Impact of Trade on Growth, Income Distribution, and Poverty
by
Karima Korayem

One may differentiate between two types of trade policy: the inward-oriented Import Substitution (IS) policy and the outward-oriented Export Promotion (EP) policy. Most of the studies in the literature tended to ascertain the positive impact of the outward-oriented trade policy (the EP policy) on growth, income distribution and poverty as compared to the inward-oriented policy (the IS policy). According to the literature on trade policies applied in different countries, the choice of the trade policy, EP or IS, seems to be affected by three factors: the level of development of the country (developed or developing), the national strategy adopted (socialist or market-economy), and the international environment (self-reliance or globalization). Empirically, one finds that the more developed the country is, the more outward-oriented trade policy it applies. This is supported usually by the market-economy system applied in those countries. The open-oriented trade policy applied in the developed countries is reflected in the relative size of international trade in those countries as compared to the developing ones. In the developing countries, the open-oriented policy is applied mostly in those countries with higher income per capita and higher GDP growth rate.

The international environment has also its significant impact on the country trade policy. In the sixties and seventies, with the strong international influence of the Soviet Union and its allies, the socialist system was applied in many developing countries with public enterprises having the dominance in most of the economic sectors, and the IS policy was quite widely adopted. In the eighties, with the advocacy of the International Monetary Fund and the World Bank structural adjustment reform in the developing countries, and

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1 Professor of Economics, Al-Azhar University, Cairo, Egypt; email: nile@link.net
in the nineties with the GATT implementation, the market-economy system has been widely adopted in the developing world, and trade liberalization and, hence, EP policy became more widespread. One may point out three effects of the trade policy on the country's economy: (1) impact on GDP growth rate; (2) impact on income distribution; and (3) impact on poverty.

1. Impact on GDP Growth Rate:

Theoretically, trade policy affects income generation in the country positively through its impact on: (i) better allocation of resources; (ii) raising total factor productivity; (iii) increasing the size of the targeted market; and (iv) creating employment opportunities. Comparing the EP and IS policies with respect to the four impacts, one finds the following:

(i) the EP policy leads to the allocation of resources in favor of the comparative advantage of the country concerned, to be able to produce commodities at competitive prices in the international market. In the developing countries, where capital is scarce and unskilled labour is abundant, the EP policy implies producing goods and services that utilizes mostly unskilled labour whose wages are low. The result is the increase in the demand for unskilled labour, the rise in their wages, which implies redistributing the national income in favor of the poor, the unskilled labour, vis-à-vis the rich, the capital owners. The impact of the IS policy in this area is negative or, at most, negligible. This is because the IS policy is accompanied by monopolistic and/or oligopolistic rules and legislations in the domestic market. The result is misallocation of resources, and raising the prices of the import substitutes produced for the domestic market. Besides, imports are usually capital-intensive goods and, hence, the production of the import substitutes entails increasing demand for the scarce factor of production, capital, and less demand for the most abundant factor of production, unskilled labour. The outcome is the continuation
of low wages for the unskilled workers, and the increase in the return to capital, which implies the redistribution of national income in favor of the rich, the capital owners, vis-à-vis the poor, the wage earners.

(ii) EP policy is accompanied by raising total factor productivity through more training and education for labour, and better management of factors of production -like better utilization of capital, minimizing waste in production - to reduce cost of production. The IS policy is not expected to raise total factor productivity since market competition is substituted by market monopoly and oligopoly which has negative impact on factor productivity and cost of production.

(iii) Both EP and IS policies increase production through increasing the size of the targeted market, but in different ways. The EP policy increases the size of the targeted market by adding export markets to the domestic market, while the IS policy increases the size of the targeted market through protection of the domestic market. Thus, it is expected that the size of the targeted market will be increased by applying either one of the trade policies, but with different impact on the prices of produced goods and, most probably also, on the quality of production. With the international competitiveness as a prerequisite for a sustainable EP policy, production prices will probably be reduced and quality of production improved. The IS policy, accompanied by monopolistic and oligopolistic regulations, entails increasing production prices and reducing the quality of the goods produced, since it closes the domestic market to competitive imported goods. Consequently, the welfare of the domestic consumer will be affected positively in the case of the EP policy, and negatively in the case of the IS policy.
(iv) Finally, both EP and IS policies will create employment opportunities in the domestic market as a result of raising production through increasing the size of the targeted market as explained above.

It is important to note, though, that despite that, theoretically, the EP policy seems to be superior than the IS policy with respect to the impact on growth as shown above, this is not conclusive empirically speaking. Many empirical studies that have been undertaken on the relationship between trade regime and economic growth have not provided conclusive evidence that the EP policy is superior to the IS policy.

2. Impact on Income Distribution:

Trade policy affects income distribution through its impact on income inequality between capital and labour, and on wage inequality between skilled and unskilled labour. The import of the developing countries consist mostly of goods that uses capital-intensive techniques and skilled labour. Hence, the production of the import substitutes will increase the demand for capital and skilled labour, which are scarce, and will reduce the demand for unskilled labour, which is abundant. Thus, the IS policy is expected to increase income inequality between capital and labour, and between skilled and unskilled labour. Moreover, due to the creation of monopoly and oligopoly in producing import substitutes, which entails capital-intensive method of production, the income inequality between capital and labour will be enhanced.

According to theory, the EP policy reduces the income inequality between capital and labour because, according to the comparative-advantage principle, developing countries will produce for export labour-intensive commodities, which depends mostly on cheap unskilled labour, and import capital-intensive ones. However, according to some empirical studies, inequality between capital and labour increased in countries adopting
the EP policy. One explanation was the high mobility of capital to move to the developing countries to produce capital-intensive goods for export using relatively cheap skilled labour. EP is supposed also to reduce inequality in wages between skilled and unskilled labour since, theoretically, the developing countries will be more competitive in exporting goods that uses intensive unskilled labour because of the comparative advantage principle. However, in practice the wage inequality between skilled and unskilled labour has increased after applying the EP policy in quite a few countries. This is explained by the substitute of skilled labour for unskilled ones in production to raise productivity in order to be able to compete in the international market.

3. Impact on Poverty:

Trade policy has its impact on poverty as well. Some differentiate between static and dynamic impacts on poverty. Trade policy impact on poverty is exercised mainly through impact on wages of unskilled workers, impact on prices, and impact on growth. Theoretically, the EP policy has positive effect on poverty since, as mentioned above, the developing countries produce for export unskilled labour-intensive goods because of the comparative advantage involved. This results in raising the demand for unskilled labour and, hence, raising their wages. As unskilled labour are among the poor strata in the society, increasing their wages implies reducing poverty in the country. This result is not expected to be realized by applying the IS policy since, as mentioned above, the capital-intensive type of goods which the country produces under this policy, and the monopolistic regulations accompanying it, entail an increase in the demand for capital and skilled workers, with unskilled labour left behind. The result is increase in poverty.

EP and IS policies affect poverty, also, through their impact on prices. Applying the EP policy increases competitiveness by better allocation of resources and raising total factor productivity, which is expected to result in lower prices for similar goods produced for
the domestic market, or at least not to push the prices up. On the contrary, applying the IS policy with its protective trade measures -like raising tariffs, applying quotas, etc.- besides the monopolistic regulations accompanying it will raise prices of the import substitutes in the domestic market; the cost of living of the population will be increased, and the poor will be hurt. The negative impact on the poor will be aggravated, if the import-substitutes are basic commodities for the low-income people. Besides, if a country opts to apply EP policy, it has to maintain macroeconomic stability in the economy, which implies keeping the inflation rate down to keep its relative competitiveness in the international market. This will help the poor who are more vulnerable to inflation as compared to the high-income groups. Keeping the inflation rate down is not a prerequisite in the case of the IS policy since the monopolistic and oligopolistic measures applied will enable the producers to set the prices they want without fearing to loose the market. The first losers will be the poor.

The dynamic argument raised for the impact of trade policy on poverty, is that trade promotes growth, and growth reduces poverty. The high growth rate achieved in China and India with its concomitant impact on poverty reduction in the two countries are taken as supporting evidence to this argument. During the two decades 1980 – 2000, real GDP grew at an annual average rate of 10 percent in China and 6 percent in India, and the incidence of poverty declined in China from 28 percent in 1978 to 9 percent in 1998, and in India from 51 percent in 1977/78 to 27 percent in 1999/2000. According to this argument, the EP policy is more favorable to poverty reduction as compared to the IS policy.