The benefits of trade openness to developing countries

Trade openness is beneficial to a developing country not only to foster foreign investment and technology transfer, but also to reduce poverty and child labour and to encourage human capital accumulation

Introduction

Trade liberalisation and integration of domestic economy to the world economy (although widely debated) has long been touted as one of the most suitable ways of inclusive economic development of third world countries. The proponents of globalisation often cite the stupendous economic growth of Asian countries like Hong Kong, Taiwan, South Korea and Singapore and emerging economies like China and India as success stories of globalisation. Moreover, the initial notion of trade openness of developing countries, largely motivated by access to FDI and technology transfers from developed countries, has also been linked to rapid economic growth and in turn to reduction in poverty and child labour in those countries. The issues of poverty, child labour, education and employability, health and housing, and basic infrastructure development are central challenges to all developing countries; however, the issue of poverty and child labour is most appalling. Chen and Ravallion (2004) reported that as per estimates in 2001 about half of the developing world population (approx. 2. 7 billion) survive on US$2 or less per day and a fifth of the total population (approx 1. 2 billion) survive on a dollar or less per day. ILO (2002a) estimated that approximately 211 million children in the age group of 5-14, in 2000, were involved in some form of employment worldwide. There has been no disagreement that poverty alleviation is the ultimate aim of economic policies but the more suitable way to achieve this goal is ardently argued and there seems no agreement on that. One of the important questions that have been consistently raised in development economics is ‘ Does poor gain from high economic growth irrespective of its characteristics?’ There are two opinions on that. The opponents of globalisation argue that trade-led economic growth of developing countries have helped only middle and upper classes and have caused further income inequity. Moreover, trade openness has caused severe damages to the world environment. On the other hand, many scholars believe in the so-called ‘ Bhagawati Hypothesis’ according to which high rate of economic growth can help reduce poverty and what drives the economic growth of a given economy is of less significance (Tsai and Huang, 2007; Bhagwati, 2005; Bhagwati and Srinivasan, 2002; Dollar and Kraay, 2002, 2004). Tsai and Huang (2007) studied economic progress of Taiwan for the period 1964- 2003 suggested that distributional and growth effect of trade-led sustained economic growth had been the major driving factor for poverty alleviation in Taiwan over the period.

Similarly a number of empirical studies done by Agenor (2004), Sharma (2003), and Winter et al (2004) have suggested a close linkage between the fast economic growth and poverty alleviation leading to an agreement among scholars that participation in international trade can be the useful way for tackling poverty in developing countries. However, Tsai and Huang (2007) argue that there is no straightforward linkage between the trade openness and poverty. In addition to the two strands on the benefits of trade openness to developing economies there is another perspective to the argument which is the benefits of trade openness to developed economies. Dowrick and Golley (2004) in their study of dynamic benefits of trade openness suggested that the benefits of trade liberalisation were substantially greater for developed economies as compared to benefits to the least developed countries.

The brief examines the role of trade openness in the reduction of poverty and child labour incidences, and development of human capital in developing economies. Firstly, the phenomenon of trade openness has been discussed. In the subsequent sections the effects (both positive and negative) of trade openness on poverty, child labour and human capital accumulations has been assessed in the light of empirical studies. In the end concluding remarks on trade openness as means of poverty and child labour reduction and human capital accumulation is presented.

Trade Openness

Trade openness may be defined as the extent of which a country partakes in the global trade and allow foreign firms to do business in its domestic market. It is of two types – revealed openness and policy openness. Revealed openness is measured in terms of ratio of total foreign trade to GDP. It is clearly defined and well measured; however, use of prices (domestic or international) to value the trade ratio has been a cause of disagreement among economists. Studies that focus on revealed openness always attempt to understand the linkage between trade openness and economic performance. In other words, deals with finding about the fact that ‘ whether economies (and particularly developing) who partake more in global trade have high rate of economic growth that those who abstain from it’. This approach has several disadvantages such as it does not explain why some countries might trade more as the high trade openness of a country may be the result of small domestic market, easy access to foreign market and policy openness. Policy openness, as the name suggest, is measured in various ways such as 1) in terms of incidence measures of trade barriers; 2) trade flow measures adjusted for structural characteristics such as size and factor endowments; and 3) price distortions. However, policy openness is difficult to measure and all these measures discussed above have their limitations and reliability issues. The policy openness measure by Sachs and Warner (1995) is considered as the most influential and useful in estimating its effects on economic performance. They classified a country as having policy openness if it does not exhibited characteristics such as 1) typical tariff rates of 40 percent or above on imported goods; 2) non-tariff barriers amounting to 40 percent or more on imported goods; 3) a black market exchange rate premium of 20% or more; 4) an economic system based on socialist vision; and 5) state monopoly on major exports. However, the model has been criticised by Rodriguez and Rodrik (2001) (cited in Dowrick and Golley; 2004) for many reasons. They argued that the crucial components of the model ‘ export monopoly’ and ‘ black market premium’ are hard to analyse for some Latin American and African economies due to their macroeconomic and political difficulties. Frankel and Romer (1999) (cited in Dowrick and Golley; 2004) produced a measure of ‘ constructed’ openness to trade by obtaining predicted value from regression of bilateral trade relations on geographic variables and created national constructed trade shares by aggregating it. The method has been used by various studies in determining the effects of trade openness on economic development (Dowrick and Golley, 2004).

As far as the empirical studies on impact of trade liberalisation on economic development are concerned, it has been found that trade openness positively correlates with economic development. However, the measurement issues in those studies are highly debated. The studies by Sachs and Warner (1995), Frankel and Romer (1999) and Dollar and Kraay (2003) have been most influential. Sachs and Warner found that open economies experienced high GDP per capita (over the study period) and it promoted convergence in incomes in poor countries. Frankel and Romer analysed differences in levels of development of 150 countries and found that 10% points increase in trade integration resulted in 20% points increase in income per person (Dollar and Kraay, 2001). Dollar and Kraay, by using Frabkel-Romer measure, analysed decadal growth of per capita GDP of countries open to trade and reported that doubling of trade integration raised annual growth by 2. 5% points (Dowrick and Golley, 2004).

Impact of trade openness on poverty reduction

Trade liberalisation can affect poverty in two ways – through economic growth gains and income distribution effect. Tsai and Huang (2007, p. 1861) argued that countries open to international trade grow relatively faster than the closed economies " because an open trade regime facilitates efficient transmission of price signals from the international market to the national economy, enhances diffusion of production and management knowledge, and improves domestic efficiency as a result of intensive international competition". The accurate price indicator from international market results in efficient distribution of resources in national economy based on its comparative advantage that leads to faster growth. The gains accrued through high economic growth rate further absorb in the economy and indirectly contribute to poverty reduction. In addition, higher economic growth also results in improved government earnings through direct and indirect taxes providing government sufficient fund for investments in education, infrastructure, employment creation and other social needs of the poor section of society (Dollar and Kraay, 2004; Todaro and Smith, 2009). However, Tsai and Huang (2007) argued that in trade-led growing economies, the degree of poverty reduction largely depend on the efficient distribution of dynamic gains of economic growth or on the comparative advantage of the country. They suggested as most of the poor live in developing world and most of these developing economies have comparative advantages in labour intensive sectors, trade openness result in expansion of labour-intensive exports and thereby higher rate of real wage for labour.

The effects of trade policies and liberalisation on economic performance have been studied by economists since 1970s. The main motivation behind the growing body of theoretical and empirical study on the subject has been the unusual growth patterns of some of the Asian, Latin American and African countries during the second half of 20th century. The observed differences in growth rate is assumed to be due to adoption of different strategies by these developing countries such as import substitution industrialisation (ISI) (by majority of Latin American and Sub-Saharan African economies) and export-promotion policies by East Asian economies. The empirical evidence shows that East Asian economies outperformed the growth rate of other developing economies who adopted ISI strategies (Yanikkaya, 2003). Dollar and Kraay (2001) identified two groups of developing countries termed as ‘ globalisers’ (who participated in international trade) and ‘ non globalisers’ (who did not participated in international trade) and studied their economic growth post-1980s. They reported the fall in income inequality in half of the ‘ globaliser’ countries such as India, Malaysia, the Philippines and Thailand among others while income distribution of Costa Rica and Ecuador remained stable over a period of 20 years since 1980s. They further concluded that as changes in income inequality in most of the ‘ globaliser’ countries remained low the income of poor grew at an average of 3% (equal to per capita GDP growth rate) per year in China, India, Malaysia, Thailand and other developing countries. In addition, all ‘ globalisers’ grew faster economically and socially during the period 1980 – 2000. This suggests that trade liberalisation leads to decline in income inequality between the countries and reduction in poverty. The developing countries that participated in international trade grew fast during 1980s and 1990s and even faster than the rich countries during 1990s. The rapid growth led to the decline in poverty levels in most of these countries. On the other hand, countries that did not participated in international trade could not catch up with the world growth and fell further behind (Dollar and Kraay, 2001).

Impact of trade openness on child labour

The impact of globalisation on the incidence of child labour has recently gained much attention from researchers and scholars, primarily due to ethical concerns on exploitation of child and interest of organised labour in protecting jobs. Globalisation is defined as the active participation of countries in global trade and increased geographical spread of foreign direct investments (FDI). It is argued to have both positive and negative influences on child labour particularly in poor economies. However, the more globalised developing country have lower incidence of child labour. It is widely agreed that poverty is the main reason (if not the only) of child labour as poor parents living in extreme poverty often employ their children in full-time work for a living. Initially, in developing economies, a child engages in employment to fulfil the basic needs of the family but soon this temporary arrangement becomes permanent as children either cannot afford education due to financial constraints or lose their interest in education (Basu, 1997 and 1999; Neumayer and Soysa, 2005).

The impact of trade openness and penetration of FDI on the child labour incidence in developing country has been explained from both the perspectives. The most compelling argument that shows that globalisation promote child labour is that trade openness increases the demand for unskilled labour in developing economies thereby raising the relative rate of returns to unskilled labour. As a result, incentives to invest in education and skills diminish causing increase in rate of returns to child labour which in turn forces parents to engage their children in child employment (Grootaert and Kanbur, 1995). It is also argued that free trade forces countries to gain competitive advantages through becoming cost-effective and a higher level of child labour can cut the cost significantly. Hence, trade openness could result in increase in child labour in developing countries with lax child labour laws. The recent cases of Nike, Reebok and Adidas are proofs that MNCs occasionally subcontract to enterprises that employ child labour (Palley, 2002; Neumayer and Soysa, 2005).

Conversely, the proponents of globalisation argue that trade liberalisation will not only have the substitution effect but also income effect as well. The relative increase in the rate of return on unskilled labour will increase the income level of impoverished parents. Consequently, less number of parents would see need to send their children to work (Basu, 1997). It is also argued that in the long run, trade liberalisation may cause sectoral shift from low-skilled labour -abundant production to high-skilled capital intensive manufacturing due to development of technological capability making employment of children less attractive. The countries more open to trade often invest in education (primary and secondary) and skill development to increase their global competitiveness that indirectly minimises the incidence of child labour. Jafarey and Lahiri (2002) suggest that more open countries will have lower interest rate and provide better access to credit which will lower opportunity cost for education and subsequently incidence of child labour. There have been various empirical studies to analyse the correlation of trade openness with child labour. Neumayer and Soysa (2005) showed that economies that are more engaged in international trade and FDI have a lower incidence of child labour. Edmonds and Pavcnik (2002) in their study reported that a liberalised trade policy in Vietnam increased rice prices and causes reduction in child labour. They found that 30% price increase in rice resulted in 9% decrease in child labour incidence and in total the price increase caused reduction of 47% in child labour during the period 1993-1998 (Todaro and Smith, 2009).

Impact of trade openness on human capital accumulation

It is argued that a developing economy with a low income and low human capital accumulation can advance in a high income (and high human capital) economy by engaging in trade with a developed economy rich in human capital (Ranjan, 2003). In order to support the argument, examples of human capital accumulation, post trade liberalisation, of countries such as Japan, Italy, Singapore, Hong Kong, China, India, South Korea and Taiwan are often cited. Ranjan (2003) suggested that trade openness results in the rise of unskilled wage that further cast aside the existing constraints on investments in human capital which initiate the human capital accumulation process in developing countries. This eventually allows the developing economy to converge in to high-income and high-skilled economic state. The recent growth of East Asian economies further supports the argument which is considered as a result of rapid accumulation of physical and human capital due to increasing focus on international trade (Young, 1995). Bergin and Kearney (2007) suggested that turnaround in economic performance of Ireland during mid-1980s and even faster growth during 1990s resulted in the large scale investment in education and human capital development. The human capital accumulation in Ireland was partly due to high-demand of skilled labour as it attracted skill-intensive and high productive FDI industries through free trade policies. Ireland maintained its competiveness in international market through the combination of rising levels of education and open labour market that meant increased employment and stable unit labour cost (Tsai and Huang, 2007). The growth literature also suggests that to support high economic growth in a developing country the rise in education level and human capital accumulation is very critical (Bergin and

Kearney, 2007). However, Ranjan (2003) stated that in spite the availability of substantial literature and empirical evidence showing positive relation of trade openness and human capital accumulation, earlier empirical studies (Stiglitz, 1970; Findlay and Kierzkowski, 1983) (cited in Ranjan, 2003) suggested that trade openness rather leads to widening of differences in factor endowments of more open economies instead of highly argued convergence. These studies are criticised for not taking in to account the possible influence of credit constraints on physical and human capital accumulation (Ranjan, 2003).

Cartiglia (1997) suggested that as economies engage in international trade the prices of high-tech goods falls in domestic economy and demand for low-skilled labour picks up due to expansion of low-tech industries. This increased demand of low-skilled labour decreases the real wages of skilled labour in developing economies. He further argued as education sector employs skilled worker this result in the fall in cost of education making it more affordable to people. Consequently, in the long term the overall supply of skilled workers increases. On the other hand, availability of cheap high-tech goods due to trade allows developing economies to devote more of their skilled labour in the training and development of next generation skilled workers.

Conclusion

The assessment of various empirical studies done on the linkages of trade openness to economic development revealed that trade openness is positively correlated to the reduction of poverty and child labour, and human capital accumulation in developing countries. The economic success of East

Asian studies and other developing economies such as India and China during the last two decades are testimony to that fact that integration to the world economy accelerates economic growth. It is found that higher economic growth causes reduction in poverty and child labour through income and distribution effects. Trade openness not only generates employment for unskilled labour but causes a rise in unskilled wage and improves income level of the poor. It provides higher tax revenue to government a part of which is invested in education, employment creation, infrastructure and other social projects that directly or indirectly supports poverty reduction. The reduced poverty further helps in reduction of child labour incidences as a result of distributional effect of economic growth. Moreover, the increased government investments in education make schooling more affordable to children and results in reduction in child labour incidences. As far as the effect of trade openness on human capital accumulation is concerned, as argued by Ranjan (2003), trade openness results in the rise of unskilled wage that further relaxes constraints on human capital investment and initiates the process of human capital development. This eventually allows the developing economy to emerge in to a wealthy and high- skilled economic state. Overall, despite the criticism of ‘ trade openness’ to be largely beneficial to developed economies, growing body of empirical evidence suggest that it does help the reduction of poverty and child labour and human capital accumulation in developing countries.