declined from the level in 1996/7; (v) There is some evidence to suggest that urban poverty declined, though at an undramatic rate and (vi) There may have been a slight decline in poverty in rural areas surrounding Kathmandu valley and in Terai during the 1990s.

Since most people live in rural areas and rely on agriculture, rural poverty is primarily related to the performance of agriculture sector. The average annual growth of 2.6 per cent in the pre-liberalisation period (1974/5–1984/5), which was the same as population growth rate, highlights the stagnation of rural economy and the persistent failure to bring about tangible improvement in the living standards of a large majority of the population. In fact, during this period there was an absolute fall in per capita income in real term (see Table 13.1). Even though the agriculture sector experienced some growth in the post-liberalisation period, it has made very little impact on poverty alleviation due to rapid population growth.

In the post-reform period (1985/6–1998/9), there has been a rise in per capita income mainly due to growth in urban-based non-agriculture sector. During this period, per capita income grew at 2.9 per cent p.a. It seems that growth in urban-based non-agriculture activities has contributed to a decline in urban poverty in recent years. The rural-to-urban migration phenomenon, coupled with other trickle-down mechanisms, has also meant that rural areas in the vicinity of

growing urban centres (mainly in the Kathmandu valley) have been able to gain from the urban growth process. But obviously the trickle-down effect of urban-biased growth has been much too feeble to make any appreciable dent in rural poverty (Bajracharya *et al.* 1999). Clearly, the lack of integration between rural–urban areas, in the absence of efficient infrastructure, has not made it possible for the rural poor to get the full benefits of liberalisation. There is a widespread perception that unemployment has been increasing in both rural and urban areas.

Over the years Nepal has made some achievements in non-monetary measures of poverty, particularly in health and education sectors, although it has a long way to go. Sustaining growth and alleviating poverty require well integration between rural–urban areas, efficient infrastructure, and educated and healthy workforce. It means a greater proportion of budget should be allocated to these sectors. But, recent trends in Nepal indicate that this is not happening. In fact, there has been a decline in health and education expenditure in recent years (as a percentage of development expenditure, see Table 13.1). Fall in health sector budget might have resulted in poor quality of public health system, especially in the rural area where most poor live. With regard to education, Nepal is far behind many developing countries despite a rise in the number of schools and school enrolments in recent years. Although the number of schools has increased rapidly in the post-reform period, there has been a fall in trained teachers, raising a doubt about the quality of manpower. Based on these non-monetary measures, it appears that Nepal is to increase investment in health, education and infrastructure to sustain growth and alleviate poverty. Liberalisation alone is not sufficient to sustain growth and alleviate poverty.

Conclusion

With serious macroeconomic imbalances and widening current account deficit in the mid-1980s, Nepal initiated a series of market-oriented reforms with a view to sustaining economic growth and alleviating poverty. However, despite over a decade of reforms this remains a major development challenge. Nepal has failed to sustain higher GDP growth, and diversify and sustain growth in labour-intensive exports. This appears to be partly due to the half-hearted nature of reforms and partly due to the inadequacy of complementary policies to enhance supply-side elasticities. Although market-oriented reforms require less state intervention, in many ways it demands good governance. Better governance is vital not just to ensure the rule of law and protect against local and international organised terrorism, but also to maintain and expand social and economic infrastructure to achieve poverty reduction. Also, efficient infrastructure is essential to sustain growth (and alleviate poverty) especially in the highly competitive environment. However, Nepal has not been able to maintain even the basic infrastructure. In fact, among the SAARC nations the gross domestic investment as percentage of GDP is lowest in Nepal (see Table 1.3 in Chapter 1). This has further declined in recent years as the government has increasingly

diverted development expenditure to combat rising insurgency in the country. For instance, development budget for 2002/3 has been reduced by about Rs 12 million to meet rising defence expenditure. In this situation sustaining growth, which is the key to poverty alleviation, remains a distant dream.

Notes

1 Informal trade between Nepal and India is a two-way phenomenon. The magnitude of such informal trade is believed to be substantial and is reflected in an often large and positive errors and omission entry in the balance payments statistics (IMF 1995; Karmacharya *et al.* 1999).
2 See Sharma (1997) for a discussion on the nature of reforms from the mid-1980s to the early 1990s.
3 In 2000, in a move to simplify the tax system, the authorities replaced excise duties on vehicles with two exceptional tariff bands, 80 and 130 per cent. It should be noted that Nepal provides preferential treatment for imports coming from neighbouring countries. Under its bilateral trade treaty, all goods imported from India into Nepal are granted a rebate in the chargeable *ad valorem* (except specific) rate of customs duty by 20 per cent up to the tariff rate of 40 per cent, and by 10 per cent on rates above that. On the other hand, the goods imported to Nepal from Tibet Autonomous Region of the People's Republic of China and those from South Asian Association for Regional Cooperation (SAARC) countries other than India (inclusive of Bangladesh, Bhutan, Maldives, Pakistan and Sri Lanka) are given preferential treatment of 10 per cent in the chargeable *ad valorem* (except specific) customs duty.
4 The only non-tariff barriers in place are for religious, health and security purposes (e.g. beef, poppy seeds and the communication equipment). Also, only the Salt Trading Corporation has a monopoly over the imports and distribution of salt on the grounds that only the Corporation has the facility to test iodine levels in salt.
5 The current approach of pegging the Nepalese rupee to the Indian rupee has both advantages and disadvantages (IMF 1995; Khatiwada 1998). The main advantages of such approach are as follows. The close to free movement of goods, labour and capital through 500 miles of open border with India and the close substitutability between Nepalese and Indian goods mean that the two economies are inextricably connected. Pegging to the Indian currency widens the effective domain of the Nepalese rupee by removing exchange rate risk and facilitates trade and capital transactions with India. Moreover, with the Indian economy liberalising and Indian financial policies targeting a reduction in inflation, the advantages of such a peg in terms of encouraging financial disciplines are greater. The system has also insured smooth supply of essential commodities from India. Its main disadvantages are undermining the importance of Nepalese monetary policy, misalignment in the Nepal's exchange rate with convertible currencies, and adverse effect on Nepal's export competitiveness.
6 The SLR required commercial banks to invest a certain portion of their deposits in Government bills.
7 Although manufactured exports have increased following the liberalisation programme, the Nepalese manufacturing suffer from a number of problems. These include underdeveloped infrastructure, high cost of imported inputs and very high transaction cost arising out of weak institutions and poor governance. Although the regulatory framework has been liberalised, the poor implementation of these policies remains a problem. It appears that openness has only a minor impact on manufacturing productivity in Nepal, at least in the immediate post-reform period. Productivity had been declining prior to reform, and this continued to be the case even afterwards (Sharma 1997).

8 Estimates suggest that use of fertiliser by farmers has increased considerably from 35 kg/ha in 1997/8 to about 58 kg/ha in 2000/1 (NASPR 2002). This is contrary to official figures which suggest that nutrient use in fact has declined from a low level of 21.9 kg/ha during 1990–5 to an even lower level of 16.4 kg/ha during 1996–9. The key problem with official figure lies with the fact that they do not take into account the unofficial imports and distribution from private sector and inflow of fertiliser from India. Estimates suggest that about 66 per cent of total use of fertilisers in Nepal is imported from India through unofficial channels representing a subsidy from India at about US$ 12.4 million in 2000/1 alone (NASPR 2002).

9 A regression analysis of agricultural GDP over rainfall explains only 44 per cent of total variation of agricultural GDP. When rainfall and a period dummy are put together, then the explanatory power of the regression increases to 79 per cent, but the statistical significance of rainfall disappears (NASPR 2002).

14 Trade and industrial policy reform and poverty in Pakistan

Tilat Anwar

Pakistan, like many other South Asian developing countries, has made attempts to open up its economy since the late 1980s. The impulse for liberalisation came from the unsustainable current account deficit which was the outcome of the overvalued exchange rates and severe restrictions in trade and payment regimes. To reduce the current account deficit, assistance was sought from the IMF/World Bank, which they provided by formulating structural adjustment programmes (SAPs). It was taught that these changes will attract foreign investment, facilitate employment-intensive exports, leading to lower poverty outcomes. However, success so far in achieving higher growth and reducing poverty has not been very encouraging. The purpose of this chapter is to examine the impact of policy changes brought about by the structural adjustment programmes on growth, employment and poverty in Pakistan.

Shift in trade and industrial policy regime

Since the late 1980s, Pakistan has made its efforts to liberalise its economies under the structural adjustment programmes of the IMF and the World Bank. These main objectives of SAPs are to remove structural rigidity and distortions in the incentive system to bring about macroeconomic balances to sustainable levels. The stabilisation measures included tight monetary and fiscal policies, liberalisation in trade and investment, removal of price controls and exchange rate liberalisation. The main components of liberalisation reforms are discussed below.

Investment liberalisation

Like many other developing countries in the region, investment and savings rates have been very low in Pakistan. In the 1970s and 1980s, investment as proportion of the GDP fluctuated between 13 and 19 per cent. However, investment as a percentage of GDP recorded an increase in the early 1990s, but since 1992–3, it has had a declining trend reaching to its lowest level 15 per cent in 1998–9, which is largely attributable to decline in the public sector investment. The declining trend in investment has contributed to the deceleration of growth

in the 1990s (Government of Pakistan 2000). This reflects the fact that the country will have to increase its investment rate, if it has to achieve a sustainable higher economic growth, which is only possible through attracting foreign investment.

Historically, there have been restrictions on FDI for many years but these restrictions have diminished sharply since the late 1980s (Government of Pakistan 1990/9). In the early 1990s, the government took a number of policy and regulatory measures to improve the business environment and attract FDI.

- The requirement for government approval of foreign investment was removed with the exception of few industries.
- Foreign equity participation of upto 100 per cent was allowed and foreign investors were allowed to purchase equity in existing industrial companies on repatriable basis.
- Foreign investors were also allowed to negotiate the terms and conditions of payment of royalty and technical fee suited to them as well as acceptable to the multinationals for transferring technology.
- The government also liberalised the foreign exchange regime. Foreigners were allowed to bring in, possess and take out foreign currency and to open accounts and hold certificates on foreign currency. Remittance of principal and dividends from FDI and from portfolio investment made by foreign investors were also allowed without prior permission or clearance from the State Bank of Pakistan.
- To further liberalise foreign exchange regime, Pakistani rupee has been made convertible from July, 1994.
- The government has also given an extensive set of investment incentives including credit facilities, fiscal incentives and visa policy.
- Import policy has also been liberalised and the maximum tariff rate has been reduced considerably. A large number of quantitative restrictions and non-tariff barriers have been removed.
- In 1997, the government also opened the agriculture, services/infrastructure and social sectors for foreign investment on repatriable basis.

In addition to the above policy and regulatory measures, an extensive set of fiscal incentives and allowances were given to foreign investors to attract FDI. Along with the investment liberalisation, deregulation, privatisation and trade liberalisation policies were also initiated during the above period.

Trade liberalisation

Along with the investment liberalisation, Pakistan also endeavoured to liberalise its trade regime to integrate its market with the World economy in the late 1980s. Historically, the country followed an import substitution strategy, thereby creating a highly protected environment for industrialisation since 1950s.

To protect the domestic production, high tariffs and quantitative restrictions were levied on imports. However, the extent of protection was very large. During the 1960s, the average level of protection provided by all sources (tariffs plus non-tariffs) was as large as 271 per cent compared to only 27 per cent in Mexico, 33 per cent in Taiwan, 49 per cent in Philippines and 118 per cent in Brazil. This resulted in an inefficient industrial structure producing with a high resource cost. The level of inefficiency in terms of domestic resource cost was around 1.20 per cent in 1968–9, which increased to 3.33 per cent in 1980–1 (Naqvi and Kemal 1991). However, the nationalisation of major industries in 1972 combined with these inefficiencies in the industrial structure frustrated the process of industrial take off as reflected by the sharp deceleration in industrial growth from 9.9 per cent in the 1960s to 5.5 per cent in the 1970s. Though, the domestic resource cost declined from 3.3 per cent in 1980–1 to 1.44 per cent in 1990–1, the trade regime remained highly complex resulting from wide dispersion of tariff rates and numerous exemptions. The trade regime relies on non-tariffs barriers rather than on tariff barriers for the protection of domestic production, which created anti-export bias. In the late 1980s, the government took a major shift in trade and industrial policy from the inward-looking import substitution policy to an outward-looking export promotion policy in the late 1980s. The following reforms were initiated to liberalise foreign trade regime since July 1988:

- In 1987–8, most of the non-tariff barriers on imports were replaced with tariffs; maximum tariff rate was reduced from 225 to 100 per cent in 1990–1, tariff slabs were reduced from 17 to 10; and various sales tax rates across commodities was replaced by a uniform sales tax rate of 12.5 per cent.
- The maximum tariff (except automobiles) was further brought down to 70 per cent in 1994–5, 65 per cent in 1995–6, 45 per cent in 1997–8 and finally to 35 per cent in 1998–9. All para-tariffs have been merged into the statutory tariff regime. All items are now allowed to import with the exception of few on religious, health and security grounds.
- In May 1999, the managed float exchange rate, operative since 1982, switched over to a market-determined inter-bank floating rate, with currency convertibility extended to trade account.

It is noteworthy that the above tariffs in Pakistan are now well below the bound tariffs under the WTO. The general level of binding in Schedule XV of WTO was between 20 and 50 per cent (except in agriculture), while tariff rates in Pakistan presently range between 0 and 35 per cent (except automobiles). This implies that the actual extent of trade liberalisation in Pakistan was more than the WTO commitment (Ali 2000).

In addition to trade liberalisation, several episodes of devaluation were also announced. The average annual depreciation of rupee against the US dollar was 9.9 per cent per annum in the 1990s. However, despite several devaluation and intensive trade reforms in the 1990s, Pakistan's trade performance has been dismal. In 1995–6, Pakistan's exports were $8.0 billion compared with

India ($32.3 billion), Indonesia ($49.7 billion), Thailand ($55.7 billion), Malaysia ($78.1 billion), Korea ($124.0 billion) and China ($151.0 billion).

Macroeconomic reform and privatisation

Over a long period of time, the country has been living beyond its mean and resorted to borrowing from foreign and domestic sources to finance the budget deficit. As a result, the government expenditure grew faster than the revenue over time. Consequently, budget deficit reached an unsustainable level in the late 1980s. The budget deficit was 9.4 per cent of GDP and current account deficit was 3.1 per cent of GDP by the end of fiscal year 1987–8. The government domestic debt doubled to 43 per cent of GDP over the period 1980–1 to 1987–8 and the external debt increased from 31 to 42 per cent of GDP resulting in an external debt service ratio of 28 per cent. Reserve fell to $438 millions equal to less than three weeks of imports. Inflation accelerated to over 9 per cent (Government of Pakistan 1992). The increasing internal and external imbalances were mainly due to the structural rigidities and distortion in trade regime, leading to implementation of structural adjustment programmes within the framework of IMF and the World Bank in the late 1980s. The major components of SAPs are briefly summarised below:

- Fiscal measures aimed at resource mobilisation efforts to increase the elasticity of the revenue system through the introduction of General Sales Tax; restructuring of the income tax system; the removal of many exemptions from custom duties on imports; and price increases for public utilities and the other services.
- Meeting the government financial requirement in a market-based manner, to remove the segmentation of financial markets.
- Market-based setting of lending rates through phasing out of concessional interest scheme and directed credit scheme.
- Privatisation of one NCB, the Muslim Commercial Bank and permission of the establishment of private commercial banks.
- Implementation of measures to reduce price controls and privatisation.
- Agriculture sector reforms by aligning input and output prices with resource costs and gradual removal of input subsidies.

However, these reforms have been criticised, not only in Pakistan but also in many developing countries, for seeking excessive reduction in aggregate demand, resulting in contraction of GDP and employment.

Growth, unemployment and poverty

Growth and employment implications of reforms

Pakistan's economic performance in the pre- and post-liberalisation periods is presented in Table 14.1. As shown GDP growth rate declined from an average of

Table 14.1 Macroeconomic indicators, Pakistan: 1970–1 to 1999–2000

| Year | Annual growth rates | | | | | | CPI inflation income | As % of GDP | | In % |
	Real GDP	Agriculture	Manufacturing	Large scale Manufacturing	Services	Per capita		Budget deficit	Current account deficit	Unemployment rate
1970/71	1.2	−3.1	6.4	6.2	4.9		5.7	—	6.7	1.7
1971/72	2.3	3.5	1.2	−0.5	5.1	−0.2	4.7	—	3.8	2.0
1972/73	6.8	1.7	8.7	9.2	5.2	3.0	9.7	3.6	1.1	1.9
1973/74	7.5	4.2	6.4	6.1	5.4	4.2	30.0	5.2	5.4	1.8
1974/75	3.9	−2.1	0.5	−1.6	5.7	0.9	26.7	9.3	9.4	1.7
1975/76	3.3	4.5	1.4	−0.6	5.7	1.4	11.7	9.5	6.2	2.2
1976/77	2.8	2.5	1.8	−0.2	3.2	1.0	9.2	8.5	5.9	2.6
1977/78	7.7	2.8	10.2	10.9	8.5	7.3	6.9	7.8	2.7	3.1
1978/79	5.5	3.1	8.0	7.9	5.8	2.9	11.2	8.8	5.0	3.6
1979/80	7.3	6.6	10.3	11.0	5.7	4.0	11.2	6.8	3.7	3.6
1980/81	6.4	3.7	10.6	11.5	6.6	2.2	13.9	6.0	2.8	3.7
1981/82	7.6	4.7	13.8	15.7	7.9	2.9	11.1	5.9	3.4	3.8
1982/83	6.8	4.4	7.0	6.6	9.2	6.2	4.7	7.7	0.6	3.9
1983/84	4.0	−4.8	7.9	7.7	7.6	1.1	7.3	7.7	2.2	3.9
1984/85	8.7	10.9	8.1	8.0	8.2	3.0	5.7	8.3	4.1	3.7
1985/86	6.4	6.0	7.6	7.3	5.8	2.5	4.4	8.7	2.4	3.6
1986/87	5.8	3.3	7.5	7.2	5.9	1.6	3.6	8.5	1.0	3.1
1987/88	6.4	2.7	10.0	10.6	6.8	1.6	6.3	9.4	3.1	3.1
1988/89	4.8	6.9	4.0	2.4	3.8	1.4	10.4	8.1	3.4	3.1
1989/90	4.6	3.0	5.7	4.7	4.5	1.6	6.0	7.3	3.4	3.1
1990/91	5.6	5.0	6.2	5.4	5.2	4.6	12.7	9.5	3.0	6.2
1991/92	7.7	9.5	8.1	7.9	6.8	4.1	10.6	8.4	1.9	5.9
1992/93	2.3	−5.3	5.4	4.1	4.6	−0.8	9.8	8.1	6.4	4.7
1993/94	4.5	5.2	5.5	4.3	4.2	0.9	11.3	6.0	3.2	4.8
1994/95	5.3	6.6	3.6	1.5	4.8	3.0	13.0	5.9	3.5	5.4
1995/96	6.8	11.7	4.8	3.1	5.0	1.5	10.8	7.0	6.8	5.4
1996/97	1.9	0.1	1.3	−2.1	3.6	−1.6	11.8	6.4	5.6	6.1
1997/98	4.3	3.8	−1.6	7.6	3.2	−1.4	7.8	7.6	2.7	6.1
1998/99	3.2	2.0	4.2	3.7	4.1	0.4	5.7	6.0	2.6	6.1
1999/2000	4.5	5.5	1.6	0.0	4.5	2.8	3.4	5.8	2.3	6.1
Decade averages										
1970s	4.8	2.4	5.5	4.8	5.5	2.7	12.7	7.4	5.0	2.4
1980s	6.1	4.1	8.2	8.2	6.6	2.4	7.3	7.8	2.6	3.5
1990s	4.6	4.4	3.9	3.6	4.6	1.4	9.7	7.1	3.8	5.7
1988–2000	4.6	4.5	4.1	3.6	4.5	1.4	9.4	7.2	3.7	5.3

Sources: State Bank of Pakistan 1990/9 and Government of Pakistan (various issues).

6.1 per cent in the 1980s to 4.6 per cent in the 1990s. The important factors contributing to a decline in GDP growth were adverse weather conditions, deterioration in irrigation system due to inadequate public spending on infrastructure, poor governance and the political turmoil with resulting uncertainty due to frequent change of governments.

Attempts to liberalise foreign trade regime resulted in considerable revenue loss. Revenue from custom duty declined sharply from 5.9 per cent of GDP in 1989–90 to 2.2 per cent of GDP in 1999–2000, resulting in an increased reliance of revenue through domestic taxes such as General Sales tax. As a result, the revenue from sales taxes increased from 1.8 per cent of GDP in 1989–90 to 3.4 per cent of GDP in 1999–2000 but the increase was not sufficient to compensate the loss of revenue from trade taxes over the period. Although the government resorted to raise domestic tax rates to offset the loss of revenue, the increased tax rates on shrinking tax base led to further shrinkage in the tax base due to tax evasion. This resulted in stagnant tax-to-GDP ratio, leading to a fall in development expenditure. The development expenditure declined persistently from 6.4 per cent of GDP in 1990–1 to 3.2 per cent in 1999–2000.

A fall in development expenditure has not only affected GDP growth rates but also resulted in reduced employment opportunities for the poor and worsened the quality and quantity of service provided to the poor through social and economic infrastructure. As part of IMF conditionalities, the government sought to restrain aggregate demand not only by granting wage increases below the inflation rate but also by freezing the employment in the public sector. These developments together with liberalisation seem to have exacerbated unemployment in Pakistan. While overall unemployment rate declined initially from 6.2 per cent in 1990–1 to 4.7 per cent in 1993–4, it rose from 4.8 percent in 1993–4 to 6.12 per cent in 1996–7 during the second programme period of structural adjustment when stabilisation and trade measures were intensively implemented (Figure 14.1).[1] Since most industrial activities are based in urban areas, urban unemployment is more seriously affected by liberalisation reforms than the rural unemployment. Urban unemployment rose rapidly from 5.88 per cent in 1992–93 to 7.10 per cent in 1996–7 during the period of adjustment.

Rising unemployment after the mid-1990s appears to be mainly due to Pakistan's inability to boost up exports particularly labour-intensive exports. As stated before despite liberalisation of trade and payment regime, Pakistan's export performance has been dismal in recent years. In contrast to the 1970s and 1980s when exports on average grew by 18.6 and 8.5 per cent per annum respectively, the growth in exports was only 4.5 per cent per annum in the 1990s (see Table 14.2). Pakistan's export performance has been rather poor when compared with the other developing countries. In 1995–6, Pakistan's exports were $8.0 billion compared with India ($32.3 billion), Indonesia ($49.7 billion), Thailand ($55.7 billion), Malaysia ($78.1 billion), Korea ($124.0 billion) and China ($151.0 billion). The degree of openness (merchandise trade as a percentage of

Figure 14.1 Unemployment rate (%) in Pakistan, 1985/6–1999/2000.

Source: Government of Pakistan (various issues).

GDP) remained not only limited but also declined after the liberalisation programme. The openness index was 32.5 per cent in 1992–3, which went down to 28 per cent in 1998–9 (Table 14.2).

Poverty implications

A number of attempts have been made to estimate the incidence of poverty in Pakistan, using the countrywide household income and expenditure surveys (HIES) conducted by the Federal Bureau of Statistics, Government of Pakistan.[2] Since a large majority of people strive to live at subsistence level in Pakistan, it is appropriate to discuss only those studies that focus on poor nutrition as poverty criterion. This approach defines the poverty lines as 2,550 calories minimum nutritional requirement augmented by a modest allowance for non-food need. Using the above definition Amjad and Kemal (1997) estimated the incidence of poverty from 1963–4 to 1992–3 (Table 14.3). Their study suggests a fall in poverty over the years, but rose marginally in 1996–7 and 1998–9 when the government implemented market-oriented reforms vigorously.

The excessive reduction in aggregate demand through expenditure-reducing policies (such as wage restraint, freezing employment, cut in development expenditure as well as expenditure relating to social services) appears to have contributed to the higher incidence of poverty since the mid-1990s. While the short-term stabilisation measures have had immediate adverse effects on growth, employment and poverty, the longer-term liberalisation measures, aimed at removing structural rigidity, have not contributed to higher growth in output and

Table 14.2 Foreign trade statistics, Pakistan: 1972–3 to 1999–2000

Years	Exports (US$ in million)	Imports (US$ in million)	Exchange rate (% change) Rs/US$	As percent of GDP					Growth rate	
				Exports	Imports	Overall trade	Trade deficit	Current account deficit	Exports	Imports
1972/73	766	891		8.2	9.6	17.8	1.3	1.1		
1973/74	1,020	1,493	15.4	11.4	16.6	28.0	5.3	5.4	33.2	67.6
1974/75	978	2,114	-1.2	8.6	18.7	27.3	10.0	9.4	-4.1	41.6
1975/76	1,162	2,139	0.0	8.8	16.1	24.9	7.4	6.2	18.8	1.2
1976/77	1,132	2,418	0.1	7.4	15.9	23.3	8.4	5.9	-2.6	13.0
1977/78	1,283	2,751	0.0	7.1	15.3	22.4	8.2	2.7	13.3	13.8
1978/79	1,644	3,816	0.0	8.3	19.2	27.5	11.0	5.0	28.1	38.7
1979/80	2,341	4,857	0.0	9.9	20.5	30.4	10.6	3.7	42.4	27.3
1980/81	2,799	5,563	-0.1	10.3	20.4	30.7	10.1	2.8	19.6	14.5
1981/82	2,319	5,769	0.1	7.1	17.6	24.7	10.5	3.4	-17.1	3.7
1982/83	2,627	5,616	28.2	9.2	19.6	28.8	10.4	0.6	13.3	-2.7
1983/84	2,669	5,993	6.1	8.6	19.2	27.8	10.7	2.2	1.6	6.7
1984/85	2,457	6,009	12.4	7.9	19.3	27.2	11.4	4.1	-7.9	0.3
1985/86	2,942	5,984	6.5	9.2	18.8	28.0	9.5	2.4	19.7	-0.4
1986/87	3,498	5,792	6.4	10.5	17.4	27.9	6.9	1.0	18.9	-3.2
1987/88	4,362	6,919	2.4	11.4	18.0	29.4	6.7	3.1	24.7	19.5
1988/89	4,634	7,207	9.2	11.6	18.0	29.6	6.4	3.4	6.2	4.2
1989/90	4,926	7,411	11.6	12.3	18.6	30.9	6.2	3.4	6.3	2.8
1990/91	5,902	8,385	4.6	13.0	18.4	31.4	5.5	3.0	19.8	13.1
1991/92	6,762	8,998	10.8	13.9	18.5	32.4	4.6	1.9	14.6	7.3
1992/93	6,785	10,049	4.5	13.1	19.4	32.5	6.3	6.4	0.3	11.7
1993/94	6,685	8,685	16.2	12.8	16.7	29.5	3.8	3.2	-1.5	-13.6
1994/95	7,759	10,296	2.3	12.7	16.9	29.6	4.2	3.5	16.1	18.5
1995/96	8,311	12,015	8.8	13.0	18.8	31.8	5.8	6.8	7.1	16.7
1996/97	8,096	11,241	16.2	12.8	17.8	30.6	5.0	5.6	-2.6	-6.4
1997/98	8,434	10,301	10.8	13.3	16.3	29.6	2.9	2.7	4.2	-8.4
1998/99	7,570	9,344	16.1	12.5	15.5	28.0	2.9	2.6	-10.2	-9.3
1999/00*	8,488	10,033	3.2	13.3	15.7	29.0	2.6	2.3	12.1	7.4
Decade's average 1970s			1.8	9.0	17.8	26.8	8.9	5.1	18.6	27.2
Decade's average 1980s			8.8	10.1	18.5	28.6	8.4	2.7	8.5	4.4
Decade's average 1990s			9.9	13.0	17.3	30.3	4.2	3.9	4.5	2.7

Sources: State Bank of Pakistan (various issues).

Note
* Projected by State Bank of Pakistan.

Table 14.3 Trends in poverty in Pakistan: head counts

Years	Overall Pakistan	Rural	Urban
1963–4	40.24	38.94	44.53
1966–7	44.50	45.62	40.96
1969–70	46.50	49.11	38.76
1979	30.68	32.51	25.94
1984–5	24.47	25.87	21.17
1987–8	17.32	18.32	14.99
1990–1	22.11	23.59	18.64
1992–3	22.40	23.35	15.50
1996–7	31.00	32.00	27.00
1998–9	32.60	34.80	25.90

Sources: Amjad and Kemal (1997); Qureshi and Arif (1999).

exports. In fact, average growth rates fell, inflation accelerated and unemployment rose in the post-liberalisation period which further aggravated poverty in the country.

Concluding remarks

Pakistan embarked on liberalisation reforms since the late 1980s to improve economic performance. However, its achievements have been disappointing so far. For instance, growth in GDP and exports remained very slow. Also, FDI, which is a complementary requirement for trade liberalisation to be successful for export promotion, did not increase sufficiently. This appears to be due to the rigidity in labour market. Reforms that promote labour-market flexibility are urgently needed to achieve employment intensive growth and thereby reduce poverty. It appears that excessive reduction in aggregate demand through expenditure-reducing policies has slowed down GDP growth rate and contributed to a rise in poverty. Fiscal and current account deficit targets should be the outcome of growth process rather than prime objectives of economic policy. A threshold of 6 per cent growth rate has brought a significant reduction in poverty in Pakistan in the 1970s and 1980s. Thus, the country should aim to achieve growth rate higher than 6.0 per cent for poverty reduction in the next three to four years. Since the population growth rate is almost 2.5 per cent, the target growth rate should be higher than the twice of the population growth rate. To achieve such an ambitious target growth rate, the country should focus on broadening the tax base through better collection of revenue, and administrative reforms rather than expenditure cutbacks, which further reduce the effectiveness of the public sector. The monetary policy should aim at lowering real interest rates to stimulate investment and revive growth. In addition, government should take initiatives to foster a positive business environment to revive investment and economic growth on a sustainable basis. Deregulation, improved governance, and reduced corruption will also help in this regard.

Acknowledgement

Notes

1 See Government of Pakistan (2000). However, independent estimates put unemployment rate at a much higher level-twice as high as above of the government claim.
2 These include Naseem (1973), Mujahid (1978), Malik (1988), Ahmad and Ludlow (1989), Ercelawn (1990), Malik (1992), Ahmad (1992), Gazdar *et al.* (1994), World Bank (1995), Anwar (1996; 1998), Amjad and Kemal (1997) and the Government of Pakistan (2000).

Part IV

Reflections on the issues

15 Trade orientation, growth and poverty

What have we learned from the Asian experience?

Kishor Sharma and Gamini Herath

Asian developing countries, together with many developing countries in Africa and Latin America, have seen waves of reforms since the mid-1970s when the failure of an inward-oriented development strategy in sustaining growth came under attack in the early 1970s. It was thought that an outward-looking development strategy (also known as economic liberalisation) would create better incentives for sustaining growth and thereby reduce poverty and inequality. However, the experiences from many developing countries including South Asia suggest that significant poverty alleviation has not yet been achieved despite liberalisation reforms. While East Asia has made noticeable achievements in alleviating poverty and inequality, in South Asia it still remains a major development challenge. For example, about 40 per cent of the people in South Asia live below the poverty line as against 15 per cent in East Asia. This figure is even higher for Sub-Saharan African countries. Globally about 24 per cent of the people live in poverty.

The debate over liberalisation, poverty and equity has come under close scrutiny in recent years as demonstrations against globalisation are rising. The view that globalisation serves the interest of the rich and that the poor are left out as liberalisation proceeds is frequently heard in public forums in both developed and developing countries. In this chapter, we shed light on this debate based on the experiences of East and South Asia, and draw some development lessons.

Key differences in East and South Asia

The success stories of East Asia suggest that sustained economic growth is a key to poverty alleviation and income equality. As Srinivasan (2001: 20) correctly points out sustaining economic growth is essential for alleviating poverty. He notes that:

> … for aggregate growth to have an impact on poverty, it has to be sustained for a sufficiently long period of time. The reason is that volatility in aggregate growth implies greater uncertainty on returns from investment by individuals in physical and human capital and in innovations, thus blunting the

efforts of the poor to climb out of poverty on their own. Growth volatility also could induce volatility in public revenues and prevent any sustained increase in public expenditures devoted to poverty reduction.

The East Asian experience also shows that policy reforms designed to sustain economic growth must be accompanied by good governance and institutions, efficient infrastructure, politico-economic environment and pro-rural investment. In the absence of complementary policies for the development of institutions, manpower and infrastructure, policy reforms may not yield the desired growth benefits. Equally important are the links between rural and urban markets and the extent to which government policy facilitates labour absorption in manufacturing and service sectors (Timmer 1991). Macro-economic stability (i.e. lower inflation, low fiscal deficit and competitive exchange rate) is also essential for sustaining growth and thereby reducing poverty and inequality.

Role of markets

Both input and output markets can play a significant role in sustaining growth and alleviating poverty. Differences in poverty alleviation outcomes between the East and South Asia appear to be linked with the efficiency of markets brought about by the greater involvement of the private sector. Markets play a critical role in alleviating poverty. Poverty can rise with the disappearance of markets for goods and services that the poor produce, while the creation of new markets or strengthening existing markets for previously untraded or unavailable goods can alleviate poverty (Winters, Chapter 2 of this volume). The East Asian experience suggests that flexibility in output and factor markets are important for attracting investment and improving productivity because real incomes of the poor cannot be increased without an improvement in productivity. Markets tend to work efficiently when there is no government intervention. For example, East Asia relied heavily on the private sector for marketing and distribution of inputs as well as outputs, which created incentives for raising production and productivity, leading to a rise in the real incomes of the poor. By contrast, in South Asia, despite over a decade of reforms, public sector remains dominant in factor markets. This has created disincentives for output growth and productivity improvement. In fact, government interventions in factor markets, particularly the labour market, have hindered growth performance in countries like Pakistan, Nepal and Bangladesh. In the presence of labour market rigidity these countries have failed to attract employment-intensive FDI. In Nepal despite abundant supplies of unskilled labour, firms are inclined toward capital-intensive technology. Thus, despite liberalisation in trade, investment and payment regime, employment opportunities for poor have not increased.

Pro-rural investment

Pro-rural investment is important because most poor in developing countries live in rural areas and rely on agriculture. Hence, such investment can significantly

increase agricultural output and productivity, which is a key to poverty alleviation. The experience so far suggests that policy reforms in South Asia have not been pro-rural. There has been urban bias in investment programmes, which has failed to integrate rural–urban markets. South Asia as a whole also suffers from poor agricultural productivity. The growth in agricultural GDP in most South Asian countries was only marginally higher than population growth, which was not enough to sustain investment (except India where agricultural GDP growth was much higher). In some countries in South Asia, development expenditure that helps the rural poor has been declining. This is especially the case in Pakistan and Nepal (see Chapters 13 and 14 of this volume). For example, in Nepal development expenditure as percentage of total budget has fallen from 65 per cent before the policy reform to 57 per cent after the reforms. Clearly, development expenditure pattern has not been pro-rural or pro-poor (Karmacharya and Sharma, Chapter 13 in this volume).

Role of institutions and good governance

A strong institutional environment and good governance is a pre-requisite for the emergence of new markets and the efficient functioning of existing markets. Good governance implies good policy, which results in higher growth and poverty alleviation. Governments with credible institutions can improve productivity, which in turn result in higher returns, enhancing the potential for poverty alleviation. Collier and Dollar (2001: 1787) correctly notes that:

> To a large extent differences in income across countries can be explained by differences in economic institutions and policies. … Rapid poverty reductions in low-income countries depends primarily on these countries improving their own policies and institution.

Effective institutions lower transactions costs of doing business, encouraging greater business activity by local entrepreneurs and foreign investors (Pfeffermann 2001). Over the years, East Asia has developed such institutions through transparent processes and privatisation. However, countries in South Asia have a long way to go. These countries have not yet overcome the monopolistic conditions that prevailed in the management of SOEs. For example, telecommunications and electricity services are still controlled by the SOEs, which are highly inefficient. Their inefficiencies are transferred to businesses through input–output linkages, resulting in a loss in competitiveness (productivity). As mentioned earlier productivity improvement is a key to sustainable growth and poverty alleviation. Also, it appears that weak property rights and corruption have hindered the full participation of the private sector and MNEs in trade, industry and agricultural development in many South Asian countries. However, this has not been severe in East Asian countries.

Infrastructure

The role of efficient infrastructure (i.e. transport, energy and communications, etc.) in sustaining growth and alleviating poverty is undebateable. There is no

doubt that liberalisation demands efficient infrastructure (such as electricity, telecommunications and water supply). The experiences from Malaysia, Vietnam, Thailand and Indonesia suggest that policy liberalisation together with substantial improvement in infrastructure facilities encouraged the development of employment-intensive industries and alleviated poverty. Also, unless poverty-stricken farmers have adequate access to transport, electricity, water and telecommunications, the success of liberalisation will be limited.[1] For example, introduction of telephones in rural Thailand have allowed farmers to regularly check prices in Bangkok, which significantly increased profits and raised incentives for raising production and productivity. This resulted in higher real income of the poor and improved their living standard.

By contrast, South Asian countries are vulnerable due to inadequate infrastructure to support the liberalisation programme. As mentioned earlier, infrastructure investment has either stagnated or declined in many South Asian countries, including Pakistan and Nepal. For example, in Nepal only about 1 per cent of GDP is being spent on education, and development and maintenance of roads and bridges. Despite a rapid growth in population, only about 0.5 per cent of GDP is spent on public health. Although in recent years South Asian countries have substantially improved telecommunication networks, there appears to be an urban bias in communication facilities, indicating that the poor are still left out (Jayasuriya and Knight-Jones 1998). In South Asia, most basic infrastructure is managed by SOEs. Where infrastructure is privatised, the institutional environment has not been credible leading to inefficiencies. By contrast, countries in East Asia have increasingly improved access to telecommunication facilities in rural areas and increased the private sector participation in managing these services. This has resulted in much higher teledensity in countries in East Asian compared to South Asia.[2]

The infrastructure needs are vast from the slums to the remote countryside. The experiences so far suggest that South Asia needs more aggressive privatisation of the infrastructure sector with independent credible regulators (Herath and Gulati 2002).

Concluding remarks

Outward-oriented policy alone does not explain differences in poverty outcomes in East and South Asia. Several other factors must accompany the reform programme to make a significant dent on poverty. These factors include efficient markets, effective institutions, good governance, infrastructure and pro-rural investment. Although some of the reforms are very difficult to implement, for example, reforms in labour market and land ownership and privatisation of public enterprises, they must be done to enhance the impact of reform programmes. South Asia lagged behind in these areas, which may explain the poor poverty outcome.

East Asian reforms have been comprehensive. Their reform agenda also included strengthening institutions and developing human capital through

greater private sector participation. Land reform was also a part of their broad reform agenda. In South Asia, policy liberalisation has been mainly limited to the liberalisation of trade, investment and payment regimes. There has been very slow progress in privatisation of SOEs, and introducing reforms in labour markets and infrastructure sector. In general, reform has been half-hearted. A deeper reform is needed to sustain growth and make a significant dent on poverty.

Apart from policy reforms, favourable external environment is also important for sustaining growth and alleviating poverty particularly in developing countries. In this context, rich countries can make a significant contribution in lifting the billions of people out of poverty in developing countries. Their cooperation should include not only financial and technical assistance, but also improved market access on MFN basis. If developed countries continue to protect their industries through non-tariff measures like MFA, and farm subsidies programme, poverty alleviation will remain a distant dream.

Notes

1 Most developing country governments made massive investments on irrigation infrastructure such as canals, reservoirs, distributaries, large and small tanks, since the 1950s. During 1947–81, despite some initial successes in India, Sri Lanka, Pakistan, massive investments made on irrigation was not correctly exploited. Water management was a serious problem. Pricing was poor and managers had no incentives to achieve efficiency due to poor pricing. In India, Pakistan, Bangladesh, Philippines and Indonesia, irrigation user fees covered less than 10–90 per cent of the costs (Sampath 1992).
2 For example, teledensity in India and Sri Lanka are 1.2 and 2.1 per 1,000 inhabitants respectively in comparison with 16.1 and 5.1 per 1,000 inhabitants for Malaysia and Thailand respectively.

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