Master in Development Economics from University Paris 1 Panthéon-Sorbonne

Development Policies

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The key question in this course (already asked by Racha Ramadan):

What kinds of economic and other policies might governments in developing countries adopt to reduce poverty and inequality while maintaining or even accelerating economic growth rates?

Two complementary aspects of such a policy:

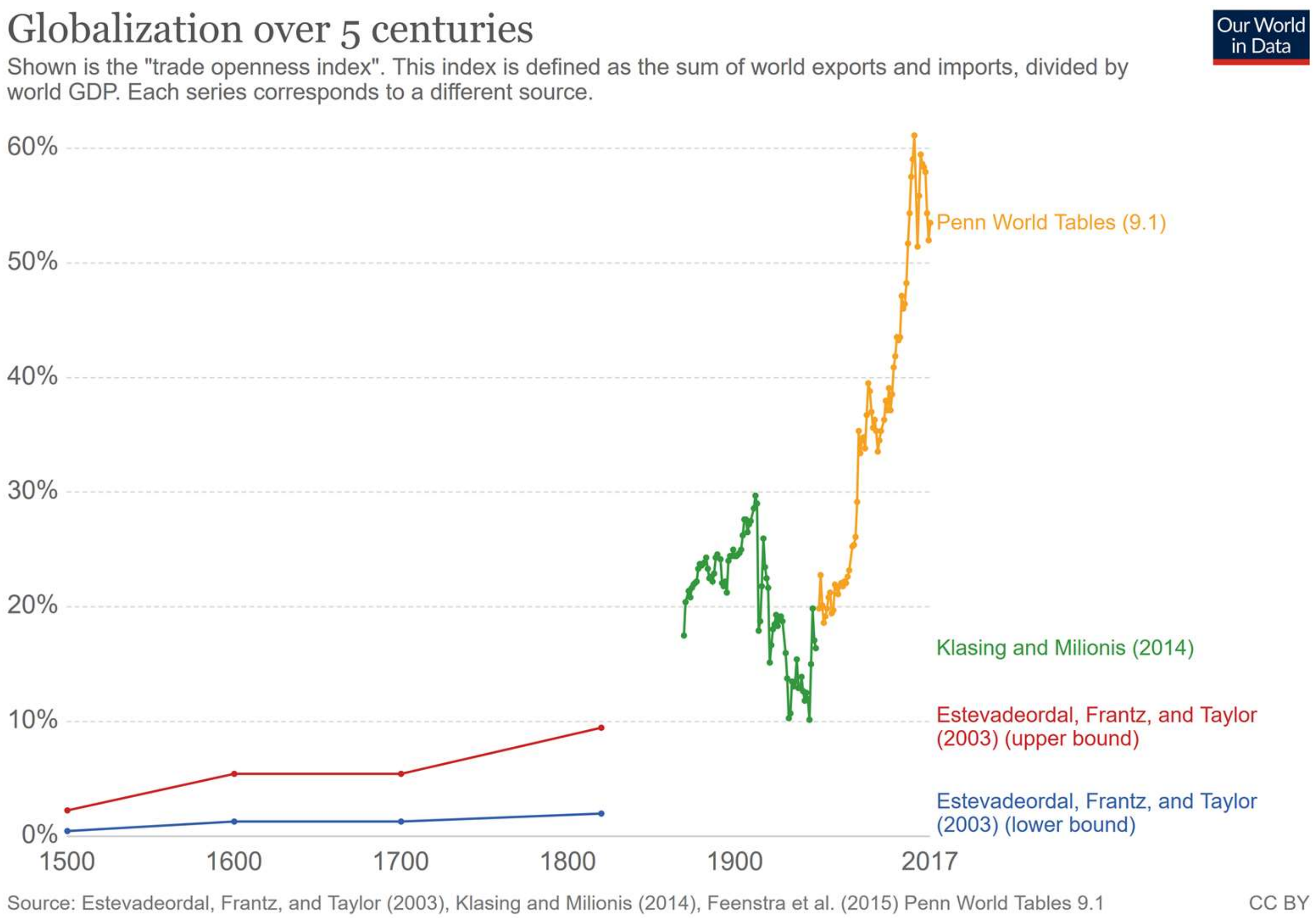
-promotion of economic growth "<u>tide lifting all boats</u>"

-favourable effect on income <u>distribution</u>: pro-poor or at least not anti-poor

My intervention will focus on opening up policies

-Degree of globalization (international opening up) of economies is unprecedented

-Dramatic trade liberalization has been implemented since 1980s in <u>developing countries</u>



Our focus is on the repercussions for developing countries

<u>2 questions</u>: What direct consequences for the poor there? (+ or -)?

-growth channel-income distribution channel

What required adjustments for other pro-poor policies?

Opening up policies, Poverty-Inequality and Development

Introduction

Section 1- Opening up policies, Poverty-Inequality

1) Traditional theoretical expectations: growth and income distribution

2) Empirical results and controversies

3) Ways forward: new channels, heterogeneity, conditionality

4) Openness and gender inequality

Section 2 - Opening up policies, structural transformation and development

1) Trade structure and the development path: Diversification away from agriculture and Sophistication

2) Opening up, institutions and development: what accompanying measures to ensure that opening up is inclusive (pro-poor)

Introduction

Introduction

Since mid 1980s Developing countries have become more **globalized** (globally integrated) following GATT Uruguay Round (1986-1994) and implementation of structural reforms promoted by IMF.

In the 1990s the so-called "**Washington Consensus**" promoted openness to trade and investment as an essential policy reform to promote growth and higher incomes.

Opening up policies:

-current account: liberalization of trade in goods and services

-capital account: promotion of international movement of capital: Foreign direct investment and capital flows

All of which imply:

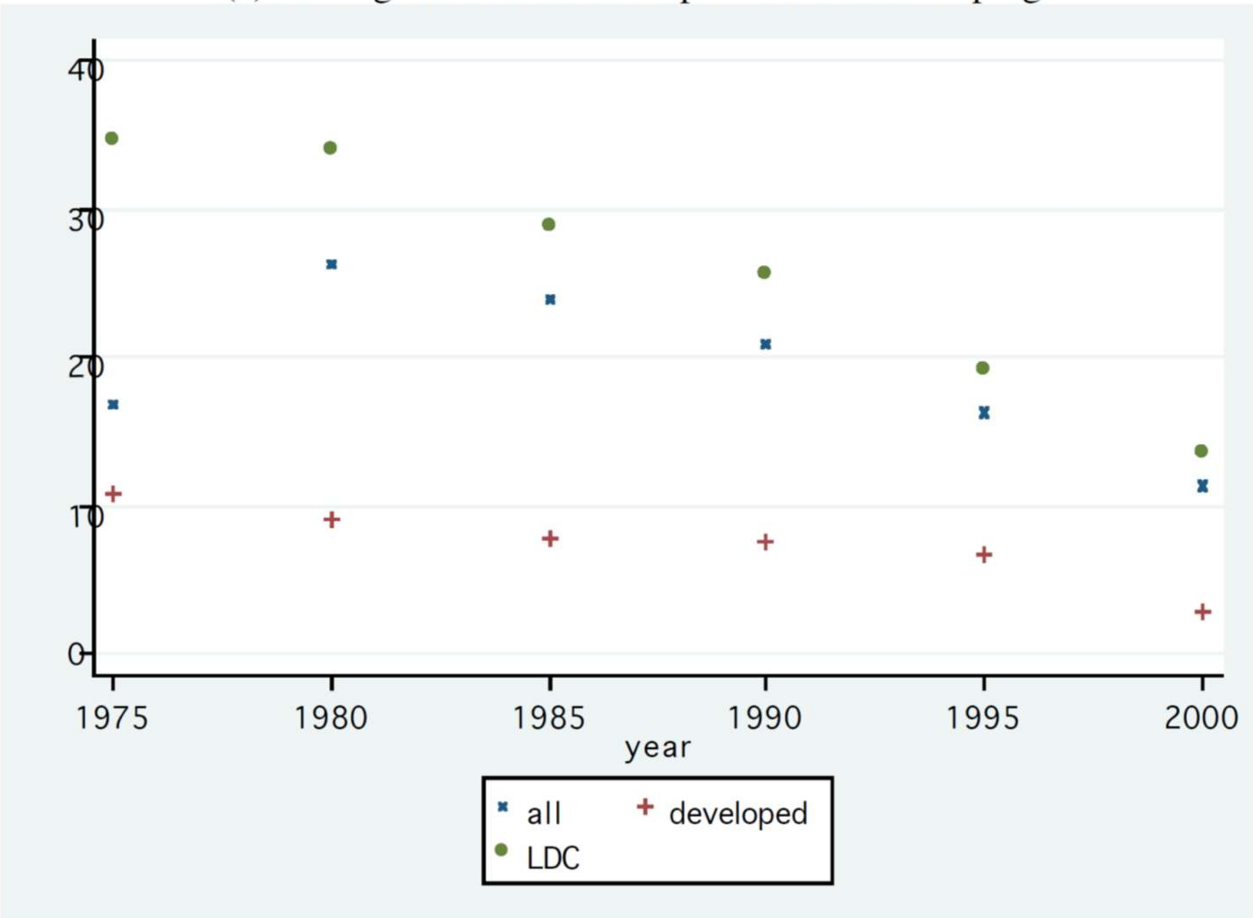
- Increased economic interdependence among countries

Trade liberalization in the developing world

By 1980 when developing countries started entering world markets, average import tariffs in rich countries was already low (5%) following rounds of negotiation under the GATT (Kennedy Round 1964-67, Tokyo Round, 1973-79)

Figure 4: The Great Liberalization: Trends in Tariffs

(a) Average tariffs in Developed versus Developing

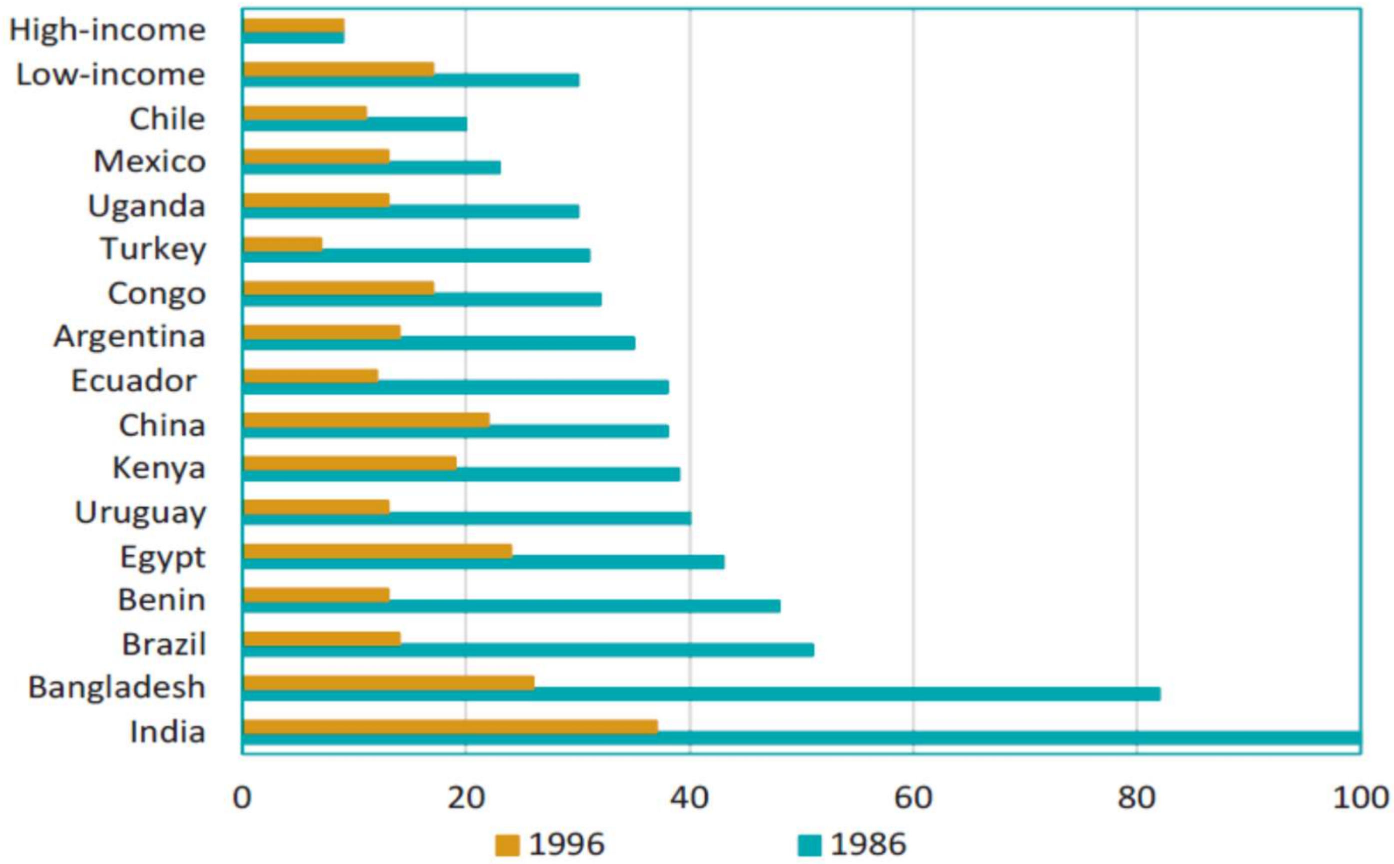


Substantial tariff and non-tariff barriers to trade remained in the developing countries (especially low income) in 1980, which were gradually phased out.

Estevadeordal A. and A. M. Taylor, 2013, Is the Washington Consensus Dead? Growth, Openness, and the Great Liberalization, 1970s–2000s, Review of Economics and Statistics, 95 (5), 1669-1690

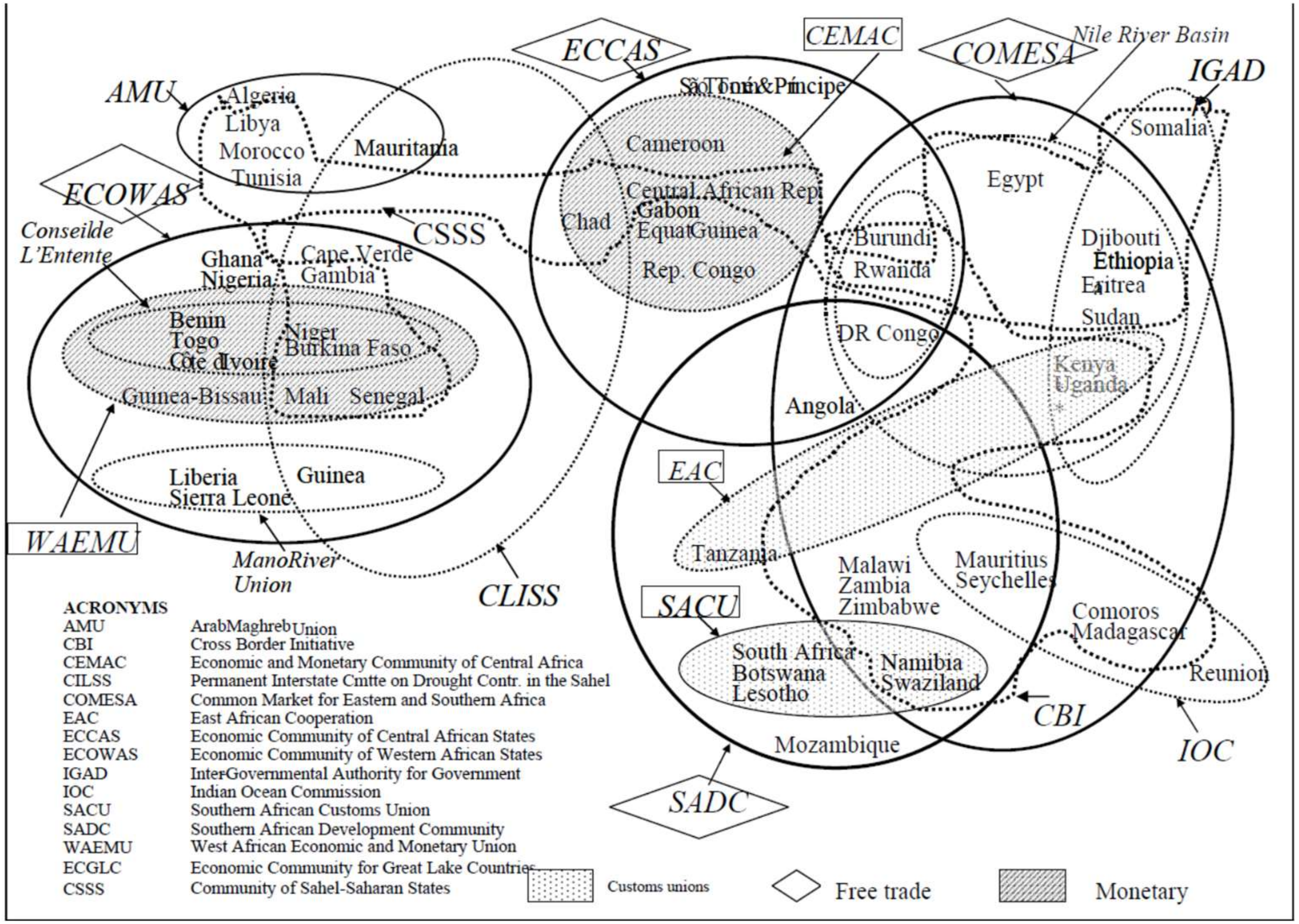
Trade liberalization was organized multilaterally by the GATT (later WTO in 1995)

Figure 2: Average tariffs in selected countries (1986 vs 1996)



Source: UNCTAD's Trains database. Reported tariffs are averages of Most-Favoured Nation (MFN) tariffs. MFN tariffs refer to non-preferential import tariffs applied to other WTO members. Between 1986 and 1996, the average tariff applied by low-income countries declined from 30% to 18%.

Trade liberalization was also promoted regionally through Preferential regional agreements (MERCOSUR, COMESA)

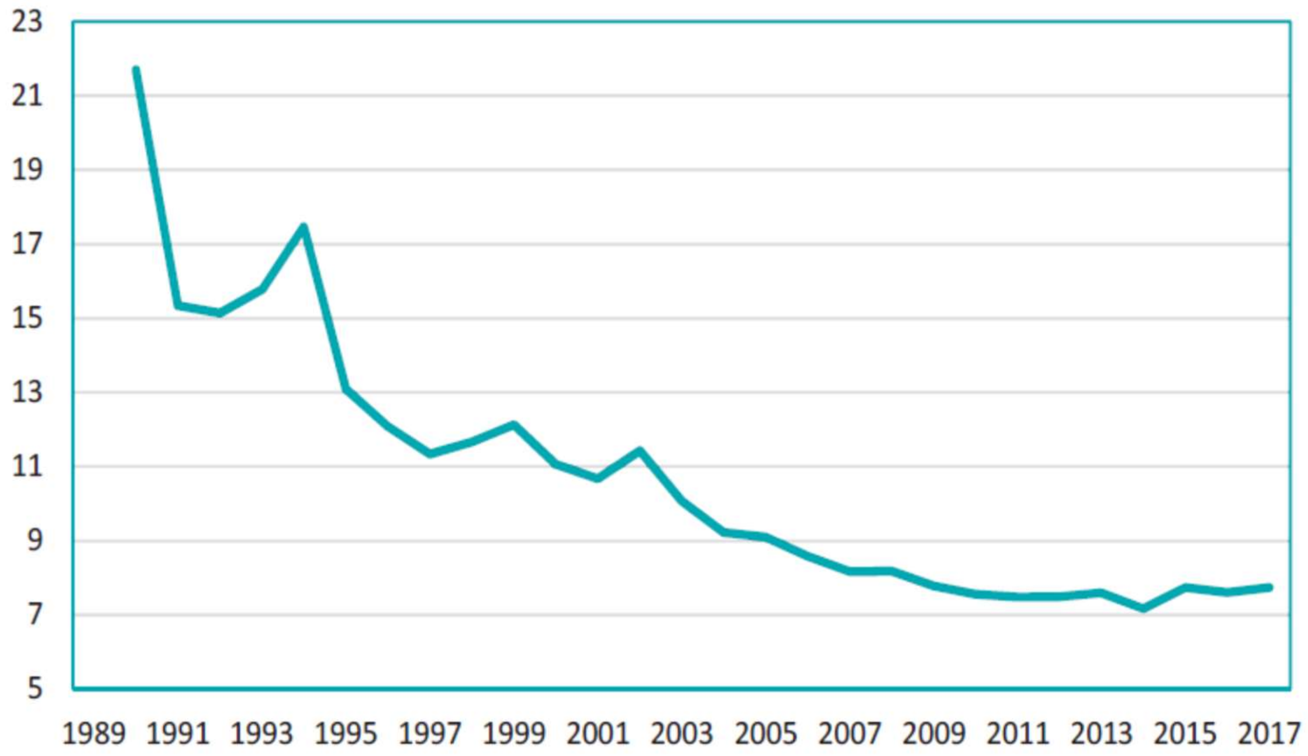


Egypt entered the WTO in 1995

It is party to several regional agreements: **COMESA** Agreement (1998), **European Union-Egypt** Association Agreement (2005), Greater Arab Free Trade Area, Egypt-Turkey Free Trade Agreement, and numerous free and preferential trade agreements with individual Arab countries.

Tariffs have been divided by 3 between 1990 and 2009

Figure 13: World import-weighted average tariff, 1989-2017

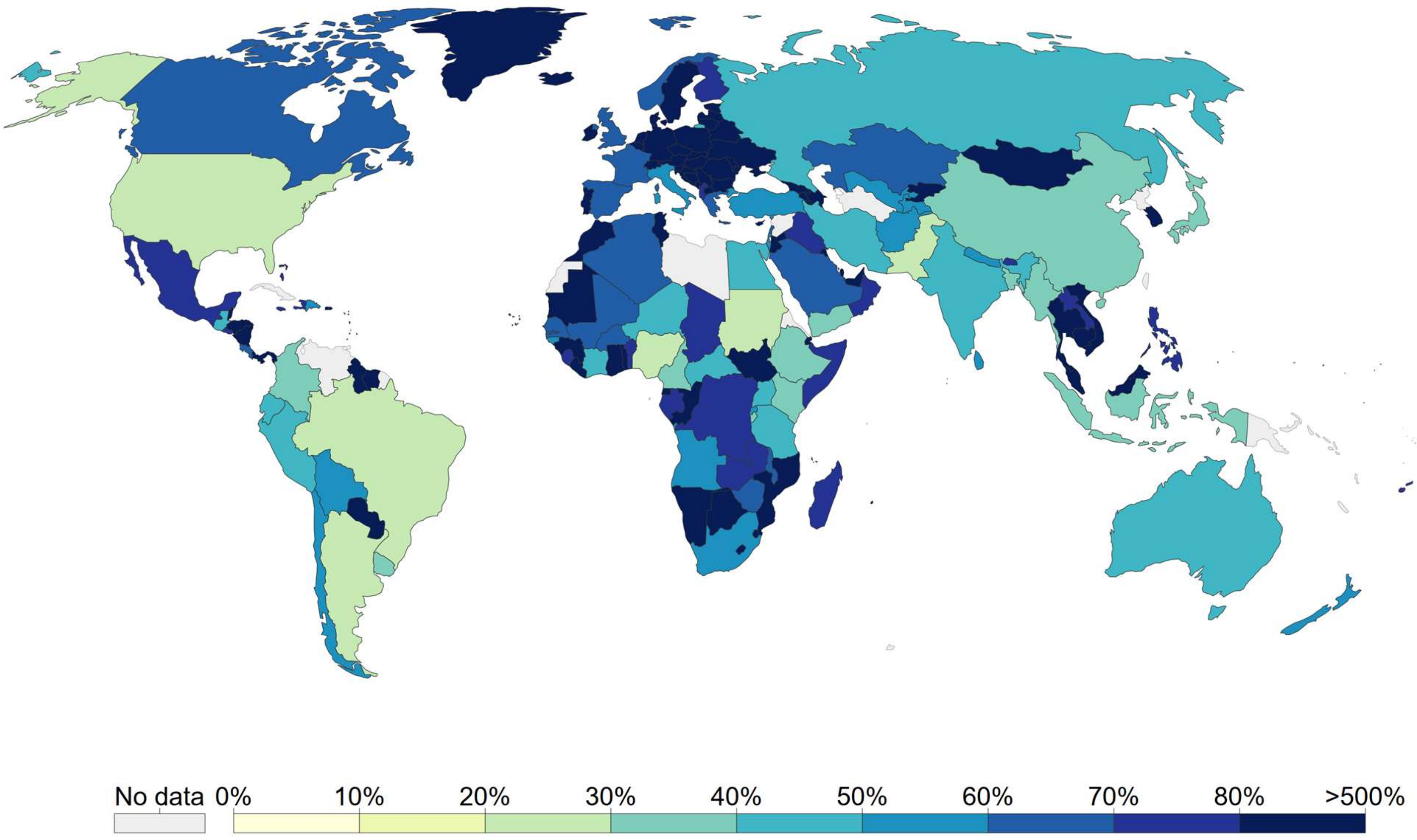


Source: UNCTAD Trains database.

International integration of developing countries has become greater than that of developed countries.

Trade – exports plus imports – as share of GDP, 2017

Shown is the 'trade openness index' – the sum of exports and imports of goods and services, divided by gross domestic product.

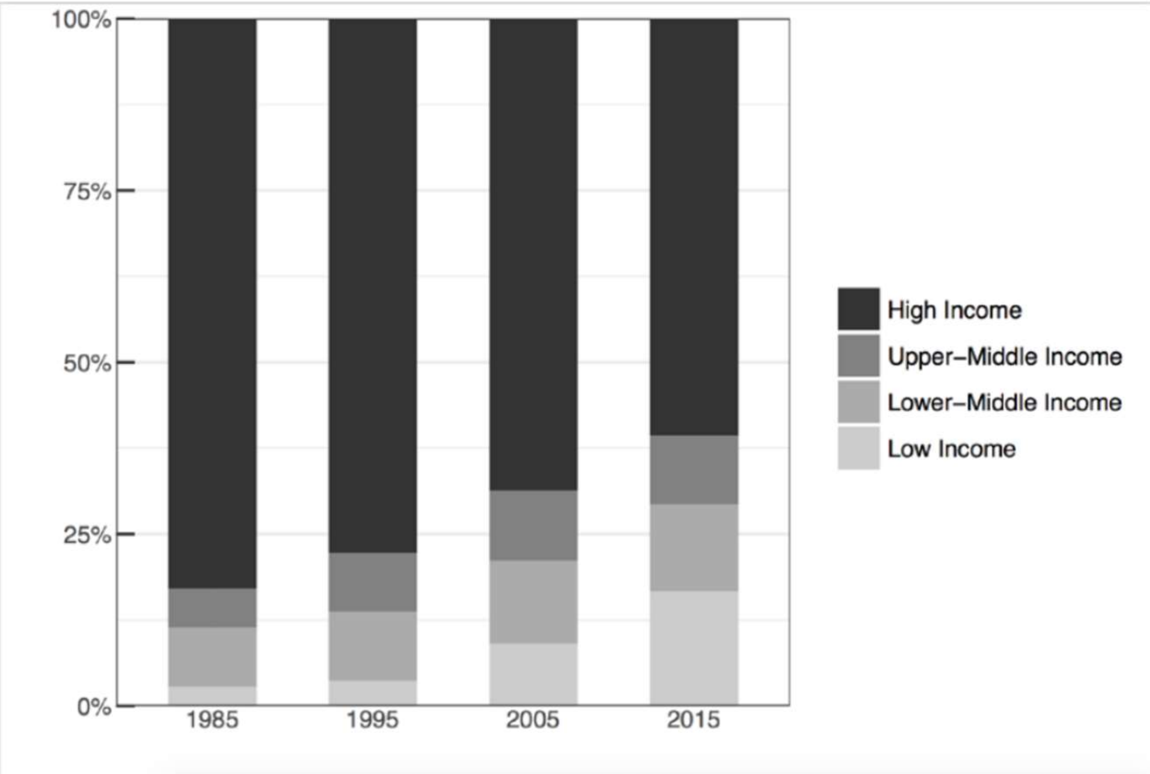


Source: World Bank

OurWorldInData.org/trade-and-globalization •

The share of world exports accounted for by non-high-income countries nearly doubled, rising from 20 percent in 1985 to 39 percent in 2015

Figure 1: Percentage of World Exports of Goods and Services by Country Income



Note: Authors' calculations based on data from WDI (World Exports of Goods and Services). A country's income category group is fixed in time and based on a country's position in 1987 World Bank income groups. See Data Appendix for a list of countries in each group.

Each country is classified into a **time-invariant income** grouping based on its income classification by the World Bank in 1987.

The low-income group includes countries such as China, India, Nepal, Vietnam, and Kenya.

The lower middle-income group includes Chile, Colombia, and Mexico.

The upper middle-income group includes countries such as Argentina, Brazil, and Korea.

Source Nina Pavcnik, 2017, The Impact of Trade on Inequality in Developing Countries, Proceedings of Jackson Hole Economic Symposium. (also NBER Working paper 23878)

Growing discontent about globalization: whatever consensus there might have been, appears lost

Conflicting views among academics:

“So far, the current wave of globalization, which started around 1980, has actually promoted economic equality and reduced poverty.” David Dollar and Aart Kraay, Foreign Affairs, January/February 2002

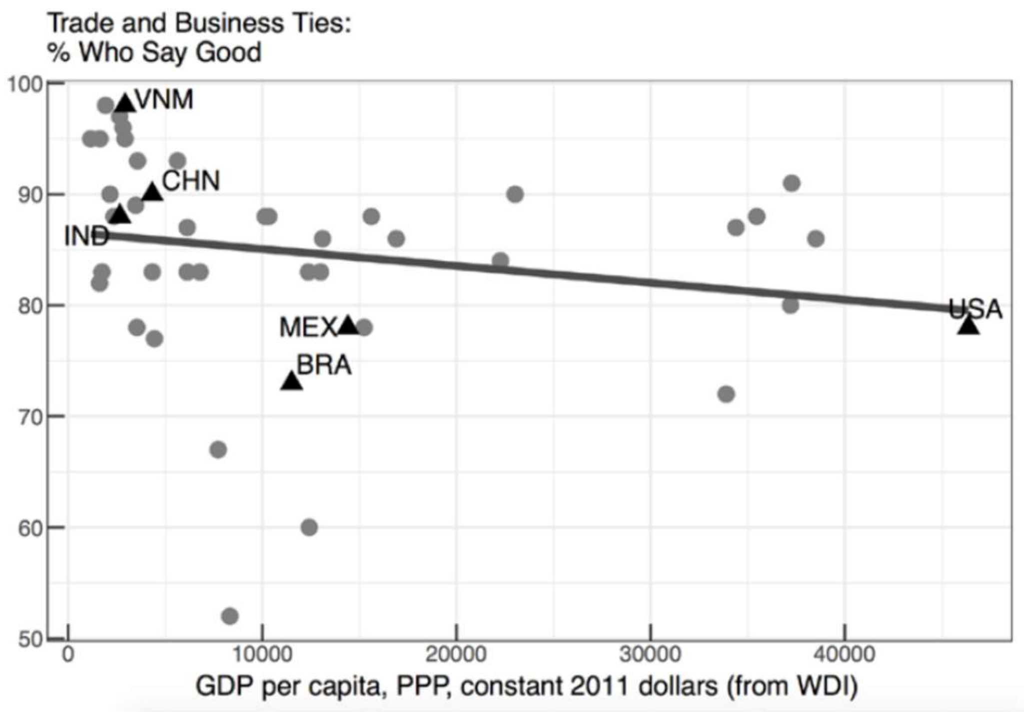
“Globalization has dramatically increased inequality between and within nations” Jay Mazur, “Labor’s New Internationalism”, Foreign Affairs, January/February 2000.

Popular perceptions of beneficial repercussions from globalization also evolved

PEW Global Attitudes survey document perceptions of individuals about the impact of trade on a country as a whole, and on earnings and employment opportunities across countries at various stages of development

<u>Question 1:</u> "What do you think about the growing trade and business ties between (survey country) and other countries—do you think it is a very good thing, somewhat good, somewhat bad or a very bad thing for our country?"

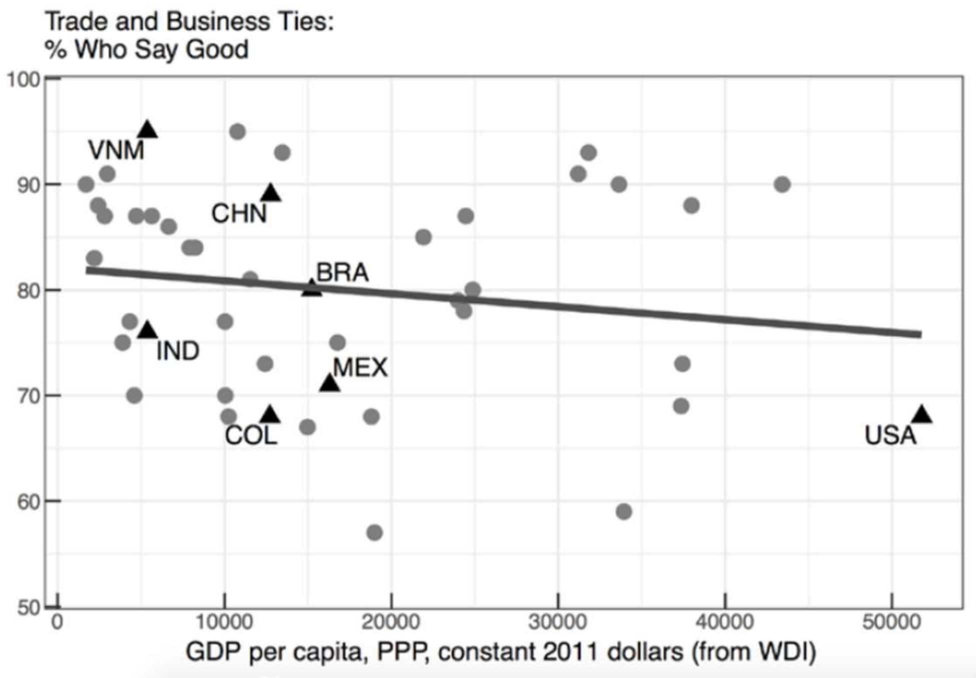
Panel A: 2002



Roughly 85% say it is good

Between 2002 and 2014, the world has become more critical of trade, with the share of individuals perceiving trade as good in an average country dropping.

Panel B: 2014

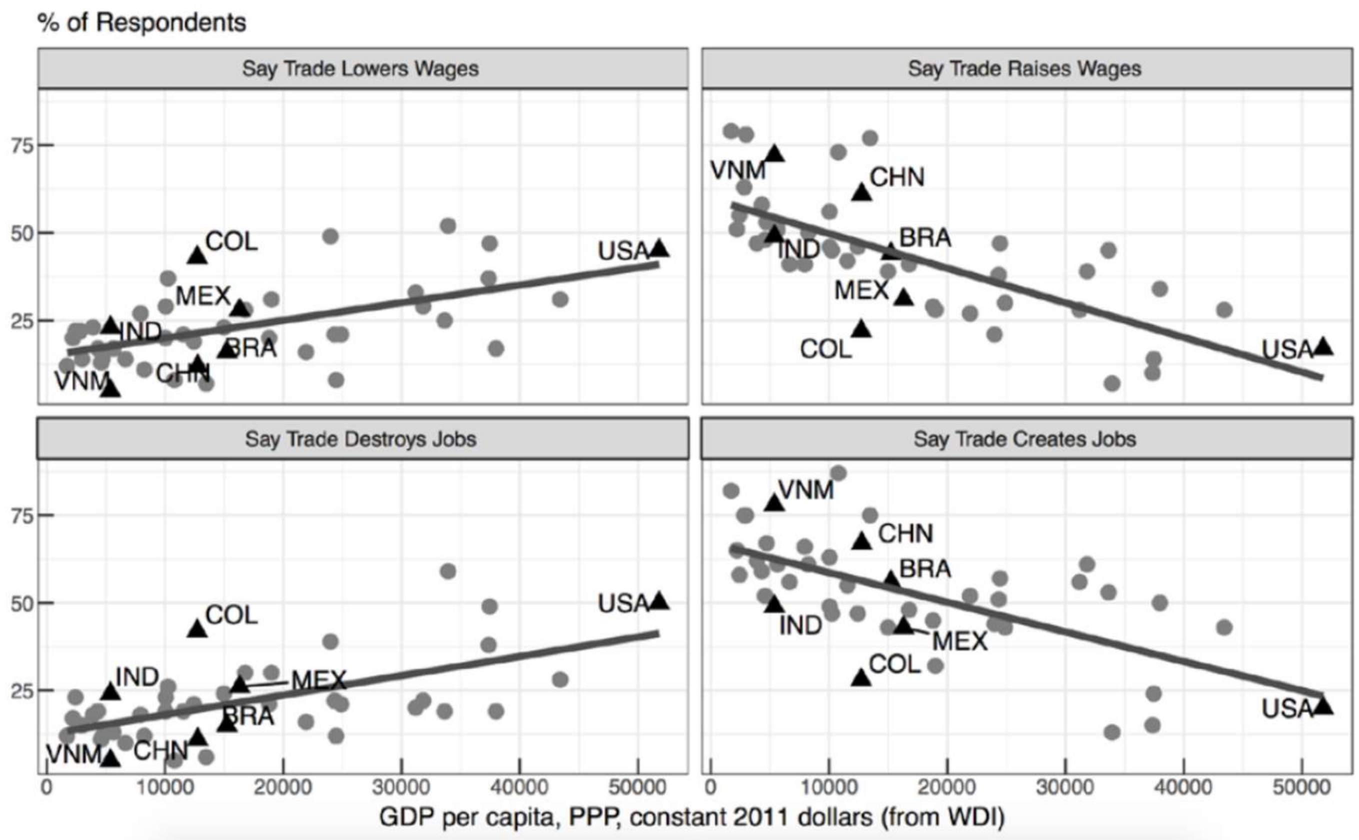


Roughly 75% say it is good

But despite the current backlash against trade, **the majority of the public in low- and high-income countries do not doubt trade's overall benefits to the economy**

Question 2: "Does trade with other countries lead to an increase in the wages of (survey country) workers, a decrease in wages, or does it not make a difference?"
Question 3: "Does trade with other countries lead to job creation in (survey country), job losses, or does it not make a difference?"

Figure 3: Perceptions of Trade's Effect on Wages and Jobs in Own Country



Individuals in lower-income countries tend to view international trade as more beneficial for job creation/wages than those in higher income countries

Colombia (COL), Mexico (MEX), the United States (USA).

To understand the divergence in perceptions of globalization (between rich and poor countries and over time) it it key:

-to know what are the **channels** through which opening up affects the level and the distribution of income : growth and inequality

-Two dimensions: **theory and empirics**

Opening up policies, Poverty-Inequality and Development

Introduction

Section 1- Opening up policies, Poverty-Inequality

1) Traditional theoretical expectations: growth and income distribution

2) Empirical results and controversies :
- -opening up and income growth
- -opening up and income inequality

3) Ways forward:
- -new channels
- -heterogeneity
- -conditionality

4) Openness and gender inequality

Section 1- Opening up policies, Poverty-Inequality

1) Traditional theoretical expectations: growth and income distribution

Early literature on the effects of opening up focused on the channels emphasized in the workhorse model of trade, the **Heckscher-Ohlin-Samuelson**

Focus was on **efficiency gains** following the reallocation of factors of production from sectors with low comparative advantage to those with high comparative advantages

<u>Hypothesis</u>:

-Trade in final goods between countries that differ in their relative factor endowments (K/L or skilled/unskilled)

-Mobility of workers ensures that there is *no unemployment* and that there is reallocation of workers from the sector that contracts to the one that expands

A simple version of this model with 2 countries (Rich/Poor), 2 goods (computer/clothes) and 2 factors of production (skilled/unskilled):

Rich country well endowed with educated labour should specialize in production of goods that use educated labour relatively
more intensively (computer)
while Poor country well endowed with less-educated labour would in return specialize in and export goods whose production requires relatively less educated labour.

Predictions: trade boosts income

Equalization of the price of each good across countries: higher price of computers in rich countries and higher price of clothes in poor countries.

Each country sees a rise in the production of the good in which it has a comparative advantage (intensive use of the abundant factor) and a decline in the other.

This reallocation prompts a (one-time) efficiency/welfare gain: higher production/income in each country and globally (for both goods). So expectation that new globalizers catch-up thanks to this gain

Predictions: trade affects income distribution Stolper-Samuelson effects

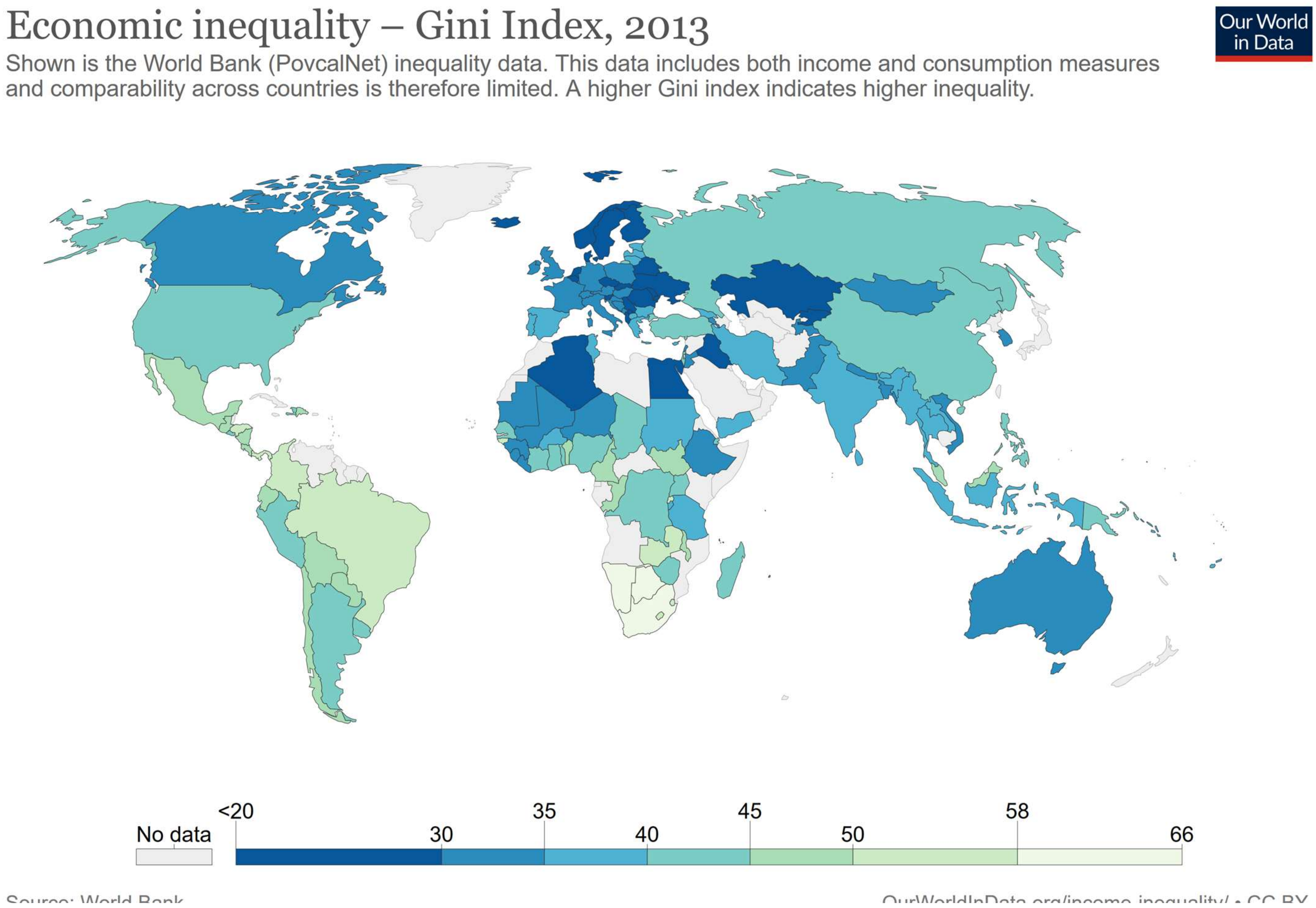
Rich countries: skilled labour intensive sectors expand and others contract. Rise in the relative demand for educated labour and thus rise in the wage gap between educated and less-educated labour: **rise in wage gap (skill premium)**

In the end all industries employ a higher share of less-skilled labour.

Poor countries: less skilled labour intensive sectors expand and others contract. Rise in the relative demand for less educated labour and thus decline in the wage gap between educated and less-educated labour: **decline in wage inequality**

In the end all industries employ a higher share of higher-skilled labour.

Decline in wage inequality would be a welcome evolution since poor countries are often more unequal than rich countries

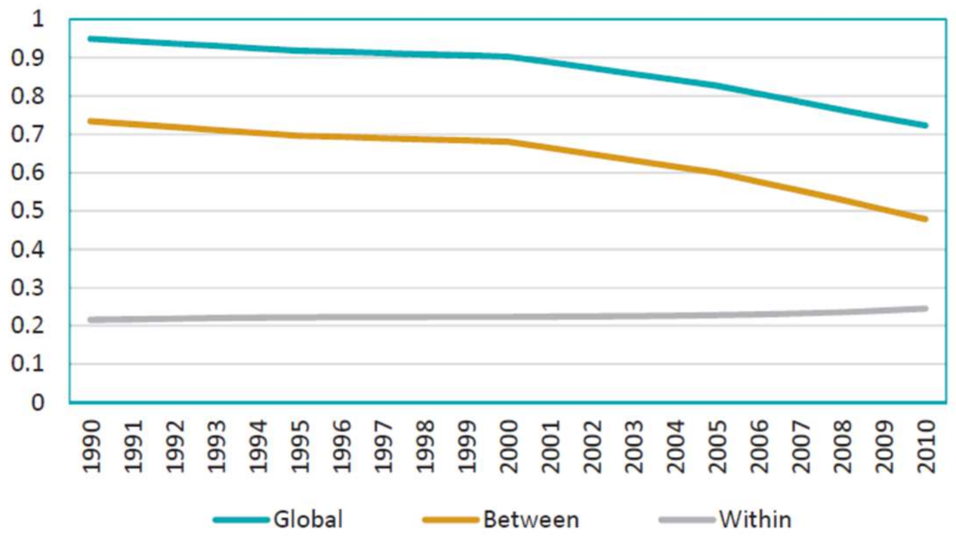


Section 1- Opening up policies, Poverty-Inequality

2) Empirical results and controversies: trade and growth

In the world we observe a **significant decline in income inequality**.
-largely driven by relatively higher economic growth in developing countries (take of China and other emerging countries)

Figure 1: Global, between and within income inequality, Theil Index, (1990-2010)

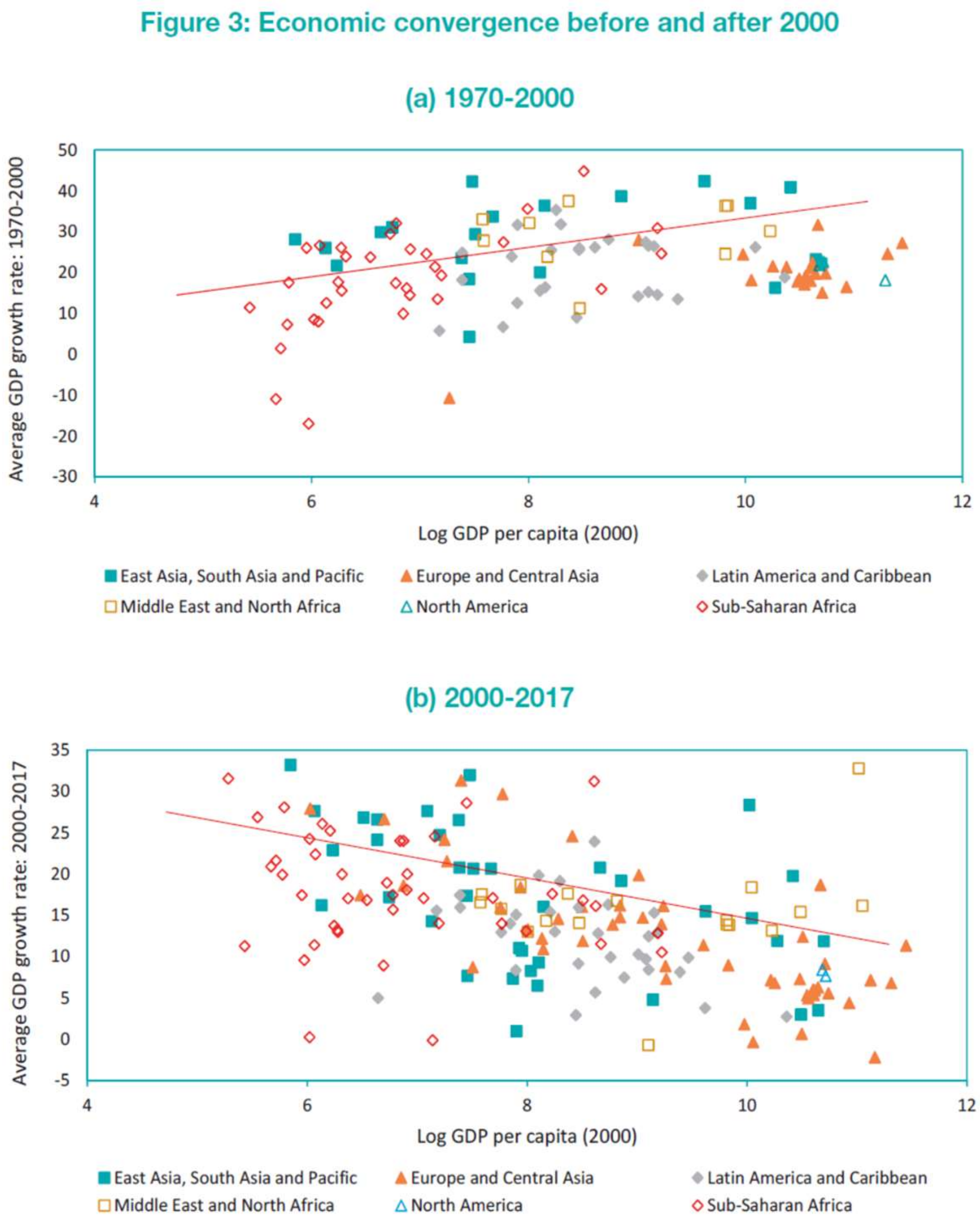


Source: Bourguignon (2016). The Theil index is a measure of economic inequality. Higher values mean greater inequality. A Theil index of 0.5 means 74% of individuals own 26% of resources. In this figure, economic inequality has declined between countries, but increased within each country on average.

Decrease in the gap in income per capita between rich and poor nations

Decline in overall inequality started in the late 1990s, and reversed a trend of increasing global inequality that goes all the way back to the 19th century (Bourguignon, 2016).

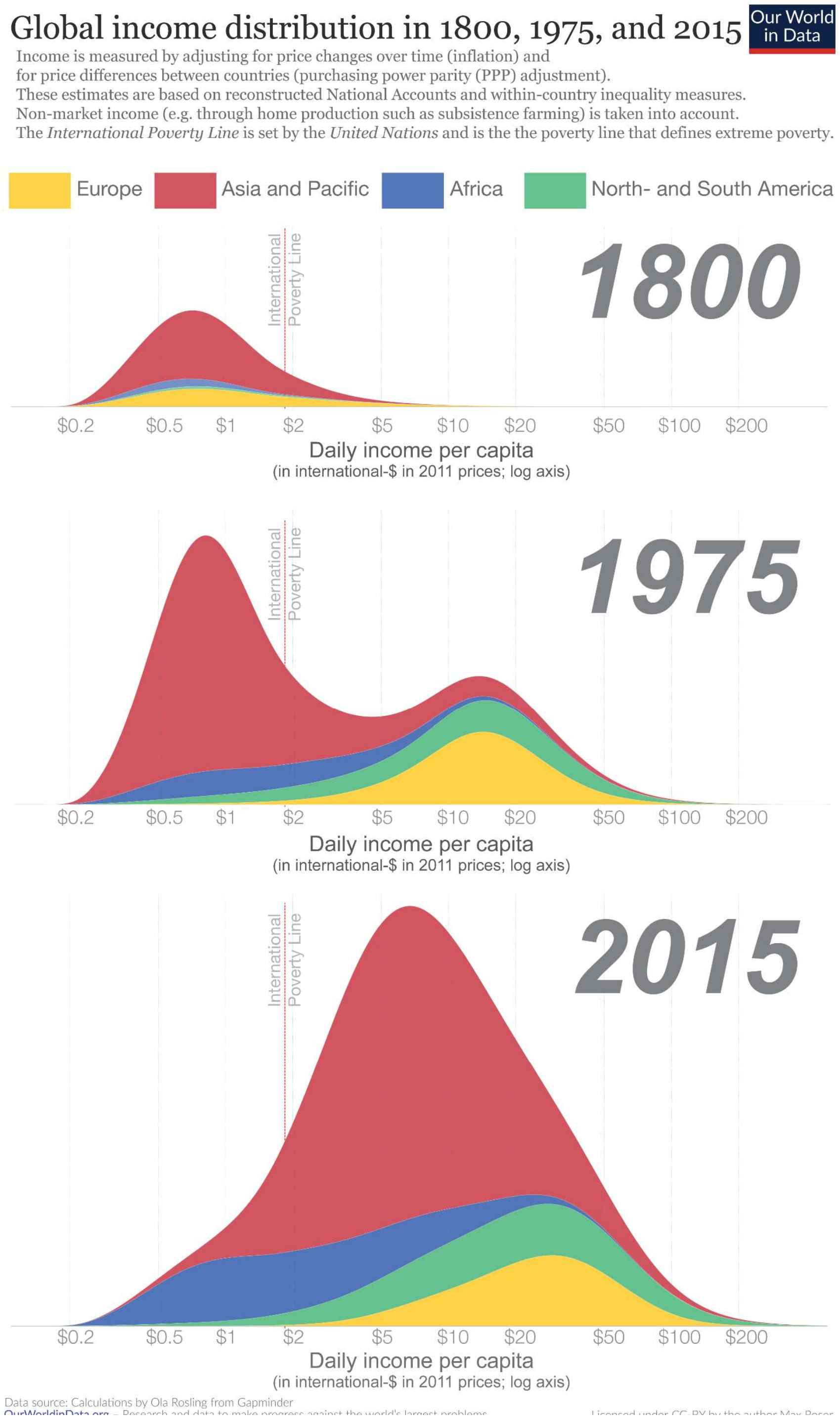
2) Empirical results and controversies: trade and growth



The economic integration of low-income countries was accompanied by relatively higher growth rates, leading to **income convergence across countries**.

Prior to globalization: positive relationship between GDP growth and initial GDP per capita.

Relation turned negative after 2000, when trade reforms accelerated in low-income countries: **catch-up.**



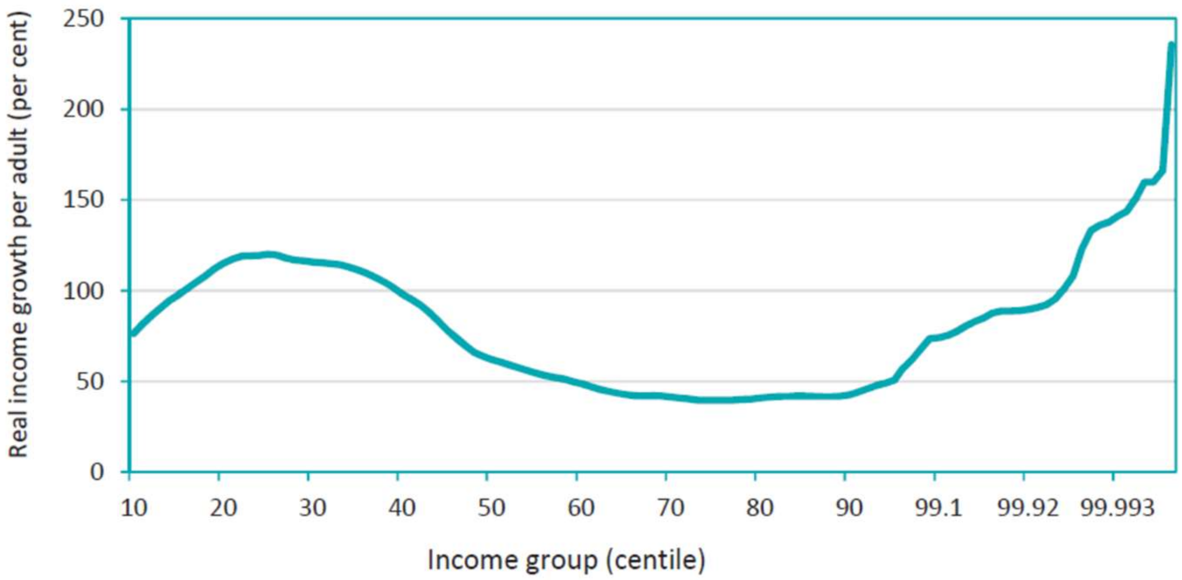
Opening up reforms in some poorer countries (notably in Asia) coincide with more rapid growth, leading to a reduction in the income gap between rich and poor
countries.

This has contributed to the decline in global relative income inequality observed since the 1990s.

2) Empirical results and controversies: trade and global income inequality

The **elephant chart** helps to look at changes along the entire income distribution: focus is on individuals (irrespective of their country)

Figure 4: Changes in income across global citizens: Elephant curve 1980-2016



Source: From Figure E4 from the World Inequality Report (2018).

Lakner C and Milanovic B (2016). Global Income Distribution: From the Fall of the Berlin Wall to the Great Recession. World Bank Economic Review 30 (2), 203-232.

Three stylized facts emerge.

1- the **poorest half** of the world population has seen its income increase over the past three decades. This is generally explained by the rapid growth in emerging economies.

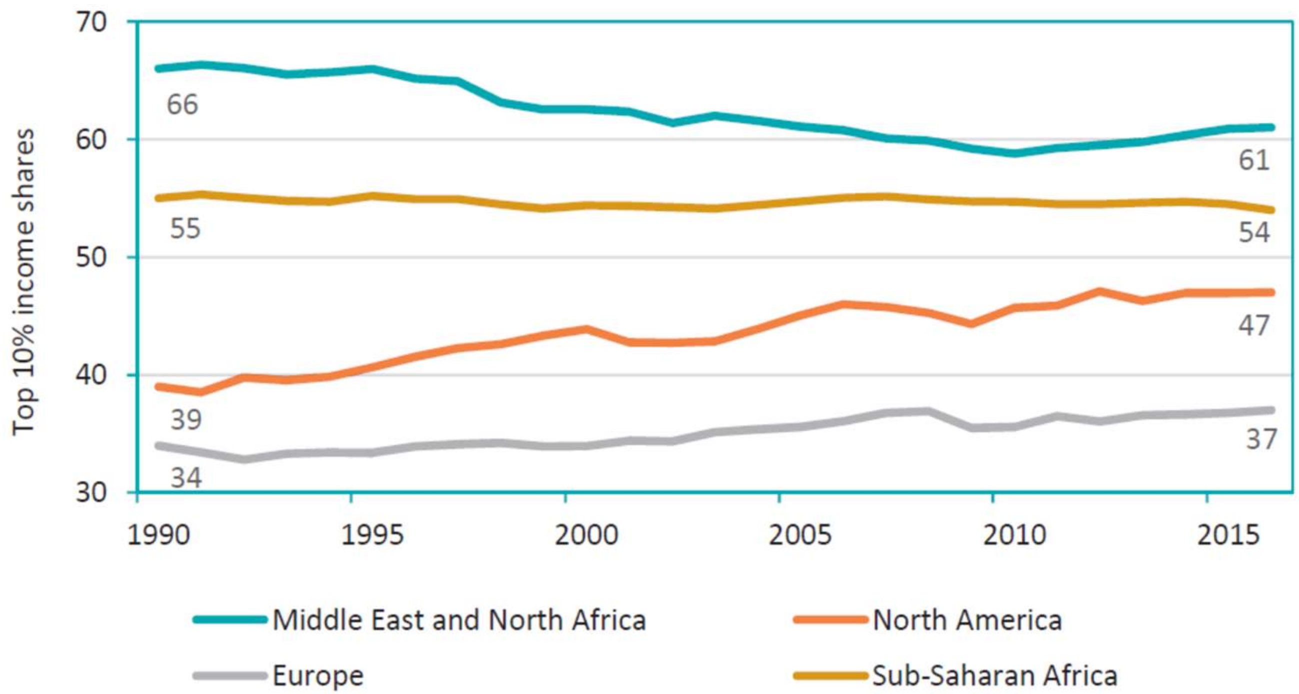
2-the **global upper middle class** (from 50 to 95 percentile) however has seen its income stagnate, which reflects the fact that the middle class in developed countries and economies in transitions has seen little income growth over the last twenty years.

3-the **global elite**, those at the top of the income distribution, have experienced far greater income growth.

So overall the decline in global income inequality is explained by the rise of the middle classes in developing countries.
This is accompanied by a strong **polarization** at the top of the income distribution, while global middle-class individuals (poor and middle class in the rich countries) experienced very slow income growth.

Global level relative inequality has declined, however **within country relative inequality substantially increased (especially polarisation at the top)**, especially on high-income countries, fuelling anti-globalization sentiment.

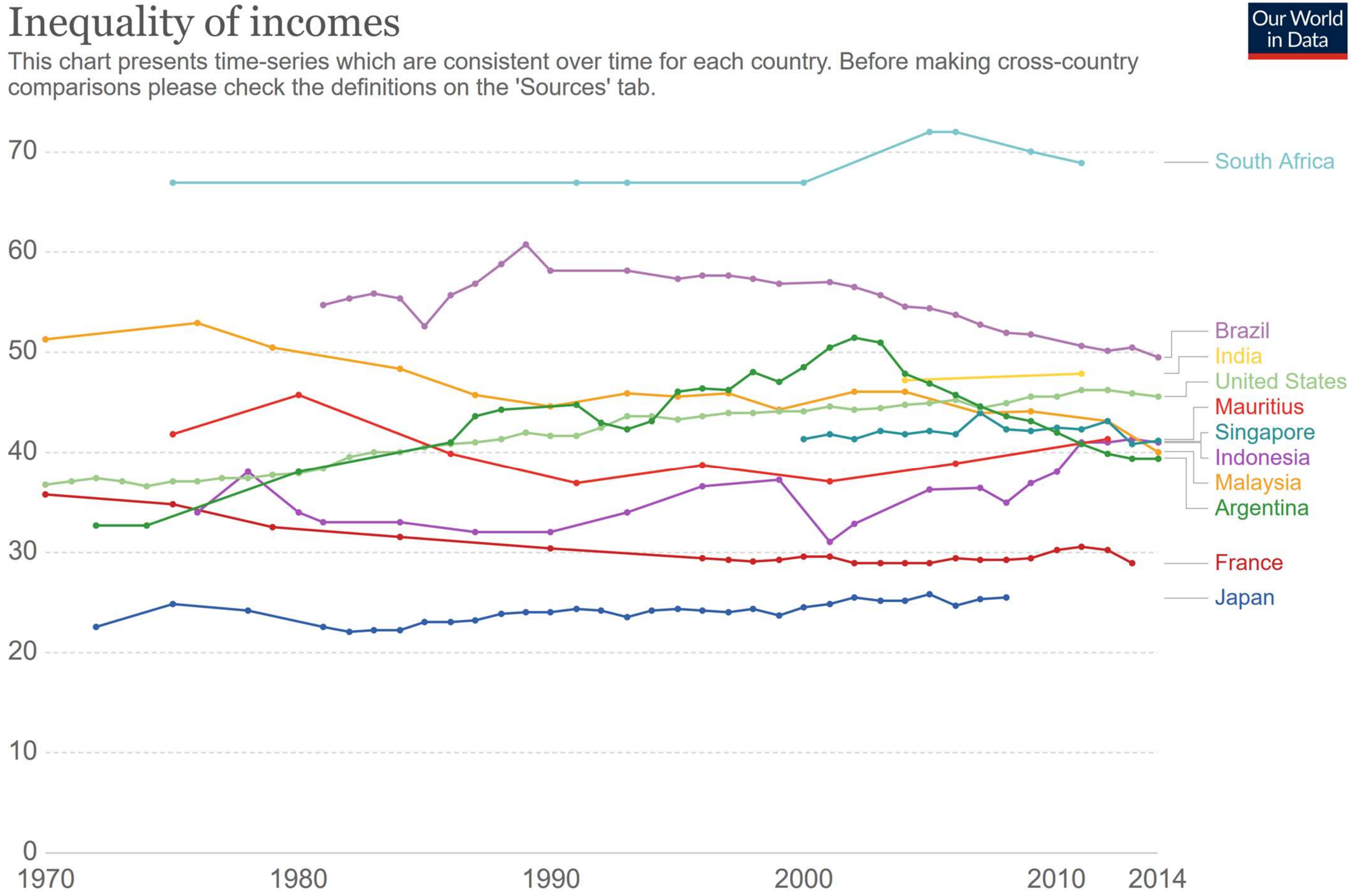
Figure 6: Top 10 per cent income shares in selected regions and countries (1990-2016)



Over the last three decades, the share of the top 10 per cent has significantly increased in North America and there has been some more modest increases in Europe.

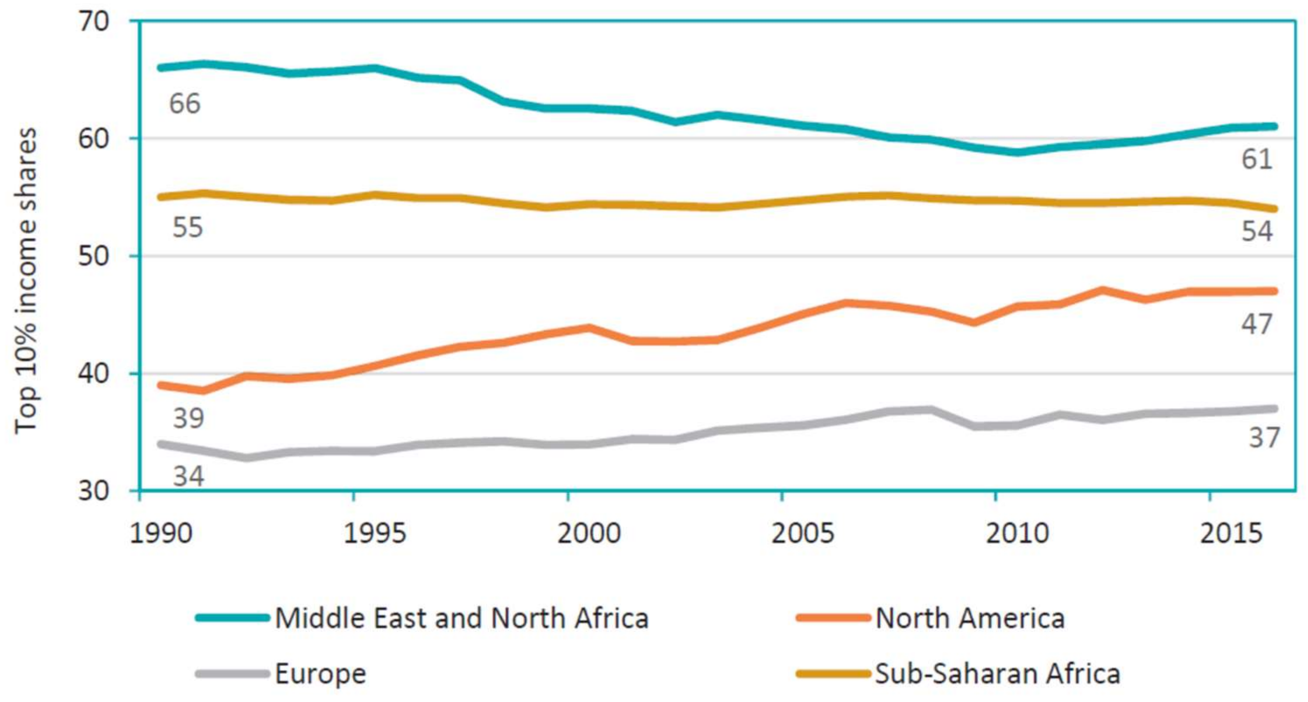
Inequality of incomes

This chart presents time-series which are consistent over time for each country. Before making cross-country comparisons please check the definitions on the 'Sources' tab.

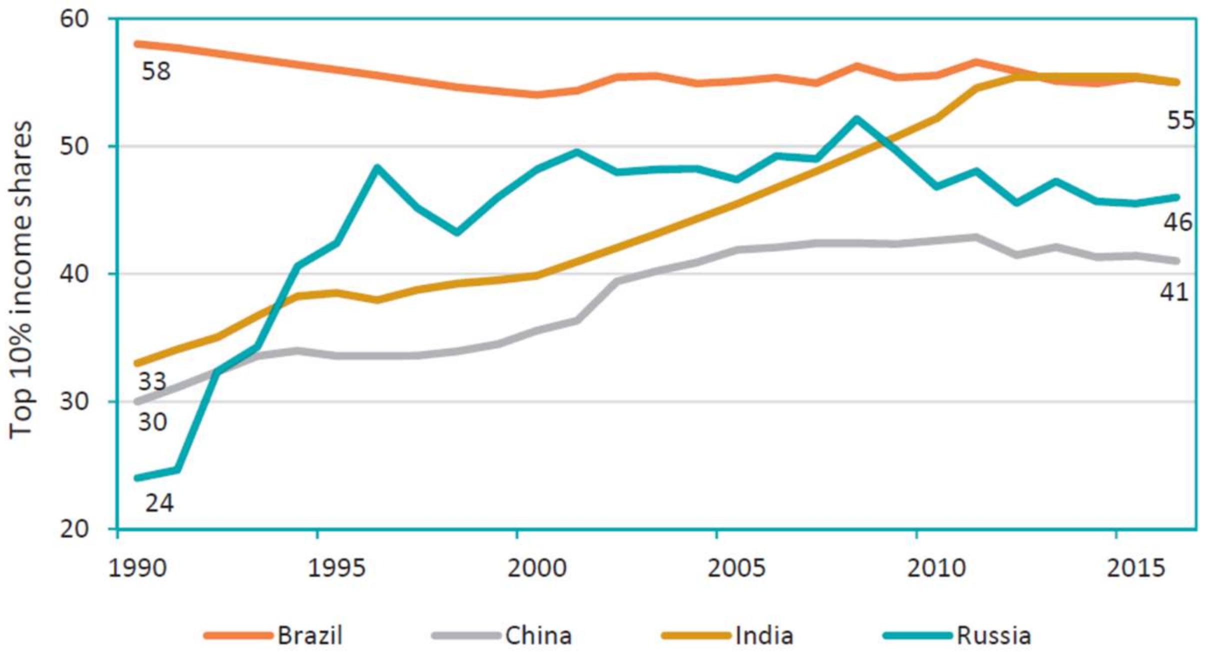


Source: Chartbook of Economic Inequality (2016)

Figure 6: Top 10 per cent income shares in selected regions and countries (1990-2016)



The share of national income held by the top 10 per cent has not changed in Sub-Saharan Africa and has modestly declined in North African and Middle-Eastern countries.



Source: World Inequality Report (2018). The figure represents the evolution of the income share held by the 10 per cent richest individuals over the period 1990-2016.

In China and India, the share of income held by the top 10 per cent of individuals increased gradually over the period to reach 41 and 55 per cent respectively by 2016.
Not much change is observed in Brazil.

Now the question is: **can opening up explain these contrasting patterns?**

Two different challenges:

-1-need to establish causality empirically: difficulty is that trade reforms are endogenous (reverse causality and omitted variables plague the proper identification of the causal impact of trade on growth/inequality)

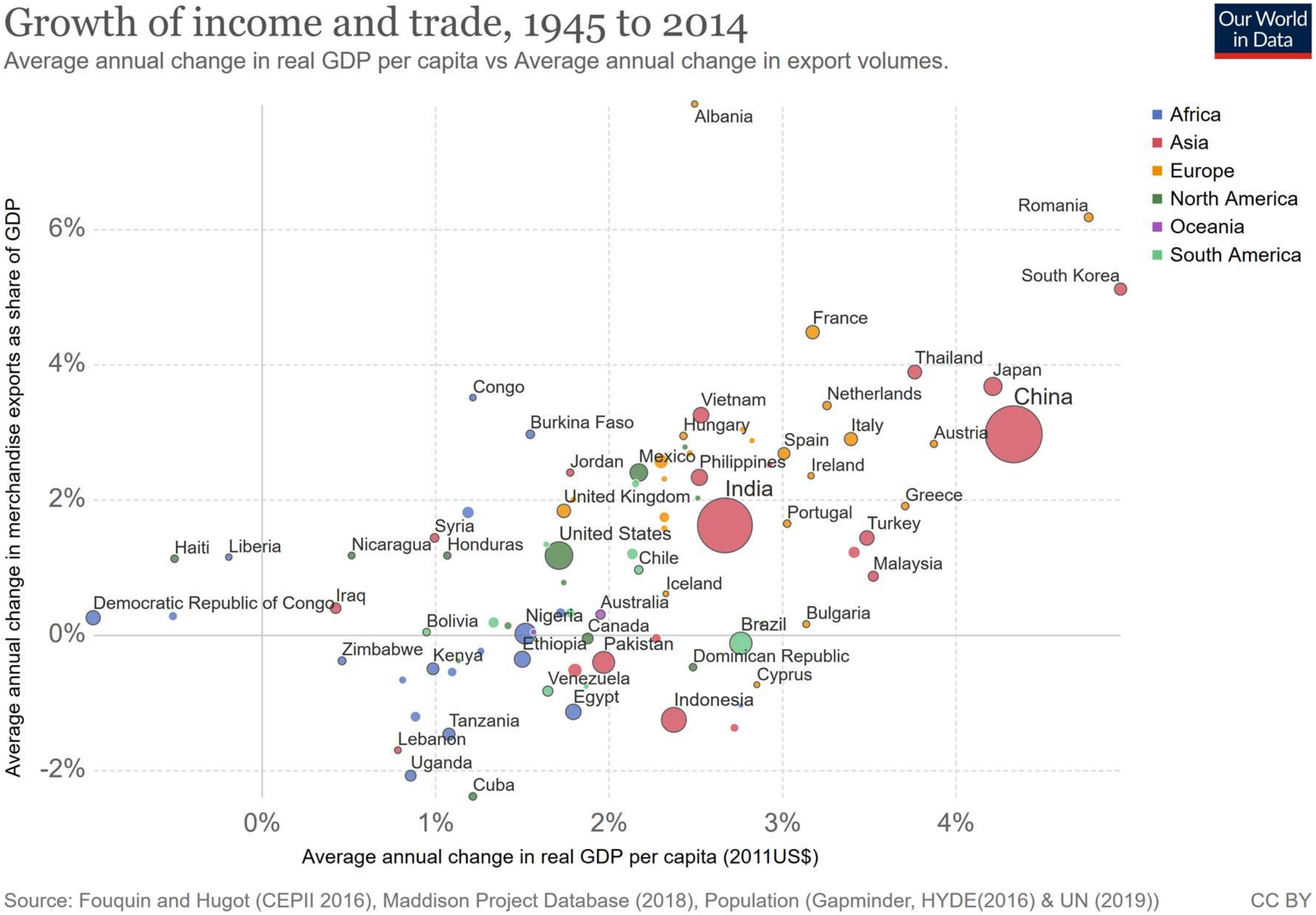
Even in the case of China: is it really opening up (rather than other reforms happening at the same time) which prompted growth?

-2-need to rationalize the channels of impact (consistency with theory)

Even if we can prove that opening up causes inequality it is key to understand how it happens to draft the best **remediating policies**.

2) Empirical results and controversies : opening up and income growth

Strong <u>correlation</u> between growth of income and growth of trade



But could indicate reverse causality or other changes (institutions?)

Early empirical literature on trade and growth was very positive (Dollar, 1992, Sachs and Warner, 1995; Edwards, 1998; Frankel and Romer, 1999).

But **later work** dealing more carefully with omitted variables (institutions) concluded that the positive estimates are <u>not robust</u> (Rodriguez and Rodrik, 2001; Hanson and Harrison, 1999).

No capacity to determine whether trade policy leads or lags growth: *Does trade policy lead to higher economic growth or do countries at a certain level of development choose to implement more liberalized trade policy?*
Alternatively, do countries with less restrictive trade policy in general have economic institutions in these economies that are associated with higher growth?

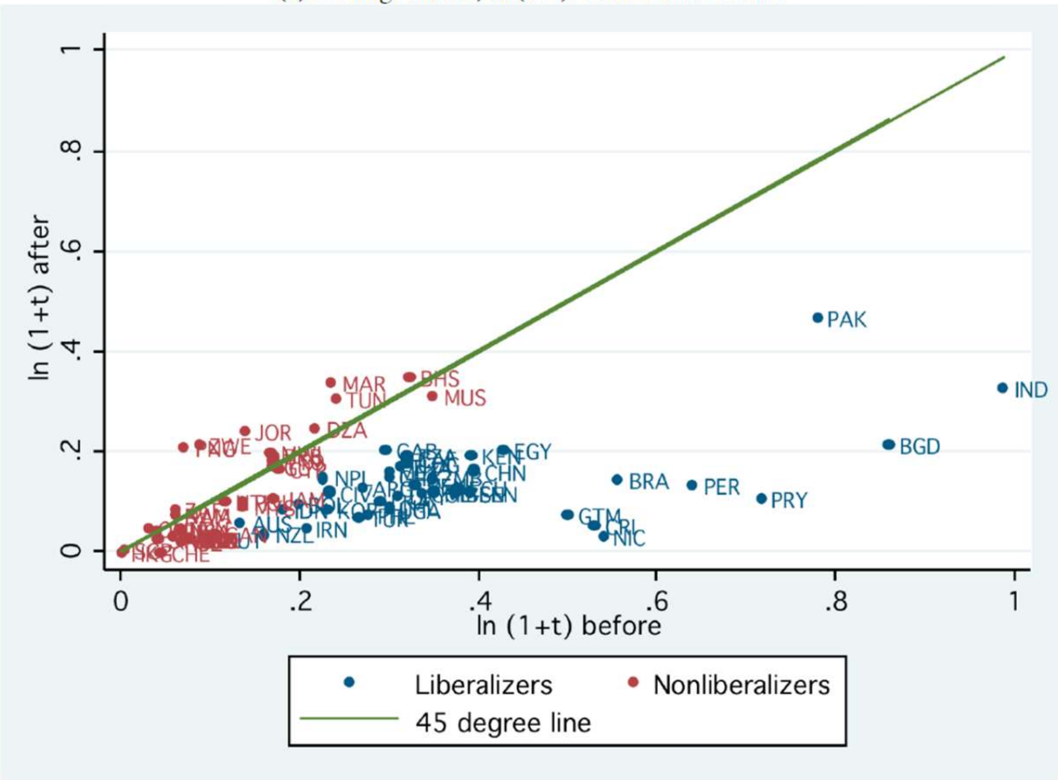
Also **traditional theory** (HOS trade theory and Solow model) do not predict that trade opening induces sustained growth: just one time gain in income due to more efficient allocation of resources (growth is temporary)

More recent empirical literature using disaggregated data and highlighting channels of impact confirms positive income gains from opening up.

Estevadeordal and Taylor (2013) compare the growth rate of countries that liberalized trade policy during the 1980s and 1990s (in part driven by the Uruguay round of the WTO negotiations) with other that did not (non liberalizers)

Figure 3: The Great Liberalization: Treatment and Control Groups

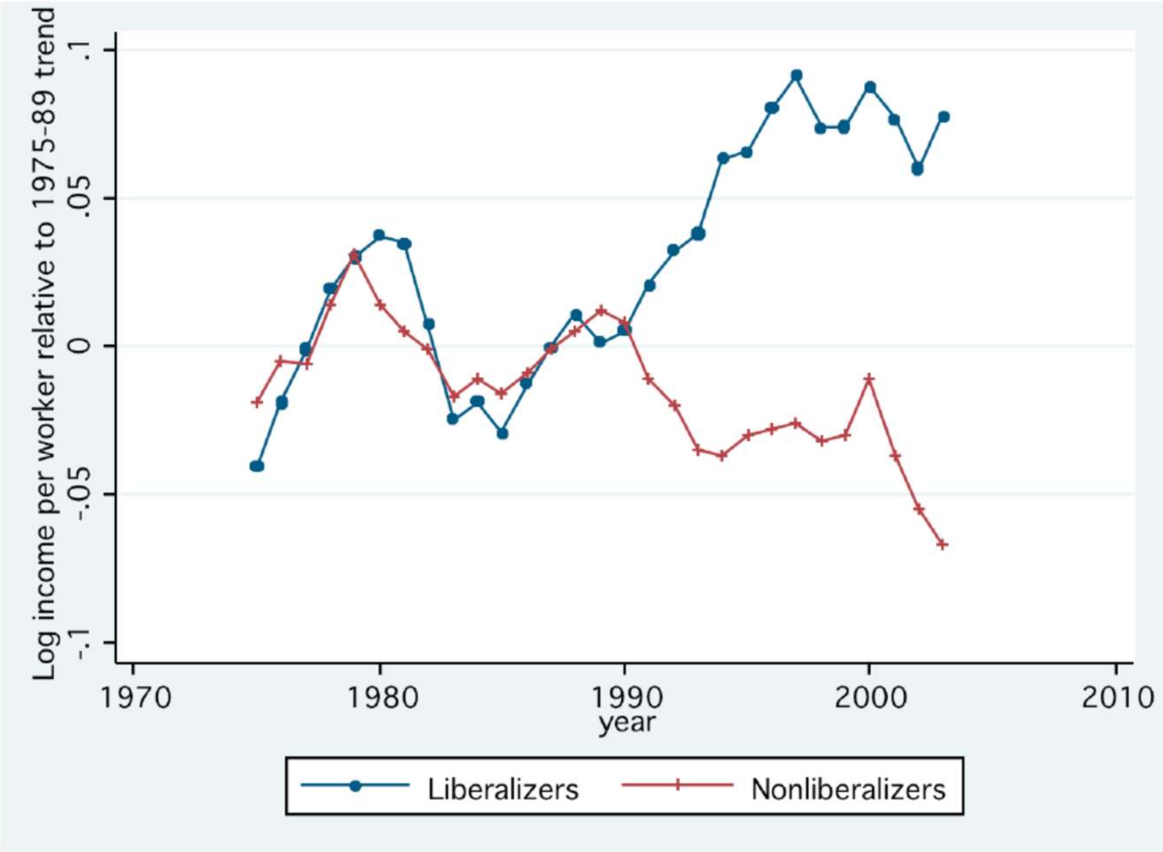
(a) Average tariffs, ln (1+t): after versus before



Estevadeordal and Taylor (2013) show empirically (dealing with endogeneity) that liberalized countries enjoyed higher growth rates of GDP per capita.

Figure 6: The Great Liberalization and Growth Accelerations

Log income per worker (PWT) relative to 1975–89 trend in liberalizers and nonliberalizers



The absence of **pre-trend** confirms that the liberalized were not already on a diverging trend of higher growth prior to the liberalization episode: **liberalization caused the growth acceleration**

$$\Delta growth_i = \alpha[\Delta openness_i] + \beta \Delta X_i + \nu_i.$$

Notes: The samples are as in Figure 4, based on changes in tariffs for capital and intermediate goods.

Estevadeordal A. and A. M. Taylor, 2013, Is the Washington Consensus Dead? Growth, Openness, and the Great Liberalization, 1970s–2000s, Review of Economics and Statistics, 95 (5), 1669-1690

Estevadeordal and Taylor (2013) furthermore highlights the channels of impact
Within a Solow model of growth they show **theoretically** that:
-a decline in *import tariffs on capital goods* increases incentives for firms to invest, which in turn increases steady state growth.
-a decline in *tariffs on intermediate inputs* increase productivity, and subsequently steady state growth.

The **empirical results** confirm those channels
Positive relationship between trade liberalization and economic growth is driven by *declines in tariffs on intermediate inputs and capital goods*:
Countries that lowered tariffs on intermediate inputs and capital goods observed increased imports of intermediate and capital goods.

In contrast there is no relationship between lower tariffs on consumer goods and economic growth.

Trade liberalization hence seems to matter because it improves **efficiency of production through imported inputs and technology.** This is confirmed by recent studies of firm performance (Amiti and Konings (2007), Topalova and Khandelwal (2011), Goldberg, Khandelwal, Pavcnik and Topalova (2009, 2010).