Trade-Development-Poverty Linkages

Reflections from Selected Asian and Sub-Saharan African Countries

Volume I - Country Case Studies

Edited by
Mohammad A. Razzaque
Selim Raihan

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Table of Contents

List of Tables

List of Figures

List of Boxes

Foreword

Achieving economic growth and poverty reduction by taking effective part in international trade is now the key challenge facing most developing countries. Moving out of inward-looking import-substitution industrialisation regimes, these countries have undertaken comprehensive trade policy reform programmes for boosting efficiencies in their domestic economies and stimulating exports. When the World Trade Organisation (WTO) was established as an institution to oversee the multilateral trading system, poor countries considered it as a landmark achievement with the expectation of their domestic liberalisation efforts being complemented by global reforms that would enhance their participation in world trade. However, that optimism has not been turned into a reality, undermining the capacity of these countries to take advantage of international trade, and the linkages between trade, development and poverty reduction.

It is indeed heartening to see that CUTS has undertaken this very ambitious project to study country experiences on trade and development closely. It could not be more timely, as the poorest economies have become frustrated by the slow progress in multilateral trade talks in general, and the even slower progress on the issues of interest to them, in particular. In addition, the group of African, Caribbean and Pacific (ACP) countries have been compelled to move from a non-reciprocal to a reciprocal trade deal with the EU, one of the most developed country groups on earth. If trade-development linkages are weak or are missing, the implications will be very challenging for these countries. By undertaking multi-country case studies and drawing relevant lessons, this particular volume from a leading civil society organisation seeks to make valuable contributions to arguably the most important discourse for the world's poor.

The country cases chosen make this volume particularly interesting. There are countries that have now become regular references for success stories, while there are others that continue to struggle to put in place trade-led development processes. By juxtaposing the varying country cases in the same volume, the CUTS-TDP project exposes the complex nature of interactions between policies, institutions and other country characteristics that result in widely different outcomes. This contrasts with and challenges the uniform predictions from some simplified theoretical formulations. As a result, this volume has highlighted the importance of understanding development experiences on a case by case basis, making use of heterodox approaches, and above all pursuing a carefully planned, flexible, and pro-active policy approach.

Promoting export (or, broadly, supply) response appears to be a critical issue in a majority of country studies. Both domestic policy failures and constraints faced under the existing international trading environment have been identified as causal factors. Furthermore, the contributors also duly emphasise, *inter alia*, the issues related to policy ownership, effective use of policy space, monitoring of the adjustment processes, and development of productive and trading capacities that jointly determine trade-development-poverty linkages.

The Commonwealth Secretariat has also been attaching the highest priority to promoting trade and development of its member countries, and from that perspective, I am pleased to see that some of the issues discussed and highlighted in the volume very closely reflect our views and concerns. In a number of areas CUTS and the Commonwealth Secretariat have been partnering. I hope our efforts will continue to promote better understanding of development problems in order to provide informed and perceptive inputs into the policymaking. At the Commonwealth, we have always valued the initiatives taken by civil society organisations and this work is an example of how such organisations can help countries undertake independent and holistic review of their developmental efforts by their own analysts.

I am also pleased to observe that CUTS has been organising a number of dissemination programmes under its TDP project. Given the underlying research, this advocacy is likely to be very useful and should better inform policymakers on issues that are often complex and controversial. This initiative, therefore, is also an excellent example of how an advocacy campaign based on objective analysis should be conducted, involving researchers, policymakers and other concerned stakeholders.

I congratulate all involved in the CUTS-TDP project on their success and do hope that they will continue to undertake similar research-cum-advocacy projects in the future. I am sure the present volume will be a valuable source of reference for policymakers, trade negotiators, donors, and other development practitioners.

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Preface

The linkages between international trade, development and poverty reduction have gradually begun to receive increased attention. The complex dynamics between trade and economic growth, and economic growth and poverty reduction have been well established in the economic literature. Yet, despite the existence of theoretical literature on the linkages between trade, development and poverty reduction, insufficient empirical evidence exists to prove the robustness of this linkage.

Moreover, the relationship between trade and growth and trade and poverty is predominantly envisaged through an export-led growth strategy, following the theory that sustained export growth is the main engine of economic growth and a key factor for sustained poverty reduction. Since trade policies affect poverty through its effects on economic growth and equitable income distribution, a pro-poor growth policy has a significant impact on poverty reduction rather than growth *per se*. The benefits of economic growth resulting from international trade can positively impact on the poor through increased spending on health, education and social welfare, an increase in employment opportunities and the acquisition of new skills and technologies.

However, the potential negative impact of trade due to the increased influence of transnational corporations (TNCs) on domestic economies and political decision-making has also become obvious. Such influence can lead to a loss of employment opportunities in formerly protected industries, the exploitation of vulnerable and marginalised groups, increased environmental degradation and threats to food security. Therefore, pro-poor and pro-development policies must be considered as integral parts of a just and anti-poverty trade policy regime. An analysis of how the poor are affected by trade liberalisation can help identify the complementary policies needed for an inclusive and pro-poor path of development.

Even though a general relationship between trade liberalisation and economic growth can be established, the set of country studies as part of this project reflects the need for individual assessments. The experiences from the 13 countries review that this volume presents has shown that the same set of policies have resulted in different outcomes on the country level, serving as a proof of the complex interactions of policy reforms and individual existing structures. The international trading system, therefore, requires complementary measures to address specific country needs and foster sustainable development and poverty reduction. The analysis of the project countries' individual economic experience stresses the need for an equitable distribution of economic growth to reach all sections of society in order to reduce poverty.

Therefore, one of the major challenges will be to identify and implement national development and poverty reduction strategies that are tailored to specific local conditions rather than following generic best-practice formulae. This ultimately challenges the “one-size-fits-all” approach of the Washington Consensus, relying on a generic formula of privatisation, deregulated labour markets, financial liberalisation and international economic integration. The experience gained in the project countries and the empirical evidence rather supports a pluralistic theory of many recipes to be more beneficial to achieve sustainable economic and human development.

With the support of the Department for International Development (DFID), UK and the Ministry of Foreign Affairs (MINBUZA), The Netherlands, CUTS International has been implementing this project entitled, “Linkages between Trade, Development and Poverty Reduction (TDP)” from January 2005 to December 2008. The TDP project manifests the policy relevance of international trade on poverty reduction and thus, helps in articulating policy coherence between the international trading system and national development strategies, in order to ensure that trade facilitates human development and poverty reduction. The research findings of this multi-country approach aim at contributing to the policy debate for achieving the Millennium Development Goals (MDGs), and particularly examine the aspects of partnership between the different stakeholders to achieve the MDGs.

The project spans across 15 countries in Southern and Eastern Africa, South and Southeast Asia, and Europe, covering developing land-locked states, island states and big emerging economies as well as developed countries. This volume has covered the research work in less developed countries where the project is being implemented. An overarching aim of the TDP project has been to bridge the link between Southern and Northern civil society and policymakers, to foster their development and the cross-fertilisation of ideas and experiences. It is hoped that the project findings will be used for enhanced dialogues, informed decision-making and further research. This comprehensive volume ultimately aims at paving the way to share the lessons learnt with relevant stakeholders to influence a policy shift among decision-makers towards a more development-oriented international trade policy.

In introducing this volume, let me thank all those who have been associated with this project in various capacities, in particular the development partners such as the Department for International Development (DFID), UK and the Ministry of Foreign Affairs (MINBUZA), The Netherlands, whose support made the project possible. I also thank the partner organisations in the project countries, and especially the editors of this volume: Mohammad A. Razzaque and Selim Raihan, as well as the contributors of the country papers and my colleagues at CUTS Centre for International Trade, Economics & Environment (CUTS CITEE).

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Overview

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Ngo Huong is a graduate in Development Management with 10 years experience in development work and social activism. She has worked for the Asian Development Bank in Vietnam and is an expert in the field of local governance. She has conducted several sociological researches in the fields of labor, migration, democracy and civic participation. She has significant experience in project management, monitoring and evaluation, internal audit, capacity building and strategic planning for local governments.

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Abbreviations and Acronyms

A

ACP	Africa, Caribbean and Pacific
ADRs	American Depository Receipts
AFTA	ASEAN Free Trade Area
AGOA	African Growth and Opportunity Act
AIDC	Alternative Information and Development Centre
AoA	Agreement on Agriculture
ADB	Asian Development Bank
AMDP	Accelerated Mahaweli Development Programme
AMS	Aggregate Measurement of Support
ANC	African National Congress
APEC	Asia Pacific Economic Cooperation
ASA	Air Service Agreement
ASEAN	Association of Southeast Asian Nations
ASGISA	Accelerated and Shared Growth Initiative for South Africa
ATMs	Automated Teller Machine

B

BBS	Bangladesh Bureau of Statistics
BDS	Business Development Services
BEE	Black Economic Empowerment
BEST	Business Environment Strengthening for Tanzania Programme
BLNS	Botswana, Lesotho, Namibia and Swaziland
BOI	Board of Investment
BoP	Balance of Payment
BPL	Below Poverty Line
BPO	Business Process Outsourcing
BTA	Bilateral Trade Agreement

C

CACP	Commission for Agricultural Costs and Prices
CAS	Country Assistance Strategy
CDC	Council for the Development of Cambodia
CDO	Coffee Development Organisation
CET	Common External Tariff
CFA	Catfish Farmers of America
CFPA	China Foundation for Poverty Alleviation
CGE	Computable General Equilibrium
CMB	Coffee Marketing Board
CMI	Census of Manufacturing Industries
COMESA	Common Market of Eastern and Southern Africa

COSATU	Congress of South African Trade Unions
COTII	Council of Trade and Industry Institutions
CPRGS	Comprehensive Poverty Reduction and Growth Strategy
CSOs	Civil Society Organisations
CTI	Confederation of Tanzania Industries
D	
DFQF	Duty Free and Quota Free
DSB	Dispute Settlement Body
DTI	Department of Trade and Industry
DTIS	Diagnostic Trade Integration Study
E	
EAC	East African Community
EBA	Everything But Arms
EDB	Export Development Board
EIC	Economic Institute of Cambodia
EIPO	Enterprise and Industry Development
EJN	Economic Justice Network
ELG	Export Led Growth
EOI	Export Oriented Industrialisation
EPZs	Economic Processing Zones
ERP	Economic Recovery Programme
ERS	Economic Recovery Strategy
ESAF	Enhanced Structural Adjustment Facility
EU	European Union
EXIM	Export and Import Policy
F	
FDI	Foreign Direct Investment
FEEC	Foreign Exchange Entitlement Certificate
EPTS	Effective Preferential Trade Scheme
FRIDGE	Fund for Research into Industrial Development, Growth and Equity
FSAC	Financial Sector Adjustment Credit
FTA	Free Trade Agreement
FTZs	Free Trade Zones
G	
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GCEC	Greater Colombo Economic Commission
GDP	Gross Domestic Product
GDRs	Global Depository Receipts
GEIS	General Export Incentive Scheme
GEAR	Growth, Employment and Redistribution
GFCF	Gross Fixed Capital Formation
GNU	Government of National Unity
GSP	Generalised System of Preferences

H

HDI	Human Development Index
HIPC	Heavily Indebted Poor Countries

I

ICT	Information and Communication Technology
IDZs	Industrial Development Zones
IGD	Institute for Global Development
IMF	International Monetary Fund
IMS	Integrated Manufacturing System
IPRSP	Interim Poverty Reduction Strategy Paper
IS	Import Substitution
ISI	Import Substitution Industrialisation
ISPs	Import Services Providers
ITAC	International Trade Administrative Commission

J

JVP	Janatha Vimukthi Peramuna

K

KEBS	Kenyan Bureau of Standards
KEPHIS	Kenya Plant Health Inspectorate Service
KPTC	Kenya Posts and Telecommunications Corporation

L

LDCs	Least Developed Countries
LFS	Labour Force Survey

M

MDGs	Millennium Development Goals
MERCOSUR	Southern Common Market
MERS	Microeconomic Reform Strategy
MFA	Multi-Fibre Arrangement
MIT	Ministry of Industry and Trade
MNCs	Multinational Corporations
MRL	Minimum Residual Level
MTCS	Medium Term Competitive Strategy
MTEF	Medium Term Expenditure Framework
MTS	Multilateral Trading System
MUB	Manufacturing Under Bond

N

NAMA	Non-Agricultural Market Access
NBC	National Bank of Cambodia
NCAER	National Council of Applied Economic Research
NECGC	National Export Credit Guarantee Corporation
NEDLAC	National Economic Development and Labour Council
NERP	New Economic Recovery Programme

NGOs	Non Governmental Organisations
NHFS	National Health Financing Scheme
NPCs	National Protection Coefficients
NSGRP	National Strategy for Growth and Reduction of Poverty
NTBs	Non-Tariff Barriers
NTP	National Trade Policy

P

PDS	Public Distribution System
PEAP	Poverty Eradication Action Plan
PHDR	Poverty and Human Development Report
PMS	Poverty Monitoring Service
PPAF	Pakistan Poverty Alleviation Fund
PRA	Pest Risk Assessment
PRBS	Poverty Reduction Budget System
PRGF	Poverty Reduction and Growth Facility
PRPS	Poverty Reduction Perspective Strategy
PRSs	Poverty Reduction Strategies
PRSC	Poverty Reduction Strategy Credit
PSRP	Public Sector Reform Programme
PTA	Preferential Trade Area/Arrangement
PTF	Permanent Trade Forum

Q

QRs	Quantitative Restrictions
QSAC	Quality System Accreditation Committee

R

RMG	Ready-Made Garments
RTAs	Regional Trade Arrangements

S

SACU	Southern African Custom Union
SAD	Special Additional Duty
SADC	Southern African Development Community
SAL	Structural Adjustment Loan
SAP	Structural Adjustment Programme
SARPN	Southern African Regional Poverty Network
SCs	Scheduled Castes
S&DT	Special and Differential Treatment
SEATINI	Southern Eastern African Trade, Information and Negotiations Institute
SEZs	Special Economic Zones
SHGs	Self Help Groups
SMEs	Small and Medium Size Enterprises
SMMEs	Small, Medium and Micro Enterprises
SOEs	State-Owned Enterprises
SPS	Sanitary and Phyto-Sanitary
SSA	Sub-Saharan Africa

SSG	Special Safeguard Measures
SSIs	Small Scale Industries
SSNP	Social Safety Net Fund
STs	Scheduled Tribes

T

TBT	Technical Barriers to Trade
TCCIA	Tanzania Chamber of Commerce, Industries and Agriculture
T&C	Textile and Clothing
TDP	Trade, Development and Poverty Reduction
TESELICO	Technical and Sectoral Liaison Committee
TFP	Total Factor Productivity
TIPS	Trade and Industrial Policy Strategies
TPSF	Tanzania Private Sector Foundation
TSG	Trade Strategy Group
TRAINS	Trade Analysis & Information System
TRALAC	Trade Law Centre for Southern Africa
TVEs	Township and Village Enterprises

U

UCDA	Ugandan Coffee Development Authority
UIA	Uganda Investment Authority
UNCTAD	United Nations Conference on Trade and Development
UNDP	United Nations Development Programme
UNIDO	United Nations Industrial Development Organisation
UPE	Universal Primary Education
UPTC	Ugandan Posts and Telecommunications
URA	Uruguay Round Agreement
URAA	Uruguay Round Agreement on Agriculture

V

VAT	Value Added Tax

W

WTO	World Trade Organisation

Z

ZPA	Zambia Privatisation Agency

1 CHAPTER

Trade, Development and Poverty Reduction in 13 Developing Countries from Asia and Sub-Saharan Africa: *An Overview*

– Mohammad A. Razzaque[1] and Selim Raihan[2]

1.1 Introduction

For a long time a large number of developing countries have strived for a development strategy that would sustain high economic growth, create employment opportunities, and eliminate poverty. The search for such a development paradigm motivated these countries in their attempts for acquiring self-sufficiency to reduce reliance on others. However, the severe crises faced while implementing this inward-looking development agenda meant that the support required for the chosen strategy could not be maintained. Most of these countries also relied on foreign financing to facilitate growth, but dependence on aid became another problem as, on the one hand, foreign aid was unable to help growth performance, on the other hand, the burden of debt repayment increased rapidly.[3] The failure of foreign aid led to the campaign of 'trade not aid', resulting in a policy reversal with a view to promoting exports.

The shift from inward-looking to outward-oriented policy in most instances was guided by the Bretton Woods Institutions to whom countries turned to facilitate their transition. At the same time, the developing countries also became actively engaged in multilateral trade negotiations having realised that their successful integration with the global economy was dependent on ensuring market opening in the products of their interest along with a rule-based system to settle trade disputes. Unilateral liberalisation by the developing countries and large scale multilateral trade negotiations therefore ushered a new era of liberalised international trade regime, promising growth and poverty reduction in the poor countries. However, after more than a decade of putting in place liberal national and international trade regimes, it is becoming increasingly clear that the experiences of trade and development are far from being similar across countries. And more importantly, most of the developing countries have failed to reap the benefits that liberalisation promised. Country experiences appear to be so diverse that the postulated general relationship between trade, growth and poverty is now a subject of regular empirical exercise.

The main objective of this volume is to document trade, development and poverty reduction experiences from a set of countries that were studied under a project initiated by the Consumer Unity and Trust Society International (CUTS International). The CUTS trade, development and poverty (henceforth, CUTS-TDP) project was intended to study the country cases closely to understand the nature and dynamics involving trade and poverty linkages. In that process, the CUTS-TDP project has examined the overall country experiences as well as experiences associated with two chosen sectors within each country. This volume brings together the general country case studies with the overall trade-development linkages, while the accompanying volume contains the sectoral studies. Both the volumes begin with an overview chapter to set the context of the work and to synthesise the main findings.

The present chapter is prepared with the objective of serving as the overview of the general country background papers and is organised as follows: after this brief introduction, the CUTS-TDP project is introduced in Section 1.2. Understanding the development experiences inevitably calls for the theoretical and empirical evidence on trade-development-poverty reduction linkages. The literature is enormous but a brief review covering only the most important issues is given in Section 1.3. Section 1.4 summarises the evolution of trade policies in individual project countries along with reform experiences in terms of trade expansion, growth and poverty incidence. Section 1.5 derives a number of lessons from the countries included in the project and is followed by some concluding remarks in Section 1.6. The individual country background papers that were prepared as part of the CUTS-TDP project can be found after this overview chapter alphabetically organised by countries in Asia and then in Sub-Saharan Africa (SSA).

1.2 The CUTS-TDP Project

As already mentioned, the underlying objective of the CUTS-TDP project has been to study country experiences and the associated similarities and dissimilarities with a view to deriving policy lessons. TDP project activities have incorporated a wide range of national and international dialogues so that the key findings and new insights from the research activities can be disseminated to promote more effective linkages between trade policy and efforts aimed at development and poverty reduction. Precisely, the four specific objectives of the project have been: (i) to facilitate cross-fertilisation of experiences and lessons learnt on linkages between trade, development and poverty reduction in the developing countries, in order to develop appropriate policy responses; (ii) to help strengthen the ability of developing countries, through the provision of policy research, to negotiate positions on issues of concern arising from the international trading system and their relationship with development and poverty reduction; (iii) to facilitate synergy between governments and civil society organisations (CSOs) through an informed process in order to strengthen their collective perspectives and positions in the emerging debate on the linkages between trade, development and poverty reduction; and (iv) to advocate development-oriented trade policies, based on learning from research and other activities, by taking into account the interests and priorities of the poor and marginalised sections of the society and by looking into the aspect of policy coherence.

As part of the research component of the project, a number of 13 developing countries was chosen for preparing background papers and sectoral case studies. These countries include eight from Asia, viz. Bangladesh, Cambodia, China, India, Nepal, Pakistan, Sri Lanka and Vietnam, and five from sub-Saharan Africa, viz. Kenya, South Africa, Tanzania, Uganda, and Zambia. Table 1.1 provide some basic characteristics of these countries.

The chosen set of countries includes both large (such as China, and India) and small countries (such as Sri Lanka, Nepal, and Zambia), and landlocked (Nepal, Uganda and

Table 1.1: Basic Statistics of the TDP Project Countries

Series	GDP ($ billion)	GNI per capita ($)	Purchasing Power GDP per capita (current int'l $)	Population (million)	Exports of goods and services ($ billion)	Merchandise exports ($ billion)	Exports of goods and services (% of GDP)	Manufacturing exports (% of merchandise exports)	Agriculture, value added (% of GDP)	Poverty headcount ratio (%) (Year)
Bangladesh	60	470	2,053	141.8	9.9	9.2	16.6	91.0	20.1	44.2 (2004)
Cambodia	6.1	430	2,727	14.07	4.0	3.1	65.1	97.0	34.2	35 (2004)
China	2234.3	1740	6,757	1,304.5	836.8	761.9	37.5	91.9	12.6	7.9 (2001)
India	805.7	730	3,452	1,094.6	165.5	95.1	20.5	70.3	18.3	26.1 (2000)
Nepal	7.3	270	1,550	27.1	1.2	0.9	16.1	74.0	38.2	30.8 (2004)
Pakistan	110.7	690	2,370	155.7	16.9	15.9	15.3	81.8	21.6	32.1 (2001)
Sri Lanka	23.5	1160	4,594	19.6	7.9	6.4	34.0	70.2	16.8	22.7 (2002)
Vietnam	52.4	620	3,071	83.1	36.7	31.6	70.1	55.0	20.9	18.1 (2004)
Kenya	18.7	540	1,239	34.3	5.1	3.3	27.4	21.1	27.0	52.3 (1997)
South Africa	239.5	4770	11,110	46.9	64.9	51.9	27.1	56.7	2.5	57 (2001)
Tanzania	12.1	340	744	38.3	2.1	1.5	17.1	14.4	44.5	35.7 (2001)
Uganda	8.7	280	1,433	28.8	1.1	0.8	13.1	17.0	32.7	37.7 (2003)
Zambia	7.3	500	1,022	11.6	1.2	1.7	16.4	8.8	18.5	68 (2004)

Note: All data except for the poverty headcount ratios are for 2005. Poverty headcount ratios are based on the respective national poverty lines and correspond to the latest year for which information is available as mentioned in the parentheses.
Source: With the exception of poverty headcount ratios, all other data come from the World Development Indicators, published by the World Bank. Information on poverty headcount ratio comes from the country-specific sources, and in most cases they are reported in the country background papers prepared for the CUTS-TDP project.

Zambia) and island (Sri Lanka) countries. Some of these countries have sustained high economic growth (e.g. China, India, Cambodia), while some have struggled with their erratic growth performance (e.g. Nepal, Kenya, and Zambia). The set also includes countries that have shown remarkable export growth (e.g. Vietnam and Cambodia) in contrast to some that have recorded dismal performance (e.g. Nepal and Zambia). There are countries that are predominantly primary commodity producers and exporters (such as, Uganda, Tanzania and Zambia) along with countries with strong manufacturing base (e.g. China and India). All these countries have undertaken various trade policy reforms and currently consider international trade as a principal means for accelerating growth and promoting development of their economies. Given the widely varying characteristics and development experiences, these countries, taken together, offer invaluable insights into trade-development-poverty linkages.

1.3 Trade-Development-Poverty Linkages: Theoretical Insight and Empirical Evidence

Trade, development and poverty linkages have broadly been analysed through two prisms. The first approach is to consider the relationship between trade and growth (as an indicator of development), while implicitly assuming that the latter exerts trickle-down effects, benefiting the poor. The other route is to analyse the effects of trade on income distribution. While one could question the significance of overall economic growth reaching the poor, whether trade liberalisation and increased openness lead to superior growth performance has been one of the most controversial issues in the economic development literature.[4] Since developing countries strive for economic growth and most attention is given to the rise in per capita income, analyses of trade-poverty linkages inevitably call for understanding the effects of trade openness on growth.

Theoretical arguments exist both in favour of protectionist and free trade regimes. Perhaps the principal reason for protection and inward-looking strategy is the 'infant industry' argument (e.g. Bardhan, 1970) that underlines the need for protecting firms from foreign competition at the beginning of their lifetime. The potential scope of an 'optimal' level of protection for a country that could influence the terms of trade and thus welfare has also featured in traditional trade models (Dornbusch, 1977; Rodriguez, 1974). It has also been shown that protection can raise income when there is no full employment (Brecher, 1974 and 1992, as cited in Vamvakidis, 2002). Structuralists justified the protectionist policy as they thought trade between the 'centre' (developed countries) and 'periphery' acted as a source of impoverishment in the latter (Singer, 1950; Prebisch, 1950). Concerns have also been expressed that in return for the 'modest' benefit of liberalisation, a country may have to pay a higher price in terms of slow productivity growth, worsening income distribution, and may be deindustrialisation (e.g. Ocampo and Taylor, 1998). Again, to some people although import liberalisation strategy is less attractive, (Deraniyagala and Fine, 2001; Heilleiner 1994) they opt for export expansion to generate positive influence on growth. Often properly done 'selective protection' is considered to be more efficient than complete trade liberalisation (Lall, 1992).

In contrast, the 'gains from trade' exposition is rooted in the theory of comparative advantage, in the Heckscher-Ohlin-Samuelson theory, and in the theory of *vent for surplus*. As far as these theories are concerned, benefits from trade are rather static and not dynamic, i.e. there are no further implications for higher economic growth or higher investment in the process of trade. While, the static theories are well established textbook models, the failure of import-substitution regimes gave an impetus to the revival of a new orthodoxy of trade liberalisation in the late 1970s with trade being seen as an 'engine of growth' and emphasising on dynamic arguments associated with pro-trade policies. Thus, while Krueger (1974) identifies costs of administration and costs associated with 'rent-seeking' activities affecting growth potential, Bhagwati (1990), argues that a liberal trade strategy is beneficial to developing countries because it would bring efficiency in resource allocation, eliminate directly unproductive profit seeking and rent seeking activities, encourage foreign investment, and stimulate dynamic positive effects on the domestic economy. The proponents of trade as an engine of growth also recognises the benefits of a larger international market, which enable the industry to gain scale effects through large-scale production, to achieve higher export productivity as a result of international competitive pressures, and to exploit different forms of externalities (Balassa, 1982; Bhagwati, 1990; Krueger, 1998). In addition, better access to imports makes new inputs, new technologies and ideas, and new management techniques available to local producers (Esfahani, 1991; and Feenstra *et al*., 1997). Because of all these positive effects of liberalisation, it has been argued that "trade liberalisation undertaken from a period of declining growth rates or even falling real GDP can normally lead to a period of growth above the rates previously realised" (Krueger, 1998; p. 1521).

The dynamic gains from trade is also one of the central features of the 'new' growth theories, often known as the 'endogenous' growth theories, pioneered by Romer (1986) and Lucas (1988). In traditional neoclassical growth model there is no connection between openness and economic growth as it regards the exogenously determined technology as the sole determinant of per capita income growth.[5] In contrast, the endogenous growth theory allows a conceptual framework for the analysis of the relationship between trade policies and economic growth. The new models consistent with the endogenous theory establish the relationships between trade and growth through several channels. First of all, through liberalised import regimes a country can procure improved technology and advanced capital goods, which are essential for improved productivity and higher production. In addition, trade is believed to result in technological spillovers, as Coe and Helpman (1995) show that a country's total factor productivity depends not only on domestic R&D capital but also on foreign R&D capital. Similarly, Grossman and Helpman (1991), Barro and Sala-i-Martin (1995), Romer (1992), and Edwards (1998) have argued that more open countries have a greater capacity to absorb the technological advancement of the world. Some of these models also emphasise on the larger economies of scale in production due to opening up to the world market.

In endogenous models, the effect of trade openness is, however, not conclusive. Based on Grossman and Helpman (1991) and Srinivasan (2001), it has been shown that trade can be growth-stunting in the endogenous growth models as well. For instance – as cited in Bashar and Khan (2007) – if the magnitude of shocks resulting from excessive volatility of output and terms and trade due to trade openness is beyond the absorptive capacity, the forces of dynamic comparative advantage may push the economy away from the direction of activities that stimulate long run economic growth. Similarly, while human capital is considered to be an important source of growth in many endogenous models, Utkulu and Özdemir (2004) cite one possibility of reallocation of skilled human capital away from research and development, leading to reduced innovation and growth.

Furthermore, Young (1991) argues that trade liberalisaiton may result in developing countries' specialisation in less sophisticated product lines that may inhibit learning by doing. Given the above, it is clear that the endogenous growth models accommodate a large number of policy choices that can be shown to have growth effects that are mixed through its effect on the accumulation or allocation of physical or human capital.

Numerous studies have attempted to explore the trade-growth relationship empirically. In most cases, these studies construct some measure of trade openness and then examine its statistical relation to growth across a set of countries. In general, the findings of the relatively recent studies support the conclusion that openness is good for growth.[6] Amongst these, most prominent ones include Dollar (1992), Edwards (1992), Sachs and Warner (1995), and Greenaway *et al* (1998). Dollar (1992) constructed two separate indices based on real exchange rate (RER) distortion and RER variability to capture the degree of outward-orientation. He then regressed these two indices on per capita GDP growth for the period 1976-85 for 95 developing countries to discover a statistically significant relationship between growth and outward orientation and thus concluded that outward-oriented developing economies grow more rapidly than the inward-oriented economies. On the other hand, Edwards (1992) constructs two basic trade policy indicators of *openness* (the way in which trade policy restricts imports) and *intervention* (the extent to which commercial policy distorts trade). Using a data-set for a cross-section of 30 developing countries, trade orientation indicators are found to have the expected signs and to register statistical significance.[7]

In one of the most cited studies Sachs and Warner (1995) identified countries as open and closed based on a number of criteria: (1) average tariff rates; (2) extent of non-tariff barriers; (3) economic system; (4) existence of state monopoly in major export items; and (5) the size of black market premium in the exchange rate market. Cross-country statistical analysis carried out by Sachs and Warner revealed that open economies had higher economic growth.[8] The analysis conducted by Greenaway *et al.* (1998) involved over-time observations across a large number of countries from which the authors tried to assess the growth effects 'before' and 'after' liberalisation programmes were implemented. They report that liberalisation and other reform programmes are associated with rapid improvement in the current account of the balance of payments (BoP) and growth rate of real exports. But, overall growth-enhancing effects of liberalisation are unlikely to be instantaneous. There is some negative (although not significant statistically) effect on growth in the first year after liberalisation followed by a positive (but again not significant) impact in year two and larger and significant positive impact in year three.

The apparently favourable effects of trade liberalisation as demonstrated in the aforementioned studies have however been strongly and quite convincingly criticised by Rodriguez and Rodrik (2000) who found that Dollar's (1992) two indices of outward-orientation, Sachs and Warner's (1995) method to capture openness, and Edwards' measures of openness and intervention indicators were inappropriate and misleading. Rodriguez and Rodrik also provide evidence that the measures of openness used in various studies provide anything but 'robust' and consistent results and the econometrics used in the regression analyses is weak and flawed. This contention is also echoed in Harrison and Hanson (1999) who found that the Sachs-Warner method failed to establish a robust link between more open trade polices and long-run economic growth. Furthermore, using a wide variety of trade openness measures, Yanikkaya (2003) shows that contrary to the conventional wisdom, trade barriers are positively associated with growth especially for developing countries.

Amongst other influential studies Frankel and Romer (1999) provide some strong evidence in favour of the relationship between trade and growth. They investigate whether the correlation between openness and growth is because openness causes growth, or because countries that grow faster tend to open up at the same time. Controlling for the component of the openness due to such country characteristics as populations, land areas, and geographic distance that cannot be influenced by economic growth, they found that an increase of one percentage point in the openness ratio increases both the level of income and subsequent growth by around 0.5 percent. But the authors acknowledge that the trade effect cannot be estimated with 'great precision', and is statistically significant only 'marginally' before concluding "… although the results bolster the case for the benefits of trade, they do not provide decisive evidence for it" (Frankel and Romer, 1999; p. 395).

The cross-country statistical growth analysis framework is often confronted with the problem of what is known as the 'fragility' of the parameter of interest (that is, for example, the variable to represent openness can not consistently show correct direction of the relationship and its statistical significance) with respect to the inclusion of a set of potential variables that might be useful in explaining the variation in cross-country growth. In an attempt, when Levine and Renelt (1992) used a suitable technique to test the sensitivity of results from cross-country growth models, they found an indirect positive impact on growth coming from international trade as they identified a robust positive correlation between growth and the share of investment in GDP and between the investment share and the ratio of trade to GDP. Therefore, trade was found to affect growth only indirectly through investment.

As trade liberalisation measures result in reduced protection for import competing sector, which, in turn, improves relative incentives for investing in the export-oriented sector, export response to liberalisation is expected to be positive. Although a small export-orientation and slower growth in the export sector of a country with a big domestic market may not be a major impediment to its overall economic growth as long as the non-export sector flourishes, a robust performance by the export sector is often considered to be central to the acceleration of the growth process (Gylfason, 1999). For any low-income country, a greater magnitude of export-orientation is thought to have several advantages. First, since export is directed to the world market, low purchasing power of domestic consumers cannot act as a hindrance to the exploitation of economies of scale in production. Second, export activities require a relatively non-distortionary policy environment, which promotes efficiency and discourages unproductive rent-seeking activities. Moreover, if exports grow in line with the static comparative advantage of the economy any reallocation of resources from the non-export to the export sector increases total factor productivity, which, in turn, raises GDP (Begum and Shamsuddin, 1998).

It is also argued that the export sector generates positive externalities on non-export sector through more efficient management styles, skill accumulation by labour, and improved production techniques (Feder, 1983; Ghatak *et al*., 1997). For these reasons, export growth following liberalisation is often dubbed as export-led growth. However, the term 'export-led' implies export to be an engine of growth, i.e. it is the growth of exports that drives overall economic expansion and not *vice versa*. This proposition of export-led growth has been the subject of extensive empirical research with a large number of studies failing to extend support to the hypothesis.[9] In addition, it has been argued that while countries that grow fast tend to experience rising export-GDP ratios, the reverse is not true in general (Rodrik, 1998).[10]

As regards the direct link between trade policy and poverty there are not many studies. Winters (2000) provides a comprehensive framework for analysis that, amongst others, considers the transmission of price changes due to policy shift, effect of reforms on markets, implications of liberalisation on government revenues and the resultant consequences, and the issue of distributional consequences both across and within households. Empirical assessment of the trade-poverty link using this framework is, however, far from straightforward and is also confronted by lack of availability of suitable data. Nevertheless, the existing empirical studies with methodological and data limitations only provide inconclusive results.[11]

Analyses carried out in UNCTAD (2004) show that amongst the least developed countries (LDCs) the incidence of poverty is found to have increased unambiguously in those economies that adopted the most open trade regimes and in those that continued with the most closed trade regimes. But, in between these extremes there was a tendency for poverty to decline in those countries that had liberalised their trade regimes to a lesser extent, and for poverty to increase in those countries that had liberalised their trade regimes to a greater extent. Having classified the countries as 'open', 'moderately open', and 'restricted', following a restrictive index prepared by the International Monetary Fund (IMF), the same study observes that out of the 108 countries for which data are available, only 10 out of 35 classified as having been 'open' have high GDP growth, and only seven out of 36 countries classified as restrictive have low GDP growth. There are 37 countries which have either high GDP growth with a 'restrictive' trade regime or low GDP growth with an 'open' trade regime.

Finally, one interesting piece of evidence that appears to challenge any generalisation about the trade-poverty link is associated with China. During the 20 years time (1981-2001) China's trade-GDP ratio has registered a three-fold rise from 15 percent to 45 percent. In the same period, the poverty incidence also declined at an unprecedented rate: the national poverty headcount ratio, i.e. the proportion of population that live below the poverty line income fell from 52 percent to just about 7 percent. This period of rapid rise in trade-orientation and falling poverty also coincides with the reform measures undertaken by China, leading to a conclusion reached by many that trade expansion has been instrumental in poverty reduction. However, statistical analysis undertaken in a study by Ravallion (2006), finds no evidence of the relationship between the two indicators, leading the author to consider other factors as the major causes of poverty reduction.[12]

1.4 Trade, Development Poverty Reduction – Experiences from the Countries Selected

***Evolution of Trade Policies*[13]**

Governments of all the countries selected in the CUTS-TDP project tightly regulated economic activities and international trade in the immediate post-independence period. While in China the controlling mechanism was enforced under a communist rule, in such other countries as Bangladesh, India, Nepal, Pakistan, Sri Lanka, and in sub-Saharan Africa (SAA) socialist style-policies were invoked to implement what is known as the import-substitution industrialisation strategy. The communist regime in China, from 1949 onwards, introduced government control over every aspect of the economy with private trading prohibited, state-owned enterprises (SOEs) controlling production and marketing, and collective farming dictating resource allocation, management, and distribution in agriculture. These measures were accompanied by high levels of protection generated by strict trade controls to support industrialisation. The import substitution strategies elsewhere were also characterised by high tariffs and non-tariff barriers (NTBs) to trade, and overvalued exchange rate regimes.

In Bangladesh, India, Nepal and Sri Lanka, the governments set the pace of development through investments in the SOEs in the manufacturing sector and other large scale public sector projects within medium to long term planning horizons. A system of controlled input and output prices and trading practices was also a salient feature of this trade regime. Although the selected African countries followed similar practices, state control was perhaps not as pervasive in the industrial sector, but was a major feature of the agricultural production and trading system. SOEs managed large scale extension programmes that provided farmers with subsidised inputs such as fertiliser and seeds while marketing of agricultural produce was managed by the states using regulated prices and operating export boards.

On the other hand, both Cambodia and Vietnam experienced extended periods of conflict following independence in the 1950s. The political regime change that accompanied these conflicts led to experiments with a number of economic systems in the immediate post-war period, including communism and strong centrally planned command economies. Common to these regimes was state control of agriculture and industry, central planning and investment, import substitution and regulation of private economic activity.

The inward-looking approach to development in almost all the countries selected was pursued with the aim of achieving the core objectives of protecting the infant industries and thereby developing an industrial base in the respective economies, lessening the BoP deficit, ensuring efficient use of the available foreign exchange, protecting the economy from international capital market and exchange rate shocks, reducing fiscal imbalances, and achieving higher economic growth and 'self-sufficiency'. It was thought that, by replacing the previously imported goods with domestic production, import-substituting industrialisation strategy would ease the BoP situation and at the same time achieve the national objective of economic growth promoting industrialisation and reducing unemployment.

Despite some success in the earlier post-independence period, most of the countries selected started experiencing serious economic crises stimulated by both internal and external factors since the mid-1970s . Although the governing influence in the choice of import-substitution was dominated by macroeconomic concerns about the BoP and fiscal balance, even after quite some time into the highly protected trade regime both the internal and external balance situations of most of these countries continued to worsen. Moreover, one serious consequence of this development strategy was that it generated a highly distorted incentive structure, resulting in widespread allocative and productive inefficiency. Import-substitution policies of widespread quantitative restrictions (QRs), high tariffs and overvalued exchange rates caused substantial discrimination against production for export and the incentive structure was shifted towards the import-competing sectors. This policy-induced 'anti-export' bias not only inhibited export growth prospects but also undermined the potential for export growth.

Along with economic mismanagement, pressure also emerged from the external fronts, beyond the control of the developing countries. The oil crisis of the 1970s exerted accentuated BoP crisis and contributed to an economic downturn in the world economy, which, in turn resulted in reduced demand for exports from the developing countries. In addition, the global recession led to rising interest rates, increasing the debt burden of some of the TDP project countries, particularly those in SSA.

It was against the backdrop of serious macroeconomic imbalances of the early 1980s and stagnating export performance *vis-à-vis* a recession in the global economy that the policy of reforms for stabilisation and structural adjustment was undertaken in most of the TDP project countries along the guidelines specified by the two Bretton Woods institutions, namely the World Bank and the IMF. This adjustment programme put forward a wide range of policy reforms which included reforms in trade policy, industrial policy, monetary and fiscal policy, exchange rate policy, privatisation of the SOEs, and promotion of foreign direct investment (FDI). The widespread recognition that outward-oriented policies had carved the East Asian 'miracle', and the world-wide criticism of import-substituting development policies also contributed to the decision of policy reversal in TDP project countries.

The trade regimes in the 13 countries in the project had registered a major shift in the early 1980s, when a moderate liberalisation was initiated. However, by the mid-1990s, a large scale liberalisation programme had been implemented. Since then, governments have continued with their commitments to more liberal trade regimes. These liberalisation programmes have led to a remarkable decline in QRs, notable opening up of trade in many restricted items, significant rationalisation and diminution of import tariffs and liberalisation of the foreign exchange regimes. In addition, as the dominance of SOEs had been a huge burden on government's finances, privatisation and reductions in government spending were undertaken to reduce the burden on state finances. Another important element of trade policy reform was the introduction of generous promotional measures for exports. While import and exchange rate liberalisation were intended to correct the domestic incentive structure in the form of reduced protection for import-substituting sectors, export promotion schemes were undertaken to provide exporters with an environment in which the erstwhile bias against export-oriented investment could be reduced significantly. Important export incentive schemes that were made

Table 1.2: A Summary of Reform Process in TDP Project Countries			
Countries	**Reforms led by**	**Reform periods**	**Key features**
Bangladesh	World Bank and IMF	1st phase -1982-86 2nd phase - 1987-91 3rd phase -1992 -	Removal of QRs (from 275 to 5); highest tariff lowered from 350 percent to 25 percent; effective rate of protection reduced from 76 percent to 24 percent; Devaluation and eventually freely-floating exchange rate system; VAT introduced; export promotion measures
Cambodia	IMF and WTO	1996-	Reduction of tariffs to 15 percent; WTO accession negotiations leading to a wide-ranging reform commitments
China	Domestically led	Agriculture reform from 1978; trade reform from 1985	Part-privatisation of SOEs; average tariffs reduced from 47.2 percent in 1992 to 9.9 percent in 2004; foreign exchange restrictions relaxed; support for SMEs; FDI promotion; devaluation
India	IMF and WTO	Trade reforms from1991; Agriculture reforms from late 1990s	QRs removed; average tariffs reduced from 80 percent in 1990 to 37 percent in 1996; fiscal austerity; devaluation; Foreign exchange restrictions relaxed; privatisation
Nepal	IMF	SAP implemented from 1985	Average tariffs down to 14 percent (10 percent in agriculture); devaluation; foreign exchange restrictions relaxed; removal of agricultural subsidies; VAT introduced
Pakistan	IMF	From 1987	QRs removed; average tariffs lowered to 17 percent; maximum tariff reduced from 125 percent to 25 percent
Sri Lanka	World Bank and IMF	1st phase-1977 onwards; 2nd phase-1990s	QRs removed; price controls removed; fiscal austerity; devaluation; FDI promotion; foreign exchange restrictions relaxed; maximum tariffs reduced to 35 percent
Vietnam	Domestically led	From 1986	Part-privatisation of SOEs; average tariffs reduced to 16%; FDI promotion; foreign exchange restrictions relaxed
Kenya	World Bank and IMF	SAP implemented from 1980; more reforms from 1986	QRs removed; average tariffs reduced from 49 percent to 17 percent; removal of agricultural subsidies; privatisation; foreign exchange restrictions relaxed; FDI promotion
South Africa	IMF and WTO	Began in the early 1980s;	QRs removed and tariffs bound; fiscal austerity; tariff reduced by one-third on joining the WTO (still high ceilings in agriculture); export subsidies removed; privatisation (some marketing boards still remain in agriculture)
Tanzania	World Bank and IMF	Reforms began in the mid 1980s; SAP implemented in the 1990s	Average tariffs reduced to 12 percent; privatisation; foreign exchange restrictions relaxed; removal of agricultural subsidies; removal of export duties; devaluation
Uganda	World Bank and IMF	1st phase from 1987; 2nd (intensive) phase – 1995 onwards	Trade liberalisation; privatisation; foreign exchange restrictions relaxed; removal of agricultural subsidies and price support; devaluation; liberalisation of state owned marketing boards

Zambia	World Bank and IMF	Reforms began in the early 1980s but controls re-imposed in 1987; serious reforms undertaken in the 1990s	Tariff slabs reduced to four; maximum tariffs reduced; QRs liberalised; privatisation

available in most of the countries selected included, *inter alia*, subsidised rates of interest on bank loans for exporting activities, duty free import of machinery and intermediate inputs, cash subsidies, and exemption from value-added and excise taxes.

One of the earliest reformers was Sri Lanka as it started implementing its reforms in 1977. This first phase of reforms was undertaken in response to IMF support and included the removal of price controls, reductions in government spending, privatisation, the introduction of FDI incentives, currency devaluation and a reduction in the number of NTBs, such as QRs (which were converted to tariffs). Tariffs were also reduced and rationalised, but high levels of protection remained until the second phase of trade reforms, which was undertaken in the 1990s. These followed a serious economic crisis precipitated by macroeconomic instability and conflict in the late 1980s, and reforms were again promoted by the IMF in the 1990s. This second wave of liberalisation removed more QRs, reduced nominal tariff rates by 30 percent and reduced the maximum tariff from 250 percent to 35 percent.

Bangladesh initiated its reform process in the early 1980s being guided by the World Bank and the IMF. These reforms continued through the 1990s and included reductions in government spending, devaluation, export promotion, the removal of QRs (reduced in number from 275 to 5) and tariff reductions (the maximum tariff rate reduced from 350 percent to 25 percent). However, Bangladesh has maintained significant levels of protection in certain sectors and is still considered as one of the most protected economies in the world.

India initiated its reform process in 1991, when following a severe BoP crisis it called on the IMF for support to stabilise its economy. The structural adjustment programme (SAP) it implemented included reductions in government spending, devaluation of the rupee, the relaxing of exchange controls, privatisation of SOEs, the removal of QRs and reductions in tariffs (average tariff fell from 80 percent in 1990 to 37 percent in 1996). However, a large number of QRs remained in place in agriculture, which remained quite heavily protected until the late 1990s. This first phase of liberalisation was focused on the capital and industrial goods sector. The major reforms in the agricultural sector took place in the late 1990s and early 2000s to comply with WTO's Dispute Settlement Body's recommendations. Agreement on Agriculture (AoA). This led to QRs being removed on a wide range of agricultural products, although these were replaced by reasonably high tariffs, providing continued tariff protection. However, the provision of subsidies in agriculture (for electricity, water and fertiliser) has continued.

Pakistan initiated its own reform process in the late 1980s following a period of macroeconomic instability and economic decline. Its reform programme saw the removal of virtually all QRs, substantial tariff reductions (from a maximum of 125 percent in 1987 to 30 percent in 1998), reductions in government spending and privatisation. These reforms were deepened even further in the late 1990s as Pakistan implemented a SAP under the tutelage of the IMF and World Bank.

Perhaps the most intensive reformers during this period were the SSA countries and Nepal. Most SSA countries were hit hugely by the debt crisis, falling commodity prices and the global economic downturn of the 1980s, and faced complete economic collapse when they called on IMF and World Bank to support their economies. Then, a radical reform programme was launched which included reductions in government spending, mass privatisation (Zambia had privatised 253 SOEs by 2001), devaluation, the relaxing of exchange controls and trade liberalisation. The trade reforms were introduced across the economy, reducing agricultural tariffs as well as industrial tariffs and removal of a wide range of QRs. It is worth noting that compared to many Asian countries, Nepal and SSA countries initiated their reform programmes with comparatively much smaller tariffs.

Under the first Structural Adjustment Loan in 1980 from the World Bank, Kenya started gradually replacing QRs with equivalent tariffs. During 1984-88, there was an emphasis on the role of private enterprises and promises to support export oriented industries, while some of the apparatus of import substitution such as import licensing and government's direct involvement in production were maintained. The formulation of the Sessional Paper in 1986 marked a change from reliance on import substitution and protectionism towards a policy of exposing industry to international competition and encouraging non-traditional exports. The second push to liberalise the trade regime began in 1988 with a focus on export development that saw, amongst others, reduction and restructuring of tariffs, abolition of export duties, and introduction of export retention schemes. Maximum tariffs fell from 170 percent to 25 percent and the number of tariff bands were reduced from 24 to 4. On the whole, the average tariffs fell from 49 percent to 17 percent. Virtually all capital account transactions were fully liberalised. Kenya also had to undertake reforms to fulfill its obligations related to WTO and regional trading arrangements (RTAs).

South Africa accepted a loan from the IMF with conditions in line with neo-liberal orthodoxy. Imports were significantly liberalised by 1985 much before the adoption of the SAP. After the transition to the democratic system, the Growth, Employment and Redistribution (GEAR) strategy was launched that, amongst others, sought to constrain government spending to energise saving and investment by the private sector. In terms of industrial strategy, GEAR primarily focused on competitiveness, liberalising trade, and promoting exports. Since the early 2000s, the Microeconomic Reform and the Integrated Manufacturing Strategies have been put in place.

In Tanzania – a country that started liberalisation in the mid-1980s with the removal of public sector from commercial and business activities – reforms were further scaled up in the mid-1990s. Fiscal consolidation has been one of the most important aspects of these reforms. Along with regaining fiscal control, donor assistance in the form of grants and concessional lending increased substantially. Tanzania has embraced trade liberalisation by opening the economy to the external markets for trade, investment and to some limited capital flows. Reduced import restrictions, liberalised foreign exchange transactions, simplified tariff structure, and elimination of export duties have been some prominent features of trade policy reforms. The financial, telecommunication and transport sectors have also been liberalised.

Uganda's economic reforms date back to 1987 when the government first undertook an economic recovery programme to address deficiencies in export competitiveness, introduce market reforms into its agriculture policy, attract more foreign investment and improve the effectiveness of fiscal and monetary policies. Reforms were carried out in the financial sector, marketing, and taxation, along with restructuring of government ministries and parastatals, privatisation, decentralisation, and rehabilitation of infrastructure. Uganda also worked closely with international donors with the aim to fostering economic growth and poverty reduction. This is reflected in the Uganda's Poverty Eradication Action Plan (PEAP) of 2004, which also provides for a framework for formulating socio-economic policy.

Zambia had a brief phase of liberalisation during the 1980s when a partial decontrol of some commodity prices was introduced followed by some more active liberalisation during 1985-1987. But due to political and social costs that the reforms brought a regime of controls was re-instituted around mid-1987 along with launching of a New Economic Recovery Programme (NERP) based on the theme of 'growth from own resources'. The NERP, however, could not be sustained for long. Then, the transition to multi-party democracy in Zambia also marked the beginning of serious policy reforms with the objectives of reviving economic growth, containing inflation and reducing poverty. Within a spell of 4-5 years, major macroeconomic, financial and institutional reforms were implemented.

The initiation of reform process in two TDP project countries viz. China and Vietnam had been quite different from others. Reform and deregulation measures in these two countries were principally domestically led. In the case of China, the reform process began in 1978 with the freeing up of agriculture to private trading which was followed in the mid-1980s with the removal of foreign exchange controls, a widespread trade liberalisation programme (reducing the average tariff to 47.2 percent by 1992, 17 percent by 1997 and 9.9 percent by 2004) and a devaluation of the Yuan. In addition, the government provided increased opportunities for SOEs to develop their production strategies and retain profits for autonomous investment. However, much of industrial and capital intensive production remained in the hands of the state and certain sectors continued to receive high-level government support (e.g. through the establishment of jointly owned, local government-private sector Town Village Enterprises) and protection throughout the reform period. For example, in the electronics sector, tariffs remained above 50 percent until the late 1990s.

On the other hand, from 1986 the Vietnamese Government started implementing its *Doi Moi* (Open Door) programme, which involved the partial privatisation of SOEs, increased opportunities for private trading, the removal of restrictions on foreign investment and the reduction of tariff and NTBs (mainly in the capital and input goods sector as higher level of protection was maintained in the consumer goods sector). To underpin its liberalisation programme, Vietnam signed a free trade agreement (FTA) with the EU in 1992, joined Association of Southeast Asian Nations (ASEAN) in 1995 and started

Table 1.3: Tariff Reductions in the TDP Project Countries					
	Tariff rates (%) over two different time periods (simple average of MFN applied rates)		Most recent simple average MFN tariffs applied	Trade weighted average MFN tariffs applied	Percent of tariff lines with MFN duties over15%
Countries	Period 1	Period 2			
Bangladesh	94 (1989)	17.1 (2002)	15.2	NA	39.9
Cambodia	35 (1996)	17 (2002)	14.3	10.9	19.3
China	40.3 (1990)	15.3 (2001)	9.9	4.7	16
India	81.8 (1990)	31 (2001)	19.2	14.7	21.6
Nepal	23 (1988)	14.7 (2001)	13.9	NA	16.6
Pakistan	64.8 (1990)	20.6 (2001)	14.3	13.1	40
Sri Lanka	28.3 (1990)	9.8 (2001)	11.2	7.4	20.9
Vietnam	30 (1989)	15 (2001)	16.8	NA	40.7
Kenya	43.7 (1990)	15.3 (2000)	12.7	6.2	40.8
South Africa	12.7 (1988)	8.5 (1999)	8	6.1	21.1
Tanzania	29.7 (1990)	17.9 (2001)	12.7	9.7	40.7
Uganda	19.9 (1987)	8.2 (2001)	12.7	11.6	40.8
Zambia	29.9 (1987)	6.8 (1999)	13.9	12	33.2

Note: NA stands for not available.
Source: Information provided in Column 2 and 3 is based on authors' compilation from different country specific studies. Figures reported in the last three columns come from the tariff profiles for individual countries as reported in WTO (2006).

negotiations to join the WTO. By 2003, only one percent of Vietnam's tariffs were over 50 percent and its average tariff had fallen to less than 16 percent. However, government intervention in the economy still remained significant throughout the reform period with SOEs continuing to play a role in the industrial sector and government funded extension services – an important part of agricultural policy.

Table 1.3 summarises the reform experiences in the TDP project countries in terms of their tariff profiles at the time of undertaking reforms and in the post-reform periods. Bangladesh, India, and Pakistan had the highest average tariffs immediately before considering liberalisation. By the late 1990s to early 2000s, high tariffs in these countries had already been slashed drastically. Nepal and Sri Lanka along with SSA countries were relatively open during the late 1980s and their tariffs declined further by the early 2000s. According to the data available for the most recent year, India had the highest average applied tariff rates of 19.2 percent followed by Vietnam and Bangladesh. In contrast, South Africa was reported to have the lowest comparable rate amongst the countries included. Trade-weighted average rates for all the countries are lower than their respective simple average rates. The last column in Table 1.3 shows the number of tariff lines in the selected countries being subject to tariff rates higher than 15 percent. China has the lowest proportion of lines with such tariff peaks. Cambodia, South Africa and India charge more than 15 percent import duties for about 20 percent of their import lines. For all other countries tariff peaks range 33-41 percent of the lines.

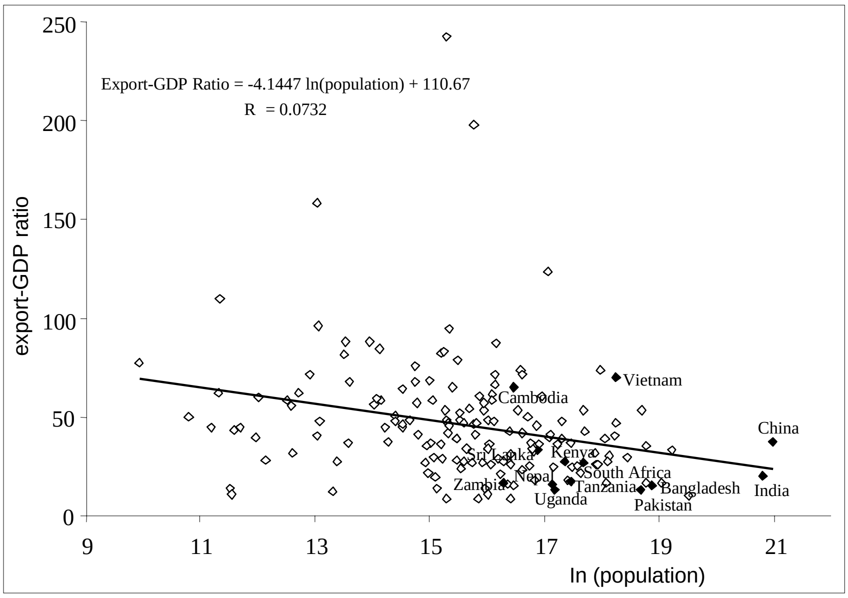
Trade, Development and Poverty Reduction: Stylised Facts from the TDP Project Countries

Table 1.1 above has provided some of basic macroeconomic and structural facts associated with the TDP project countries selected, while the foregoing discussions and Table 1.2 portrayed their trade policy reforms. As the results of academic and empirical studies, the review of which is presented in Section 1.3 above, appear to be inconclusive as regards the link between trade liberalisation and economic performance, it is of interest to know the developments related to trade, growth and poverty reduction that have taken place in the project countries. Policy reforms are expected to enhance the significance of international trade in a country as import liberalisation (e.g. tariff reductions and removal of QRs) tends to increase imports and should contribute to the reduction of anti-export bias by reallocating resources from import-competing to export sectors. This is generally manifested in a rising trade-GDP ratio of a country undertaking liberalisation. However, since policymakers are more concerned with exports, the share of exports in GDP is most often considered as the important indicator to monitor the post-liberalisaiton period.[14]

The changes in export-GDP ratio are assessed either absolutely, i.e. for an individual country alone, or relatively, i.e. in comparison with other countries. Although both the approaches provide useful insights, it is important to consider one important problem associated with the cross-country relative comparison of export-GDP ratios. It has been demonstrated that large countries (in terms of population) tend to have lower export-propensities (Amsden, 2000; Gylfason, 1999). The reason may be that countries with large population find a ready domestic market and thereby can produce more for the internal market substituting imports. Since the basic objective of export is to facilitate import, and since imports are being replaced by domestic production, export-propensity is to be low. According to Amsden (2000) a large domestic market is a valuable asset and bigger countries might be expected to be more protectionist than smaller ones. Therefore, while making cross-country comparisons, it is essential to control for country sizes. Figure 1.1 validates this argument as the scatterplot of the export-GDP ratio and population for 168 countries, for which the information can be obtained, reveals a strong negative relationship.[15] The line fitted through the scatter can be considered as a yardstick for identifying countries with higher and lower propensities to export, controlling for their sizes. Amongst the TDP project countries, only Cambodia, Vietnam and China turn out to be the countries that have actual export-GDP ratios higher than what can be predicted for them using the average cross-country experiences.[16] All other countries seem to have lower export-propensities compared to global average.

While Figure 1.1 depicts export-GDP ratios for individual countries in 2005, Figures 1.2 and 1.3 show the evolution of such ratios for TDP project countries in Asia and Africa, respectively. Amongst Asian countries, Cambodia and Vietnam have spectacular rise in export propensities during the past 20 years or so. The share of exports in China's GDP has also grown quite strongly since 2001, which coincided with the country's acceding

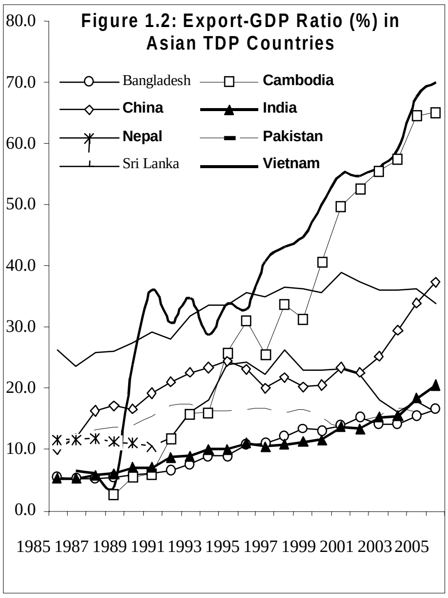
Figure 1.1: Cross-Country Relationship between Country Size and Export-GDP Ratio

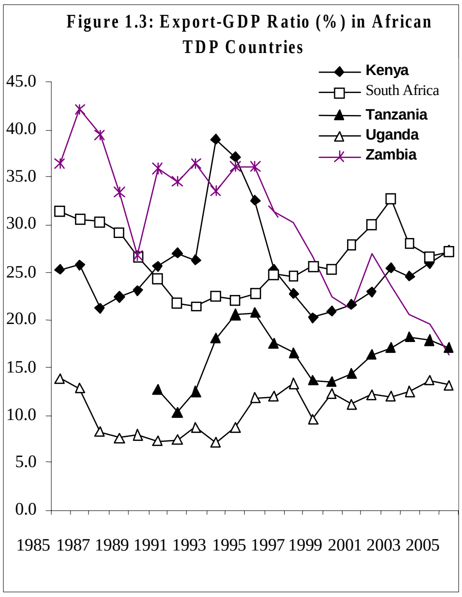


to the WTO. Bangladesh and India have also been able to register a steady increase in their export orientation. Amongst other Asian countries, Nepal's export ratio has suffered in recent years while Pakistan and Sri Lanka show stagnating performance.

Turning to the five SSA countries in the sample, it is found that Zambia's export-GDP ratio has steadily declined since in the past 20 years its absolute export volume has hovered around US$1bn as against an annual average GDP growth rate of about two percent. Excessive dependence a single primary commodity, copper, global price of which is subject to long-term decline along with widespread fluctuations, has resulted in this disappointing performance. On the other hand, despite some improvement over the relatively recent past, the current magnitudes of export-orientation in Kenya, South Africa, Tanzania and Uganda are not impressive compared to what these countries achieved earlier in the sample period, as shown in Figure 1.3. That is, for the selected African countries, there is no strong evidence of steadily rising significance of the export sector. Kenya, Tanzania and Uganda, like Zambia, are also predominantly primary producing countries and the problems associated with these economies are quite well known.[17]

It is rather difficult to link trade liberalisation with the export performance of the sample countries and is perhaps impossible to generalise the trend in export-orientation. For Bangladesh, Cambodia, Sri Lanka and Vietnam, the growth of exports of textiles and clothing, particularly under the Multi-fibre Arrangement (MFA) quotas, has been an important contributing factor to rising export-ratio, but only Vietnam has witnessed a diversified export structure.[18] Export volumes of Bangladesh and Vietnam in 1989 were almost identical (at about US$1.5bn). Since then both countries have undertaken





important reforms, and in terms of openness, as measured by average MFN tariffs and the proportion of tariff lines with more than 15 percent duties (see Table 1.2) they now look almost similar. Nevertheless, Vietnam's exports during the past 15 years have increased to about US$37bn, while the comparable figure of Bangladesh – which is also often dubbed successful in energising its exports – is merely about US$10bn.[19] Similarly, Cambodia and Nepal had export volumes of equal size in 1995. But since then Nepal's exports have hardly grown while those of Cambodia almost quadrupled, despite the fact that both the countries turn out to have comparable trade regimes after their reform programmes. Being a landlocked country, trading costs must be excessively high for Nepal, suggesting that liberalisation may have much less positive effects on its export sectors.

Table 1.4 provides growth rates of exports of goods and services by 13 TDP project countries over different sub-periods along with other groups of world economy. If the 1980s is to be regarded as pre-reform period and the period from the mid-1990s as the post-liberalisaiton period then Bangladesh, Nepal and Sri Lanka turn out to be the countries that have not had any improved export performance in the last 10 years of the sample. China, India, Pakistan and Vietnam have registered high growth rates during 2001-05, but one could doubt the reasons to be associated with liberal trade policies. China had achieved high export growth during 1986-90 and there are reasons to believe that its entering into the WTO in 2001 has boosted recent export performance. Similarly, Vietnam posted very high growth of exports in the mid- to late-1980s even within an excessively controlled policy regime. For India, the recent remarkable export growth is generally attributed to a buoyant service sector that is unlikely to have been so much influenced by policy reforms.[20]

Pakistan and the five SSA countries in the sample also show export growth rates in the range 10-14 percent in the most recent sub-period of 2001-05. However, a close look at

Table 1.4: Growth of Exports of Goods and Services (annual average %)					
Year	1981-85	1986-90	1991-95	1996-2000	2001-05
Bangladesh	10.2	9.4	18.0	9.9	9.0
Cambodia	NA	NA	80.1	14.3	17.4
China	8.9	17.5	20.1	11.2	24.9
India	1.5	13.3	12.1	10.4	21.7
Nepal	7.0	5.0	23.4	4.9	-0.2
Pakistan	2.4	14.0	10.7	-0.3	11.5
Sri Lanka	4.7	8.6	14.7	6.8	4.9
Vietnam	NA	19.2	24.5	21.1	16.8
Kenya	-5.9	7.8	6.2	-1.4	13.4
South Africa	-5.6	6.4	5.0	1.6	12.5
Tanzania	NA	NA	15.9	4.0	9.8
Uganda	24.4	-7.7	23.9	0.8	11.9
Zambia	-12.0	9.6	1.3	-10.3	13.2
Other country groups					
World	-0.2	13.6	8.4	4.4	10.6
Low income	-6.6	11.6	8.3	8.4	17.0
East Asia & Pacific	1.9	15.3	18.8	8.3	17.3
Sub-Saharan Africa	-7.7	8.4	3.6	4.8	14.8
LDCs	NA	8.5	6.2	5.8	15.5

Source: Authors' estimates using World Bank World Development Indicators data.

Note: NA stands for not available.

Table 1.3 would reveal that this improved performance follows subdued export activity levels of the previous sub-period of the late 1990s.[21] Being exporters of primary commodities, the recent export growth of Kenya, Tanzania, Uganda and Zambia has also been aided by the on-going commodity price boom in the global economy. Therefore, from the information provided in Table 1.3, it is difficult to infer the beneficial effects of liberalisation on export performance convincingly.

One of the arguments for trade policy reforms is that the resultant reduction in anti-export bias is to promote export growth thereby directly contributing to overall economic growth.[22] Figure 1.4 scatterplots average growth of exports and GDP in 168 countries during 1990-2005, while in Figure 1.5 the same relationship is exhibited for the 13 TDP project countries. The positive association of exports and GDP growth is found to be stronger for the TDP project countries.[23] That is, compared to the global experience, export and GDP growth rates are more closely linked in the set of countries chosen. Obviously, amongst the 13 countries selected, Cambodia, China, and Vietnam are the countries that have experienced the fastest export and GDP growth rates during the

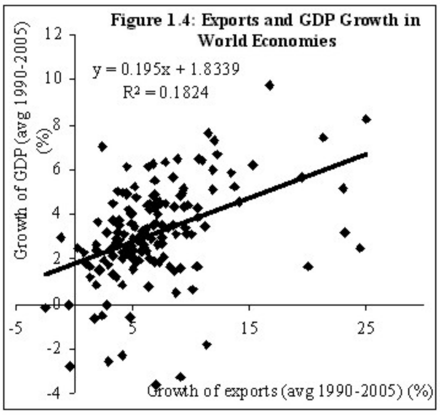


Figure 1.4: Exports and GDP Growth in World Economies

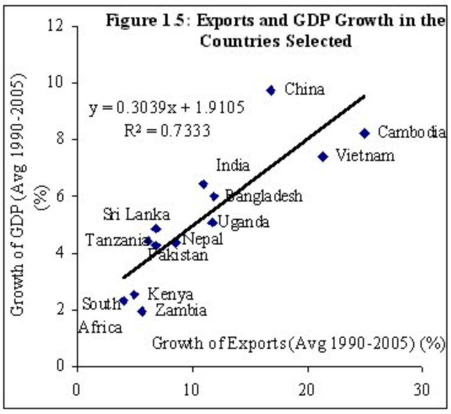
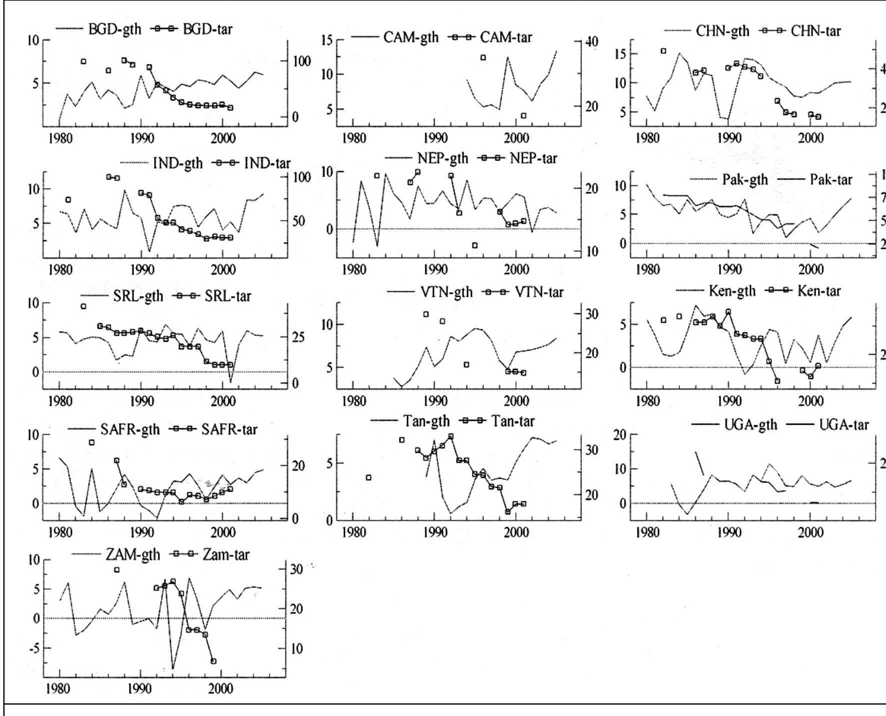


Figure 1.5: Exports and GDP Growth in the Countries Selected

period of 1990-2005, which coincided with the most serious liberalisation efforts undertaken by many developing countries. Bangladesh, India, and Uganda are the next three countries in the export-growth nexus ladder followed by Nepal, Pakistan, Sri Lanka and Tanzania. Kenya, Zambia and South Africa appear to be at the bottom of the ladder.

Figure 1.5 portrays some further interesting facts. Amongst the top performing countries, both Cambodia and Vietnam have had considerably higher export growth than China.

Figure 1.6: Average Tariffs and GDP Growth Rates in TDP Countries



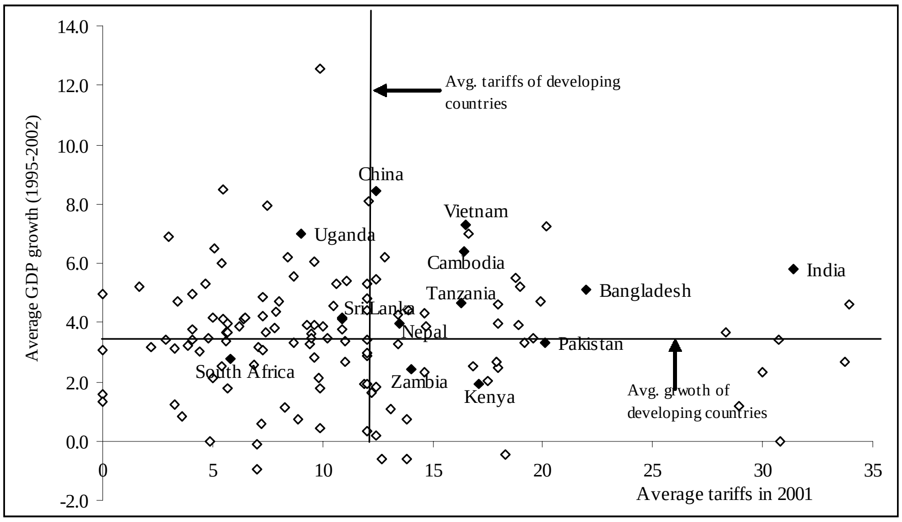
Note: GDP growth rates are measured on the left vertical axis while tariffs are on the right vertical axis.

Nevertheless, China outperformed both the other countries in terms of overall output growth. Similarly, despite having similar average export growth, Zambia's average GDP growth (of about 2 percent during1990-2005) falls far short of that of Tanzania's (4.2 percent) and Sri Lanka's (about 5 percent). These comparisons seem to suggest that non-export sectors may have a significant role in promoting economic growth.

Apart from promoting exports, greater openness is supposed to result in better allocation of resources and gathering improved technologies and inputs thereby directly influencing growth. As mentioned earlier, the effect of liberalisation on growth has been most controversial. Without delving into econometric niceties with regard to exploring the effects of liberalisation, in Figure 1.6 we simply plot simple average tariffs and growth of individual TDP project countries.[24] It becomes apparent that apart from Bangladesh and Tanzania, growth rates since the 1990s do not show a sustained increase over the previous decade, although for almost all countries average tariffs decline quite remarkably.[25] For China, India and Vietnam, high economic growth appears to have emerged within policy regimes characterised by high tariffs. In the cases of Nepal, Kenya and Sri Lanka significant lowering of tariffs in around 2000 did not accompany invigorated growth. Again, the figures for South Africa, Uganda, and Zambia hardly reveal any association between changes in tariffs and overall economic activity.

How do the TDP project countries stand in the cross-country landscape of average tariffs and economic growth? Figure 1.7 provides the scatterplot of annual average GDP growth rates for the period 1995-2002 and average tariffs of the countries in 2001 for a set of 135 developing countries. It is found that out of the 13 TDP project countries, with the exception of South Africa, Sri Lanka and Uganda, the balance 10 countries

Figure 1.7: Tariffs and GDP Growth Rates in Developing and TDP Project Countries

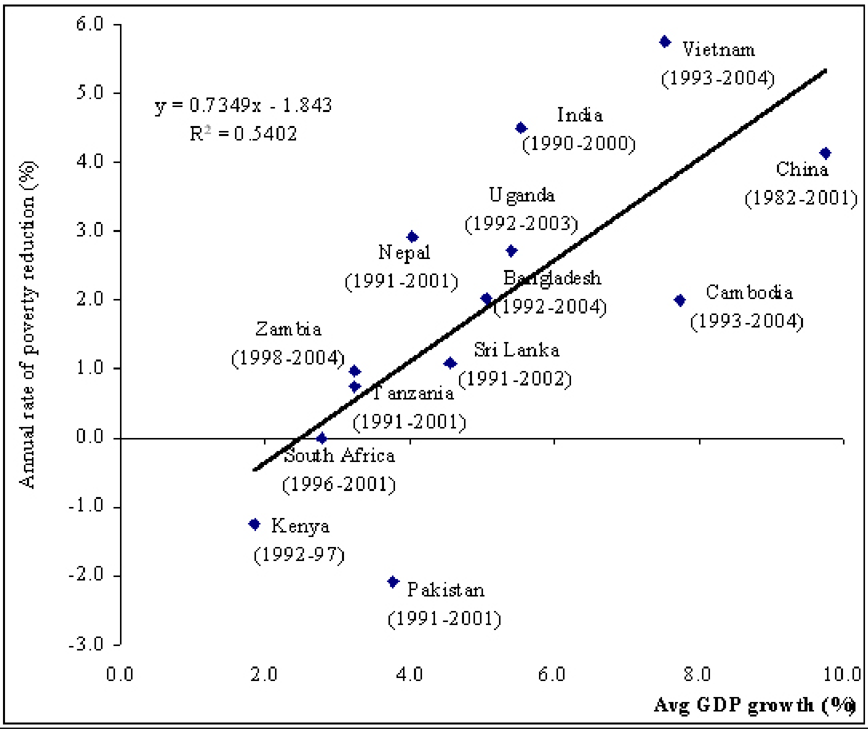


Notes: GDP growth rates are annual average over 1995-2002, data for which come from the World Bank World Development Indicators. Average applied tariff rates are from WTO (2003). They correspond to average tariffs for all goods (both agriculture and non-agricultural goods).

were having average tariffs higher than the developing country average in 2001. Of these 10 countries, seven (viz. Bangladesh, Cambodia, China, India, Nepal, Tanzania and Vietnam) had had GDP growth rates higher than the developing country average. In 2001, Bangladesh and India were amongst the most closed economies, nevertheless their annual average growth for the period 1995-2002 had been higher than most of the developing countries.[26] Within the set of TDP countries, with average tariffs of 5.8 percent South Africa grew at a rate of 2.7 percent per annum in comparison to India's comparable growth of 5.8 percent taking place with high average tariffs of about 32 percent. Similarly, one can compare Kenya and Vietnam – the two countries with almost identical tariff profile – the former struggled to ensure an annual average growth of 2 percent as against the latter's staggering average growth of 7.3 percent. Amongst the 13 TDP countries, only Uganda had shown impressive growth performance with comparatively smaller average tariffs.

The next important aspect is the relationship between growth and poverty. There has been some concern amongst the policymakers that the benefits of growth are often not equitably distributed. When the poor cannot participate in the growth process, poverty reduction becomes a much more challenging task. The term 'pro-poor growth' is therefore coined to emphasise the inclusive nature of the expanded economic activities. As trade adjustment is more likely to create a group of 'winners' along with 'losers', distributional consequences need to be understood carefully for assessing the implications for poverty reduction efforts.[27]

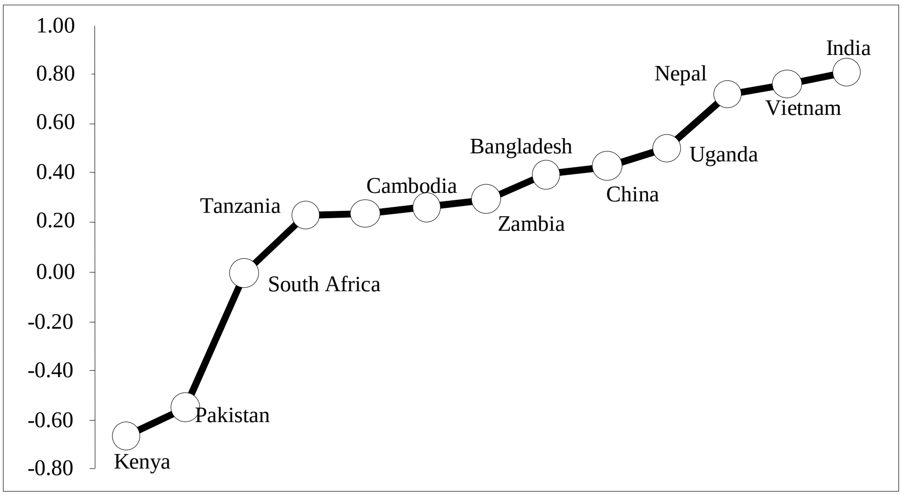
Figure 1.8: Growth and Poverty Reduction in TDP Countries



To get some idea about the relationship between changes in poverty and changes in income in the TDP project countries, Figure 1.8 plots observations on growth and poverty reduction over various spells for which information is available. These spells are essentially defined by the availability of comparable poverty incidence measures – the proportion of population falling below the poverty lines as defined by the respective countries – with the most distant ends being considered in the case of adjacent annual observations.[28] As expected, the scatterplot of observations shows a positive relationship between economic growth and poverty reduction. The fitted ordinary least squares regressions line has a slope equal to 0.7 implying that a one percentage point increase in GDP growth in the countries selected would lead to reduction of headcount index by 0.7 percent. Changes in growth explain only about 54 percent of the variance observed in the changes in poverty headcounts.[29] Therefore, apart from growth performance there is some substantial scope of understanding the reasons why poverty in various TDP countries tends to react very differently to the same increase in the growth rate.

As is obvious from Figure 1.8, Vietnam has had the highest rate of poverty reduction, followed by India and China.[30] On the other hand, despite some modest growth, poverty situation has deteriorated in Kenya and Pakistan and remained unchanged in South Africa. With the exception of Uganda, other SSA countries seem to have been trapped into a slow growth and poverty reduction phenomenon. A close look at the figure reveals the need for studying country experiences and sharing lessons from more successful countries rather than merely focussing on growth as the recipe for poverty reduction. For example, it would be of immense interest to know why the similar magnitude of economic growth in Cambodia resulted in an annual average poverty reduction of less than 2 percent as against of close to 6 percent achieved in Vietnam. In the same way, replication of India's success would have led to a fall in the proportion of population living below the poverty line in Bangladesh in 2004 from 44 percent to 25 percent. Similar other interesting observation can also be derived from Figure 1.8.

Figure 1.9: Growth Elasticity of Poverty in TDP Countries



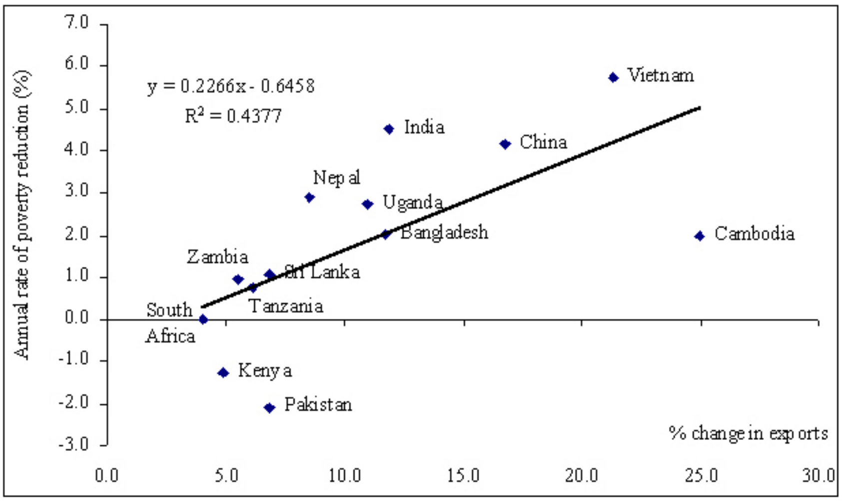
Source: Authors' estimates

In Figure 1.9 the estimated growth elasticity of poverty is shown for individual TDP countries.[31] India appears to have the largest elasticity, as during 1990-2000, a one percent annual GDP growth in the country has been associated with 0.8 percent decline in the poverty headcount index. Vietnam and Nepal are the two other Asian countries to demonstrate impressive pro-poor growth. Amongst the SSA countries in the sample, Uganda performs the best while Kenya the worst. Take the three countries with widely varying growth experiences – Cambodia (annual average growth of 7.7 percent), Sri Lanka (annual average growth of 4.5 percent) and Tanzania (annual average growth of 3.2 percent). However, when the poverty alleviation effects of their growth are considered, not much difference can be found amongst them. By contrast, as already referred to, despite having comparable GDP growth rates, poverty reduction experiences of Bangladesh and India have been remarkably different.

Finally, the association between the growth of exports of goods and services and poverty in TDP project countries is examined. The motivation for doing this stems from the fact that even when there is weak or no relationship between exports and GDP growth, export expansion can have direct impact on poverty incidence. In fact, Chapter 2 of this volume argues that, even without being the engine of growth the expansion of highly labour-intensive export sector has contributed to Bangladesh's poverty alleviation by generating huge employment opportunities for mostly unskilled workers.[32] Contrarily, exports growth can bypass the poor.

Figure 1.10 plots the annual rate of poverty reduction and growth of exports in the TDP project countries. A positive relationship between the growth of exports and reduction in poverty is visible with Vietnam registering both high export growth and poverty reduction. Cambodia turns out to be a clear outlier, as it experienced the highest export growth rate with only a modest rate of poverty reduction. During the period under

Figure 1.10: Growth of Exports and Poverty Reduction in TDP Countries



Note: Export growth rates correspond to the same time periods as used for Figure 1.8.

consideration, Cambodia recorded an average export growth rate 15 percentage points higher than that of Bangladesh, but the former's annual poverty reduction rate has been at par with that of the latter. This might appear as such given the fact that both Bangladesh and Cambodia overwhelmingly rely on apparel items, and the labour-intensity in the export production of both countries is likely to be similar. However, it needs to be kept in mind that there are other factors that have influenced poverty reduction differently in these two countries.[33] On the other hand, given its export growth, Bangladesh performs just average in terms of poverty reduction. But, with an almost identical export growth rate, India achieves must higher rate of poverty reduction than that of Bangladesh. Despite some modest export growth, Nepal and Uganda, too, have shown impressive poverty reduction records. While Sri Lanka, Tanzania, and Zambia have both low export growth and low poverty reduction rates, the deterioration in the poverty situation for Kenya and Pakistan make them rather unusual in the landscape of TDP project countries. On the whole, therefore, the project countries seem to suggest that despite the general relationship, the relationship between overall output growth, export expansion and poverty reduction is much more complex.

1.5. Lessons Learnt

As mentioned at the outset, the objective of the TDP project was not to find out a broad and general relationship involving trade, growth and poverty. Rather, attempts have been made to go further by studying the country-specific experiences more closely, and in that process to identify interesting and useful lessons that can be shared with the relevant stakeholders. While one can derive a large number of such lessons, in the following we list only those that are likely to have some relevance to most of the countries in the sample as well as to a large number of countries within the broad set of the developing world. These lessons have also been selected from a forward-looking perspective so that they can be used while devising and implementing future policy regimes that are intended to influence the trade-growth-poverty linkages in low-income developing countries.

Ownership of the Policy Regime

The first important lesson that comes out of the TDP project is that countries that have undertaken reforms through domestic initiatives tend to have succeeded most. China and Vietnam are bright examples of this. While trade has certainly played an important role in both the countries' outstanding performance in expanding economic activities and poverty reduction, unlike most other developing countries they had firm ownership over their policy regime. There has been a lot of discussion in the development literature on the importance of the ownership of the policy regime and the cases of China and Vietnam only confirm its significance. A home-grown initiative not only ensures better implementation of reform measures, but perhaps also help institute a creative policy regime that attempts to identify the loopholes and shortcomings in the process and seeks to redress them. When this indigenous initiative lacks, reforms are likely to be haphazard. Thus, the case study on Nepal (Chapter 3 of this volume) mentions the problem of national priorities distortion in the face of receiving foreign aid, which, in fact, is a problem that has characterised a large number of poor countries. The Kenyan country paper (Chapter 10) also mentions that the progress in liberalisation in the country has been sporadic, with periods of significant progress followed by slower movement and even reversals, which are attributable to the lack of a shared vision among the key actors in the reform process, namely the government, donors and Kenyans themselves. The same country also refers to the lack of coordinated policy advice to the government when the SAPs were implemented. This is again a typical problem faced by almost all low-income countries that had to implement SAPs.

In light of the above, effective and fruitful implementation of the poverty reduction strategies (PRSs) needs to be taken into consideration. Most of the TDP project countries have formulated their PRSs that are currently being used as major policy directives to tackle poverty.[34] The issue of ownership in the preparation and implementation of theses strategies was given some consideration. But, given the fact that PRS in the first place were developed to secure financial support from the donors greatly undermines the spirit of any home-grown initiative. Despite its focus on poverty reduction, the basic nature of trade policy (or for that matter any other policy) in PRS countries has not changed much from the SAP regime. Therefore, in terms of the scope of directions and ownership, PRS regimes are no different from the previous unsuccessful regimes.

Export Response to Liberalisation

There is an overwhelming evidence to suggest that the export response to trade liberalisation has been very weak. One of the fundamental premises of liberalisation was to correct the distorted incentive structure so that in terms of allocation of resources export sectors are not discriminated. This reduction in the policy-induced anti-export bias was thought to spur export activities. The reality, however, has been quite different in many TDP countries. For example, despite undertaking significant reforms exports of merchandise goods from Nepal, Uganda and Zambia either declined or stagnated, as no new sectors emerged to flourish in the global market. There has been some modest expansion of new sectors in Kenya and Tanzania. Nevertheless, the overall growth of exports has not been very encouraging.[35] Even some of the countries that have appeared to do well in terms of aggregate exports have failed to diversify their export base with Bangladesh and Cambodia being examples of this. The Bangladesh case study (Chapter 2) shows that largely because of the ready-made garments (RMG) growth, the country's aggregate exports have registered robust growth. However, export response from non-apparel sectors has been frustrating. Similarly, Cambodia's exports have been critically dependent on apparels. There is a great deal of apprehension that in the near future these countries are going to face severe competitive pressure from China, India, and Vietnam requiring them to look for alternative sources of export earnings.

The concern over the weak export response has brought attention to the supply-side capacities in most low-income developing countries. The theoretical premise of reallocation of resources in export-oriented sectors in the aftermath of liberalisation is not straightforward as exporting activities require a prior knowledge about production and marketing activities, access to production and distribution networks and improved infrastructural facilities. Quite rightly, therefore, the Ugandan country paper (Chapter 13), mentions lack of entrepreneurship as one of the reasons for expanding production and export base. In recent times, a lot of emphasis have been given on aid for trade in improving poor countries' supply-side capacities, in the absence of which it seems that trade reforms cannot generate adequate export stimulus.

Initial Distribution of Endowments

The experiences of TDP project shows that countries with initial distribution of endowments, have been able to reduce poverty more than countries that did not take such measures. One fundamental ingredient in Vietnam's poverty reduction record was the property right reform in agriculture along with trade liberalisation both of which took place in the late 1980s. The contract system introduced in agriculture coupled with granting tradable long-term land use rights to farmers released productive forces in the sector, contributing to substantial productivity improvement. The distribution of land was egalitarian and pro-poor. Careful attention was also paid so that the quality of the distributed plots across households did not differ much. As a result of these adroitly handled critical reforms, farmers were able to benefit from higher output prices in the aftermath of liberalisation. As the vast majority of the poor lived in rural areas, these measures had resulted in pro-poor distributional consequences with rapid reduction in rural poverty. The effectiveness of agricultural growth in reducing poverty in China was also due to an almost similar reason – a historical context when a relatively equal land distribution could be achieved at the time of the breaking up of the collective system of farming. The Chinese and Vietnamese cases are clear contrasts with other developing countries where reforms did not consider the distribution of endowments with which the poorest of the poor can take part effectively in a more open market system.[36] South Africa is an example where growth appears to be bypassing the poor because of its lack of inclusiveness.

It has been pointed that the experiences of China and Vietnam are unusual, and thus cannot be replicated elsewhere (Ravallion and Chen, 2004). Without refuting this observation what is important here is to recognize the most essential factors that have determined success. The lesson from China and Vietnam should not be interpreted in terms of land distribution alone, but the fact that the capacity of the poor needs to be enhanced if they are to benefit from more liberal policies. Capacity enhancement could include skill development, access to better education, and any other measures specific to countries concerned. The basic lesson is that poor people need to be endowed to benefit from liberalisation.

Easy Reforms versus Critical Reforms

The review of the TDP country experiences so far has shown that trade reform measures implemented under the SAPs have been characterised by a number of common features. Removal of QRs, reduction in import tariffs, simplification of tariff structures, liberalisation of the exchange rate and promotional measures for export sectors. These reforms may actually be considered as relatively easy reforms. More difficult but fundamental measures such as institutional reforms have hardly been considered. The general conditionalities imposed for SAP reforms failed to improve the quality of institutions. There are, however, some solid grounds to believe that it is the difficulty in reforms that usually has far reaching implications for growth and economic development. This point has been explicitly pointed out in the Bangladesh background paper, but is also implicit in many other country cases. For example, the Kenyan paper (Chapter 10) shows the difficulties associated with setting up an institution for enforcing sanitary and phyto-sanitary (SPS) measures, which has been critical for its exports of agricultural products. The traditional approach to trade policy reforms failed to recognise the need for such institutional development, as the Kenyan paper also argues that most policies were not sustainable and this was mostly due to a weak institutional framework.

Countries such as China, India and Vietnam have developed a network of well-resourced institutions to monitor and manage the process of market development. These institutions are responsible for macro-economic management and for developing and implementing economic plans to guide the economy, including strategies for investment, liberalisation and export production. They are also responsible for overseeing regulatory issues such as competition, the functioning of labour markets and customs procedures. In contrast, other project countries have failed to develop effective institutions to manage their economies and their reforms have failed to stimulate the effective functioning of private markets. This problem has been especially prevalent in SSA countries where institutions face serious financial and human resource constraints and continue to suffer from high levels of corruption.

The Role of Agriculture

One critical challenge facing most poor countries is manifested in creating productive employment through the development of the manufacturing sector. In fact, the inward-looking policies of the import substitution era attempted to develop domestic manufacturing base, which in the process discriminated against the agricultural sector in terms of unfavourable terms of trade. When liberalisation measures were undertaken, agriculture however did not attract additional investment. More importantly, under SAPs output support and input subsidies in agriculture were scrapped, leading to direct poverty and welfare consequences particularly for rural population. This has been particularly true for Nepal, while in the context of Sri Lanka there is some evidence of liberalisation affecting the population dependent on such products as rice, onions, chillies, and potatoes. In fact, for a majority of TDP project countries agricultural growth has been weak, which may be a reason for the countries being relatively less successful in addressing rural poverty. Even for countries with relatively high economic growth such as Bangladesh and India, the trend growth of agriculture is quite modest.[37] There is a growing recognition that along with the shifting of production structure away from primary to manufacturing activities, a vibrant agricultural sector will be required to exert the most effective impact on poverty, especially when in most countries agriculture continues to be the principal source of employment.

It is important to recognise that the poor export performance of many SSA countries is attributable to some characteristic features associated with primary commodities that do not help expand the demand for these export items.[38] As a result, for most of these countries focusing on sectors with static comparative advantage appears to be not very rewarding in the medium to long-term. While the diversification of their export basket and the shift towards the sectors with dynamic comparative advantage of course demands policy attention, it needs to be kept in mind that, given the dependence of a majority of the population, poverty alleviation efforts would require maintaining dynamism in the traditional sector. That is, the structural shift in the composition of the economy and export basket should take place in parallel to a productive and vibrant agricultural sector. This may require looking for alternative primary products for exports, processing of traditional items, and improving productivity.

Liberalisation and Economic Growth

TDP country experiences suggest that there is hardly any systematic relationship between the level of tariff protection and economic growth. Bangladesh, India, and Vietnam have achieved high growth, maintaining relatively closed economies. On the other hand, despite rapid liberalisaiton and much greater openness, SSA countries have failed to materialise high growth rates in a consistent manner. This suggests that reforming the tariff regimes may not have been the principal determinant of growth. Countries that have captured the most positive impacts from trade liberalisation are those that have taken a selective approach to open their markets, with these decisions based on variables such as potential impacts on the poor and levels of competitiveness. This points to the need for research to explore further the right pre-conditions and accompanying reforms that are required to benefit from trade liberalisation.

Priority for Future Reforms

It then follows from the above that, in future growth-promoting endeavours, further tariff cuts may not be construed as a priority, as is often suggested by many. Export response to tariff liberlaisaiton, as mentioned above, has been weak, in addition to the absence of any clear-cut relationship between tariff levels and growth across countries. Liberalisation encompasses a host of measures including reforming institutions. As argued above, these fundamental reforms might hold the key to success. Furthermore, lessons need to be drawn as regards what made India and Vietnam to diversify and grow under relatively closed regimes and whether these lessons can be replicated elsewhere.

Supply-side Capacity and Trade Barriers

Inadequate supply-side capacities have been recognised to be one of the most serious obstacles faced by many developing countries, including most of the TDP project countries, resulting in their inability to participate in global trade. In light of the many structural problems affecting production and exporting activities, a number of developing countries and LDCs have been granted preferential market access in major industrialised countries for the past three decades. However, preferences offered have been far from homogenous and differ in terms of product coverage, depth of preference, eligibility, and other preconditions such as rules of origin (RoO) requirements. The coverage of preferences is often such that products that are of export interest to some poor countries are excluded. Although in recent times, most developed countries have offered various types of duty-free and quota-free market access to LDCs and other poor countries, there are also important exceptions and restrictions. For example, the US preferential scheme in textiles and clothing regime has excluded Asian LDC suppliers such as Bangladesh, Cambodia and Nepal, making these suppliers often subject to very high tariffs.[39]

On the other hand, realising duty-free access in the EU market is subject to the fulfillment of stringent RoO requirement, which many less developed countries find it difficult to comply with.[40] Preferential treatments are also laden with excessive health and safety regulations that poor countries cannot meet. Therefore, although the tariff levels are declining, various non-tariff barriers are being erected that discourages supply response from some of the most vulnerable countries in the world. This particular issue has been highlighted in a number of country background papers including those of Bangladesh, Nepal and Kenya. Along with not getting duty-free access in the US market, Nepal's agricultural exports are being adversely affected by standards related regulatory measures.

Similarly, both Kenya and Bangladesh in the past have experienced import bans slapped on their fisheries items exported to the west. Currently, horticulture products from SSA are also facing challenges in meeting strict SPS standards.

The important issue is therefore how to build supply-side capacities in poor countries so that they could take advantage of international trade. As these countries' exports are generally highly concentrated in nature, restrictions in a few lines substantially impede their increased trade potential. As the export response is low, the chances of new sectors flourishing in the backdrop of the already established industries' being restricted are very slim. Therefore, without a development-friendly global trade regime, building of exporting capacities and effective participation of the poor countries can hardly be ensured.

Related to the above, one can point out the role of remittances in aiding development and reducing poverty. In spite of providing somewhat less than adequate attention in the country background papers – largely because of not having clear cut trade-oriented focus – the importance of remittances for a number of TDP project countries such as Bangladesh, China, India, Nepal, Pakistan, and Sri Lanka cannot be overemphasised. However, given that labour markets in developed countries are highly restricted, the development potentials of one of the key sectors in which developing countries have clear comparative advantage are ignored. An international trade regime that is intended to promote development in the Southern countries must explicitly consider opening up such sectors that the latter can access effectively, particularly when such access has direct implications for poverty reduction.

Policy Space and Making Use of It

The issue of policy space always gets a lot of attention in the studies and analyses related to trade liberalisation. This is because sometimes the distinction between 'trade policy' and 'policy of trade liberalisation' is not made. TDP case studies have demonstrated the use of effective policy support in a number of cases. For example, the background paper on India mentions that policy support helped create a reasonably good industrial and financial sector base led by public sector enterprises. The case study on China shows how such support was provided in the development of electronics, and how the government established favourable trade and tax policies to encourage technological improvement. China, India and Vietnam also adopted various other measures to boost their domestic production base and exporting capacity.

Implementation of the reform measures implies the reduction of policy space overtime. Multilateral trade negotiations along with donors' pressures for further opening-up and streamlining public sectors means that policy manoeuvrability is greatly reduced. While this can be some cause for concern, it needs to be kept in mind that without judicious decisions the use of policy space can be wasted with unfavourable consequences. Reduced policy space along with limited availability of resources would imply that only a few selective interventions can be undertaken with regard to, for example, promoting sectoral developments. Therefore, the selection of wrong sectors for support can be disastrous. This requires instituting an analytical trade and industrial policy framework so that the scope of the existing policy space can be used in the best possible manner. The failure of the import-substituting interventions further emphasises this point. Thus while the reduced policy space is a challenge that many poor developing countries are faced with, the proper utilisation of the existing space is perhaps even more challenging.

Growth and Poverty Reduction and Pro-active Policy Initiative

A comparative analysis of the TDP project countries shows an overall positive relationship between poverty reduction and economic growth. The project countries that achieved the most significant reductions in poverty were generally those who achieved the highest levels of economic growth, namely China, Vietnam and India. In contrast, most of the countries that failed to reduce poverty (or even saw it increase) are Kenya, Tanzania and Zambia that also failed to stimulate sustained economic growth following their reforms. Along with this broad trend, TDP project studies also vividly portray the widely varying growth and poverty reduction experiences across countries. Indeed country cases are so heterogenous that the resultant experiences are difficult to generalise. There are countries with high growth with high poverty reduction rates (such as China, India and Vietnam) to be contrasted with the Cambodian experience of high growth but low rates of poverty reduction along with low growth rates of both GDP and poverty reduction (such as Tanzania and Zambia).

One lesson that can be derived from these remarkable differences is that while growth helps alleviate poverty, pro-active policy initiatives need to be undertaken to have maximum impact on the poverty situation. The case of property right reforms in Vietnam has been mentioned above, in addition to which a series of programmes were undertaken to transfer resources to specific population groups in the same country. These interventions explicitly favoured or compensated households or communes with specific characteristics. Similarly, the Chinese policymakers undertook comprehensive measures in distributing gains from growth to the less developed regions. In contrast, in the absence of pro-active initiatives liberalisation and increased openness has not managed to translate into poverty-alleviating growth in Kenya, South Africa, and Tanzania.

It then also follows that poverty reduction strategies would also depend on protecting and using some of the policy space effectively. Targeting the poor and vulnerable is now an integral part of most of the TDP project countries' poverty reduction policies. Countries are now also trying to transfer resources directly to the poor through micro-credit schemes and other financial institutions. Policy initiatives are also required to confront the rising inequality. The implication is that success in poverty reduction strategies is dependent on considerable amount of policy space. Trade reforms and the existing poverty reduction strategies often undermine the need for distributional measures, which on the one hand contributes to rising inequality and low growth elasticity of poverty.

Development of Domestic Productive Capacity

It can be inferred from the TDP case studies that development of productive capacities have been instrumental in sustaining economic growth over long periods for the countries that have managed to do so. Examples from China have already been given above which can be related to its efforts to promoting domestic capacity. In the case of India, the view expressed in the relevant background paper (Chapter 5) that despite its pitfalls, the import-substitution policies helped create the reasonably good industrial and financial sectors. Preferences were also ensured for small-scale industries, which contributed significantly in employment generation. Furthermore, the state supported Green Revolution in agriculture resulted in India's becoming self-sufficient in food production. It is indeed quite remarkable to find that both China and India have maintained their food self-sufficiently in spite of their very large populations and high overall economic growth. India has also used export policies to provide support to its domestic industries by making agricultural raw materials available to them before exporting.

It needs to be pointed out that most often the relationship between trade and growth and trade and poverty is envisaged through an export-led growth strategy only, with the belief that sustained export growth is to be the engine of economic growth, which is most important for sustained poverty reduction. However, the inconclusive evidence concerning the hypothesis has been mentioned earlier. When the concentration of export activities takes place with only a few linkages with the rest of the economy, small share of exports in total domestic production, and the "Dutch Disease" effects arising from export boom from a natural resource intensive export item may lead to such weaker relationship. The experience of Cambodia amongst the TDP project countries shows that export expansion is no guarantee for poverty reduction.

In contrast, the Bangladesh background paper argues that even without becoming the "engine" of growth there can be substantial poverty alleviation effects of the export sector if adequate employment can be generated. It points out that the link between export and poverty alleviation through growth is indirect, but through employment generation is not only direct but also supportive of the development of the productive capacity. The Bangladesh experience therefore suggests that an appropriate approach to achieve a more virtuous trade-poverty relationship may be a development strategy that strives to attain adequate export growth rather than export-led growth.[41] This is also consistent with the argument that if countries can ensure growth (i.e. expand productive capacities), exports are also likely to grow as a result of it (Rodrik, 1998).

Productive capacities encompass a large number of factors – development of skills, technological progress, savings for investment, quality of investment (particularly of public investment), etc. These factors are more related to overall development than trade. That is why it has been argued that the national and international policies facilitating the development of productive capacities must be rooted in a development-driven approach to trade rather than a trade-driven approach to development (UNCTAD, 2004).[42]

Taking Advantage of Liberalised Trade Regime

Liberalisation has certainly generated a lot of benefits. In most TDP project countries, benefits arising from deregulation and opening up of the telecommunication sector have been enormous. The issue is not whether to liberalise or not. Rather, how the policy of liberalisation can be used in combination with other options is the fundamental challenge. The policy suggestion of going back to the old days of import-substitution is to be discarded, while the idea of across the board liberalisation needs to be evaluated carefully. Most of the TDP countries are already quite open and how to take advantage of this liberalised regime constitutes an important policy task.

Development of Infrastructure to Promote International Trade

Lack of good infrastructure and particularly trade infrastructure is important. Trade liberalisation alone may not provide much incentive if trade infrastructure remains weak. This includes both physical infrastructure (such as improved roads and port facilities) as well as institutional settings (such as ports and customs procedures, quality of duty-draw back systems, etc). For landlocked countries like Uganda, Zambia and Nepal, this is an even more serious problem, as these countries have to use not very efficient ports and road transportation facilities in the neighbouring countries. The cost disadvantages suffered due to poor infrastructure can very well erode the existing comparative advantage of the suppliers from these countries. On the other hand, institutions can also hamper international trading activities due to cumbersome bureaucratic procedures. These obstacles often discourage accessing the export support measures that have been made available in the post-liberalisation period. Poor infrastructure is likely to be one reason for observing weak supply response to liberalisation.

Managing A Pro-Development Regional Trade Regime

Almost all the TDP project countries are members of some regional trading blocs. Even under the WTO-sponsored multilateral trade talks, there has been a proliferation of RTAs. This tendency has developed given the very slow progress made in multilateral trade negotiations, partly because of developed countries' rigidity over a number of issues. Furthermore, many developed countries are increasingly trying to bypass the multilateral process by striking bilateral deals with developing countries. Under such a situation, developing countries need to be aware of the limitations of such trading arrangements by considering the scopes of their potential trade and welfare gains. Particularly, in regional blocs involving developing countries alone, the scope of trade diversion can be very high. As such, there is a need for evaluating the regional approach to international trade carefully.

Monitoring and Facilitating Adjustment Processes

How the poor are affected by trade liberalisation, including identifying the complementary policies that need to be put in place to help ease the process of adjustment should be considered an important component of anti-poverty trade policy regime. Trade liberalisation measures do not consider the distributional consequences of welfare gains, potentially concealing their negative consequences which are often borne by the most vulnerable socio-economic groups within a country. Effective safety net measures to offset the worst adjustment costs of liberalisation for poorer groups and also to provide some protection against any increased post-reform vulnerabilities should comprise an important component of poverty reduction strategy. Therefore, while the Kenyan sugar sector may be relatively inefficient, without considering the adjustment process, the withdrawal of support for the sector can have disastrous poverty consequences. As it is learnt from the experiences of Zambia, the privatisation process led to some better operational efficiency at the cost of soaring unemployment in the formal sector. Establishing effective trade-poverty linkages would imply adroit handling of policy options so that adjustment costs do not aggravate the poverty situation.

Weak State of Governance

Another significant factor that has contributed to disappointing trade-development-poverty linkages is the weak state of governance in developing countries. Nearly all

TDP country background papers highlight the problems arising from poor management, functional inefficiencies, weak implementation of reforms and development projects. Weak governance almost inevitably is reflected in the poor business climate of which widespread corruption has become a salient feature. It raises the costs of production and trading, makes business less profitable, and discourages investment. In the aftermath of the reform process, when most emphasis is given on the private sector development, poor business environment stifles supply response, particularly of small and medium scale enterprises (SMEs). In many of the project countries, especially those in SSA poor infrastructure, excessive red tape, corruption, an inefficient financial sector and weak institutions have made it difficult for entrepreneurs to operate. As a result, the ability of these economies to create jobs and promote labour-intensive production has been limited.

Political and Social Stability

Political and social stability is also an important precondition for promoting international trade. Many TDP project countries have seen long episodes of civil unrest because of social and political tensions. Lack of stability hampers business decisions as the returns become unpredictable. This is more so in the cases of businesses that tend to rely on labour-intensive processes. It is rather unfortunate that when many developing countries desperately try to ensure market access through regional and multilateral trade negotiations, their own domestic environment does not allow them to take advantage of the opportunities that are already available. Lack of stability means highly mobile capital and firms of this modern era will look for business opportunities in other countries.

1.6 Conclusion

Trade policy has been a fundamental component of development strategies for all the developing countries that try to combine higher economic growth with employment generation in order to ameliorate their poverty situation. Earlier attempts by most of the countries focused on inward-looking development paradigm that sought developing domestic industries under a shield from foreign competition offered by the state. Failure of these attempts resulted in a policy reversal that had witnessed widespread and massive deregulation and liberalisation measures implemented by these countries largely according to the dictum of the Bretton Woods Institutions. The success record of this liberal policy regime is very modest with an overwhelming majority of the poor developing countries still looking for a development paradigm that can address their concerns over low economic growth and high poverty incidence.

Even when one can establish a general relationship between trade liberalisation and economic prosperity, the deviations from this general relationship are so pervasive that the need for studying the individual country cases becomes inevitable in order to better understand as well as inform the policy discourse concerning the trade-development-poverty linkages. Given this, the CUTS-TDP project aims to make some modest contribution by bringing together experiences from13 countries – drawn from Asia and SSA.

Perhaps, the most significant feature of the country experiences studied is that the same set of policies in different countries produces dramatically different results. The differing outcomes could be due to varying physical and geographical characteristics of the countries, the nature of implementation of these policy measures, the capacity and quality of institutions under which the reforms are implemented, and political and social environment. The complex interaction of policy reforms and the existing structural country attributes determine the overall outcomes that are beyond the predictions of simplified theoretical constructs.

It then follows that the same set of policies to deal with the problems bred under diverse situations is unlikely to work unless there are well-designed supplementary policy frameworks to address the heterogeneities. Indeed, the CUTS-TDP country cases clearly exhibit that 'the same size fits all' philosophy has failed to deliver the envisaged results. There is now a general recognition that the policy of liberalisation alone can hardly render benefits, and that there are other critical issues that require urgent attention for promoting trade and development. This, however, does not undermine the merits of many essential reforms, but only questions the overemphasis attached to these measures as panacea for development.

The CUTS-TDP country studies strongly make a case aimed at the need for learning from others' experiences. It is important to know the manner in which reforms were carried out, any complimentary policies undertaken and above all the initial characteristics that provided the background for implementation. As significant dissimilarities emerge with regard to each of these, the case studies also caution against any policy prescriptions that would suggest making blind attempts at replicating the success stories.

Notwithstanding the above cautionary observations, analysis of success records will help individual countries assess their respective context, allowing them to consider appropriate adjustments that might be needed while pursuing good practices. Therefore, the orthodox route to dealing with developmental problems is to be replaced with heterodox approaches. This requires setting up an analytical policy regime capable of identifying structural weaknesses along with the pros and cons of all available policy options in order to formulate the best possible policy mix.

The emphasis on developing an analytical policy regime never means going back to the ages of the old import substitution strategies. It needs to be remembered that like the severely protected regime, the mad rush towards liberalisation has also not worked in many developing countries and therefore the possible options must avoid relying on any of these extremes. A proactive policy regime takes advantage of the static comparative advantage to gain from trade while recognising the scopes for dynamic comparative advantage. Development of domestic productive capacity is a clear focus here so that expanded economic activities including export production can be sustained through an inclusive process that can be participated in by populations of all groups. Such a regime needs to be carefully guided by a solid home grown initiative with firm commitment for its effective implementation.

A pro-active policy regime is also important for distributing the gains from trade as well as growth. TDP case studies have demonstrated the usefulness of interventions in the absence of which growth could bypass the poor. Playing the role of a facilitator so that the relatively backward segment of the population can benefit from trade and growth or to put in place a suitable safety-net mechanism as a fall back option for the most vulnerable groups often requires considerable policy space, which is not well-accommodated in the reform measures that are largely concerned with static efficiency gains in the long run, ignoring the short-run shocks that are required to be addressed with policy initiatives. A well-designed domestically-owned policy initiative is therefore challenged by these constraints and trade-offs.

There is no denying the fact that in many developing countries social and political instabilities seriously confront the developmental efforts. These unfavourable circumstances discourage investment both from domestic and foreign sources. In addition, bad governance as manifested in bureaucratic tangles and widespread corruption constrict the supply response thereby affecting growth. Part of the problem is also associated with weak institutions that characterise most developing countries.

Finally, a development-friendly international trade regime is also equally important in promoting trade-development and poverty linkages in the poor countries. Undiversified production and export structures of these countries imply that tariff or NTBs – either on the ground of trade or non-trade reasons – on a few items of export interest can have a heavy detrimental effect. With the exception of a few countries, export response from a majority of low-income developing countries has been very weak, in the backdrop of which trade barriers against them will only aggravate their already limited exporting capacities. National development strategies with a focus on poverty reduction will work best if the international trade regime is enabling and if increased and effective international financial and technical assistance is provided to poor countries to help develop their production and trade capacities.

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3 Moreover, foreign aid in many cases had carried economic, political and military interest of the donor countries. For instance, according to one estimate, up to 40 percent of the total foreign aid given had been used to serve the military purposes of the donors (Black, 1991, p.57).

4 Economists are generally of the view that growth is the most essential precondition for poverty alleviation. Using a large dataset of 137 developing countries from 1950 to 1999, Dollar and Kraay (2001) show that the incomes of the poorest quintile grow one-for-one with average incomes.

5 According to this theory, openness can influence the long-run level of welfare and the transition to steady state, but not long-run economic growth (Utkulu and Özdemir, 2004).

6 See Winters (2004) for a recent review of the literature, who, concludes: "[T]his paper has documented the strong presumption that trade liberalisation contributes positively to economic performance. For a variety of reasons, the level of proof remains a little less than one might wish but the preponderance of evidence certainly favours that conclusion" (p. F18).

7 He also applies some other alternative indicators such as, average black market premium, coefficient of the variation in the black market premium, index of relative price distortion, average import tariff, average non-tariff barrier coverage, an index of trade distortion, index of effective rates of protection, and World Bank index (1987) on outward orientation and claims that the results support his original findings.

8 In Sachs and Warner's (1995) experiments "open economies grow, on average, by 2.45 percent more than the closed economies, with a highly statistically significant effect" (p. 47).

9 Giles and Williams (2000) provide a comprehensive survey of more than one hundred and fifty published articles on this subject alone. The results coming out of these studies are mixed.

10 Moreover, there is some strong support for the proposition that the relationship between export growth and output growth is weaker in the LDCs than in other developing countries. It has been found that in almost all LDCs and other developing countries, declining exports are associated with declining GDP per capita, but for about a third of the LDCs positive export growth is associated with declining GDP per capita. This proportion is about three times higher than that of the group of other developing countries (UNCTAD, 2004).

11 There are studies based on computable general equilibrium models that try to capture the effects of trade shocks on welfare, income distribution and poverty incidence. These exercises, however, rely on restrictive assumptions and eventually provide *ex-ante* predictions of the impacts of policy shocks on welfare and poverty incidence. What is however more appropriately required is *ex-post* assessment with actual data. Such studies are rarely available.

12 Ravallion (2006, p.1381) concludes, "…a closer look at the time series evidence for China casts doubt on the view that greater openness to external trade has been the driving force in poverty reduction. Indeed, it is hard to even make the case from the available data that trade has helped the poor on balance. More plausible candidates for explaining China's success against poverty can be found in the role played by the agrarian reforms starting in the late 1970s, subsequent agricultural growth (which had an unusually large impact on poverty given a relatively equitable allocation of land achieved in the wake of the early reforms to de-collectivize agriculture), reduced taxation of farmers, and macroeconomic stability".

13 Some discussions in this section draw on Rabinowitz (2006).

14 Note that both the trade-GDP and export-GDP ratios are sometimes regarded as measures of 'openness' or 'trade orientation' of a country. It needs to be mentioned here that, since GDP is a measure of 'value added', i.e. final goods less intermediate inputs, while exports are not, the export-GDP ratio appears to be bigger than its actual contribution to GDP.

15 The estimated regression relationship shows that each doubling of population from one country to another reduced export-propensities by almost 3 percentage points, as in (2) multiplied by 4.14 (the estimated slope coefficient) is 2.9. There are, however, large variations around this average relationship resulting in a very low R2 value that measures the goodness of the fit of the estimated linear relationship.

16 The regression line fitted into the scatterplot can be interpreted as the line showing the predicted export-ratios for individual countries based on cross-country experiences. For example, given the size of its population, the cross-country relationship predicts an export-GDP ratio of 35 percent in contrast to the actual figure of 70 percent thereby making the country an 'over'-exporter.

17 Discussions on the problems of commodity producing countries and their implications for development can be found in Grynberg and Newton (Ed) (2007).

18 The trade in textile and clothing was long restricted in developed countries and the resultant quota system for controlling imports caused global dispersion of production in the sector by limiting imports from such countries as China, Hong Kong, India, and South Korea, that would have resulted in much bigger export volumes were they not constrained by their quota allocation. During 1974-2004 these import quotas had been governed under the so-called MFA. The operation of this managed trade led to exporting opportunities in many other developing countries (including Bangladesh, Cambodia, Sri Lanka and Vietnam) where textile and clothing were not traditional export items.

19 The Bangladesh country background paper as presented in Chapter 2 of this volume points out that its export growth has been single-handedly driven by clothing items under the shield of the global MFA quota system. The growth of exports from other sectors has been sluggish. Therefore, the export response to liberalisation of the trade regime is thought to be very weak or non-existent.

20 In 2005, India's services exports stood at more than US$70bn or 42 percent of total exports.

21 That is, growth of exports in all these countries is picking up from export bases that either suffered declines (in the cases of Pakistan, Kenya, and Zambia) or managed to expand little.

22 As discussed earlier, however, the export-led growth hypothesis is far from being conclusive. Without inferring about the causality running from exports to GDP, it is nevertheless true that export and GDP growth rates are closely associated.

23 As the estimated relationship shows, for the global economies (Figure 1.4) a one percentage point increase in export growth is associated with a 0.19 percentage point rise in GDP growth rate, while the comparable effect for the set of TDP project countries (Figure 1.5) is 0.30. The scatterplot for the set of TDP project countries also gives a better fit as reflected in its much higher R2 values compared to the fit obtained for the set of global economies in Figure 1.4. For reason discussed earlier, we refrain from inferring about the direction of causality.

24 One could argue that the simple average tariffs did not truly reflect liberalisation. In fact, it is very difficult to obtain a measure that can adequately capture the liberalisation efforts. For simplicity and availability of the same information for all the countries, this particular measure of liberalisation is used here.

25 The Bangladesh country paper as presented in Chapter 2 of this volume argues that the superior growth performance of the country in the 1990s cannot be correlated with any of the liberalisation indicators available.

26 During 1995-2002, there were only 16 developing countries that had experienced average GDP growth higher than India. While this is true that since then India has liberalised further, it does not affect the point being made as tariffs and growth are both compared for period up to 2002.

27 Most analyses on ‘gains from trade’ and/or growth effects seem to ignore the issue of distributional consequences. However, the goal of poverty reduction may be critically determined by the nature of distribution of these gains.

28 Note that the poverty incidence measures are based on the national poverty lines and not on the basis of the often used line of US$1-a-day.

29 This is what is reflected in the R2 value of the estimated regression equation.

30 However, note that for China the sample period is much longer. Also, as China’s poverty incidence already fell to a much lower level by the early 1990s, the average over a bigger period of about 20 years makes its poverty reduction record look somewhat less remarkable than is usually perceived.

31 This is defined as the percentage change in poverty headcounts over the annual average GDP growth rate during the spells for which comparable poverty incidence data are available.

32 Bangladesh’s exports are critically dependent on the labour-intensive textiles and clothing items (popularly known as readymade garments in the country). Currently, this item alone accounts for 76 percent of Bangladesh’s total exports, providing direct employment to more than two million people.

33 Since only a bi-variate relationship between exports and poverty is plotted in Figure 1.10, the influence of other factors cannot be captured.

34 Apart from India and South Africa, all other TDP countries are currently implementing their PRSs.

35 In Kenya, the modest expansion in the country’s exports has largely been attributed to the growth of the horticultural sector, while mineral resources, fish and fish products, and horticulture have emerged to be the newly developed sectors for Tanzania.

36 Indeed, what is known as the Second Welfare Theorem in Economics, argues that after an initial wealth distribution, if the market takes over, efficient outcomes can be achieved.

37 However, despite relatively low growth of agriculture, India, like China, has maintained its food self-sufficiency.

38 For example, the demand for primary commodities is price and income inelastic in nature. This means that a fall in the prices of these products will result in less than proportional rise in demand. Similarly, the low income elasticity of demand will be reflected the less than proportional rise in demand in the face of rising income of the consumers.

39 Average tariffs on textiles and clothing items are much higher than average applied tariffs on other industrial goods. For example since 1995 while the average applied tariffs on industrial goods in the developed countries has been around 3.5 percent, for textiles and clothing the corresponding rate is more than 16 percent in the US and 12 percent in the EU.

40 This is particularly true in the case of EU RoO in textiles and clothing.

41 This is what is also recommended in UNCTAD (2004) – according to which in an export-led growth strategy export expansion is the major demand-side component of economic growth. By contrast, in a strategy that seeks adequate export growth, both export expansion and domestic demand expansion are important demand-side components of economic growth. There is thus more balance between domestic demand and export expansion in the process of growth.

42 It is mentioned in UNCTAD (2004) that an exclusive focus on trade, which assumes that poverty is reduced through trade rather than through development, is likely to prove counter-productive.

2

CHAPTER

Trade, Development and Poverty Reduction: *Evidence from Bangladesh*

– Mohammad A Razzaque[1]

2.1 Introduction

Although trade and development strategies are intimately related, the link between trade, development and poverty alleviation has been a subject matter of intense research and analyses, generating persuasive evidence as well as counter-evidence to baffle the consumers of this literature. The collapse of the centrally planned economies, malfunctioning of the import-substituting regimes, economic 'miracles' of 'Asian tigers', and cross-country regression results exhibiting open economies doing better are the key evidences of the trade liberalisation school (e.g., Dollar 1992; Dollar and Kraay 2000; Sachs and Warner 1995; World Bank 1993). In contrast, while the leading opponents do not reject the role of trade reforms, they emphasise that the benefits of trade openness should not be 'oversold'. In support of their view, they strongly point out Asian tigers' use of trade-distorting measures (such as, subsidies and selective interventions), all of today's advanced countries' embarking on growth behind tariff barriers, and use of doubtful variables and sloppy econometrics in establishing the relationship between openness and economic performance (Rodrik 2002, 2001, 1995; Rodriguez and Rodrik 2000).

Similarly, turning to the trade-poverty nexus, very recent research has confirmed considerable heterogeneity in the welfare impacts of trade openness, casting doubt on any presumption on both sides of the liberalisation debate (Ravallion 2005).[2] In this backdrop, it has been argued that trade policy should be regarded as an essential and integral component of the whole set of policies designed to achieve the growth and poverty reduction objectives, where other policies are not to be treated merely complimentary to trade policy, but all complement one another (UNCTAD 2004).

The relationship between trade, growth and poverty also has an important relevance to Bangladesh. In its pursuit for development, Bangladesh has moved away from an inward-looking to outer-oriented development strategy. The once heavily foreign aid-dependent economy, has demonstrated a spectacular transformation into a trade-dependent country, registering a rapid rise in exports from US$1.5bn in 1990 to US$12bn in 2005.[3] While the growth of labour-intensive ready-made garments (RMG) exports has established a direct link between trade and the most important development objective of the country, i.e. eradication of poverty, the end of Multi-fibre Arrangement (MFA) has brought about a great deal of uncertainty about the future prospect of trade being an effective means of poverty alleviation.[4]

The main objective of this paper is to highlight trade and development perspectives from the experiences of Bangladesh. Drawing upon existing research, this paper first summarises the measures taken by Bangladesh in liberalising its trade regime in Section 2.2, while it provides an assessment of the effectiveness of trade reforms in Section 2.3. In Section 2.4, it points out a number of issues for making trade policies effective for poverty alleviation.

2.2 Trade Liberalisation in Bangladesh

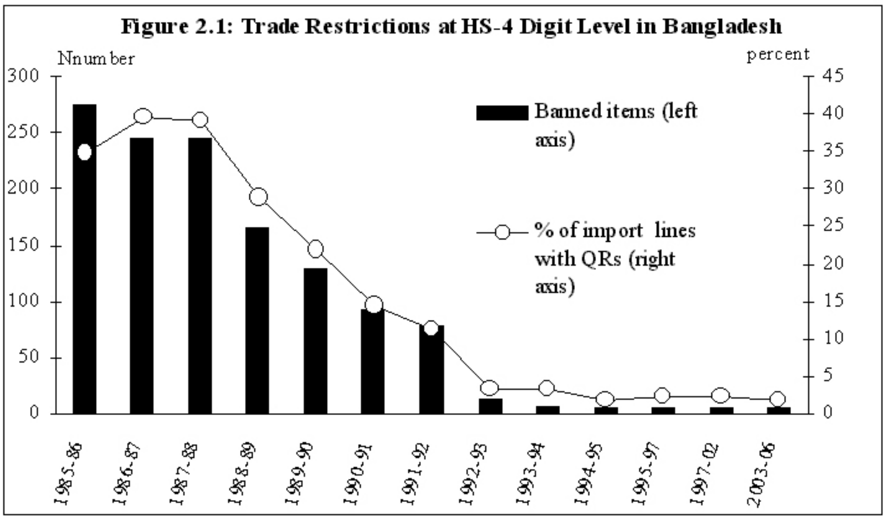
Bangladesh pursued an import substitution (IS) industrialisation strategy in the 1970s, using such policy instruments as high import tariffs, quantitative restrictions (QRs), foreign exchange rationing, and an overvalued exchange rate.[5] It was believed that the strategy of replacing imported goods with domestic production would ease the balance of payments (BoP) situation and at the same time achieve the national objectives of economic growth and reduction of unemployment. Although the choice of IS strategy was generated through macroeconomic concerns *vis-à-vis* the BoP and fiscal balance (Rahman, 1994), even after a decade of a highly protected trade regime – both the internal and external balance situation continued to worsen (Bhuyan and Rashid, 1993). It was against the backdrop of serious macroeconomic imbalances of the early 1980s that the policy of reforms for stabilisation and structural adjustment was undertaken along the guidelines specified by the International Monetary Fund (IMF) and the World Bank (Mahmud, 1995).

Trade liberalisation policies pursued by Bangladesh have passed through three phases. The first phase (1982-86) was undertaken as Bangladesh came under the purview of the policy based lending of the World Bank; the second phase (1987-91) began with the initiation of the three-year IMF structural adjustment facility (SAF) in 1986; and, finally, the third phase, since 1992, was preceded by the IMF sponsored Enhanced Structural Adjustment Facility (ESAF).[6] The liberalisation programmes have resulted in significant changes in the country's trade policy regime.

Reforms of Quantitative Restrictions, Tariffs and Exchange Rate

The liberalisation process toward removal of QRs began in 1985. Since then the number of trade-related HS-4 digit banned items has declined from 275 to 5. In 1987-88, about 40 percent of all HS-4 digit import lines was subject to trade-related QRs, but these restrictions had drastically been reduced to less than two percent (Figure 2.1). In fact, QRs no longer poses any significant trade barriers.

In addition to dismantling non-tariff restrictions, import tariffs were cut drastically. The highest tariff rate was brought down from 350 percent in 1992 to 25 percent in 2004-05. The number of tariff slabs (including zero) has come down from 24 in the 1980s to only 4, thereby greatly simplifying the tariff structure. Taxation on imports traditionally included a combination of custom duties, excise duties, sales and other taxes. A supplementary duty – supposed to be a trade-neutral consumption tax – was introduced to replace regulatory duties on imports. Furthermore, a uniform 15 percent value-added tax (VAT) on both imports and domestically produced goods replaced the import discriminatory multiple rate sales tax. This has increased government revenue and has contributed to reducing the protection enjoyed by the domestic import-substituting industries.

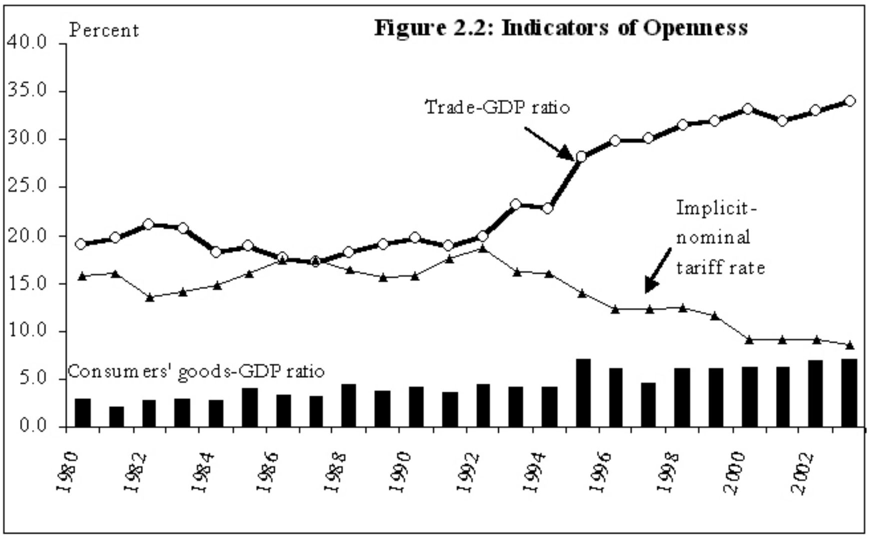


Until the early 1980s, Bangladesh maintained an 'overvalued' and fixed exchange rate system, which was then replaced by a 'managed' system of floating when the Taka was made pegged to a basket of currencies. Alongside the official one, an additional exchange rate for attracting remittances from the Bangladeshis working abroad and for providing some incentives to the exporters of non-traditional items was put in place. Due to conditionalities imposed by the IMF, serious reforms of the exchange rate regime were undertaken in the early 1990s, which included unification of the exchange rates, convertibility of taka in the current account, and other relaxation on foreign exchange transaction. Again, along the guideline of the IMF, the government introduced the free-floating of Taka in 2003.

Another important element of trade policy reform has been the operation of a set of generous support and promotional measures for exports. Important export incentive schemes available in Bangladesh include, *inter alia*, subsidised rates of interest on bank loans, duty free import of machinery and intermediate inputs, cash subsidy, and exemption from domestic taxes. Along with these domestic schemes, many exporters have also been benefited by preferential treatment granted by other trading partners under various Generalised System of Preferences (GSP) schemes.[7] The country has also benefited from the clothing exporting opportunities arising out of the MFA quotas.

Liberalisation and Openness of the Economy

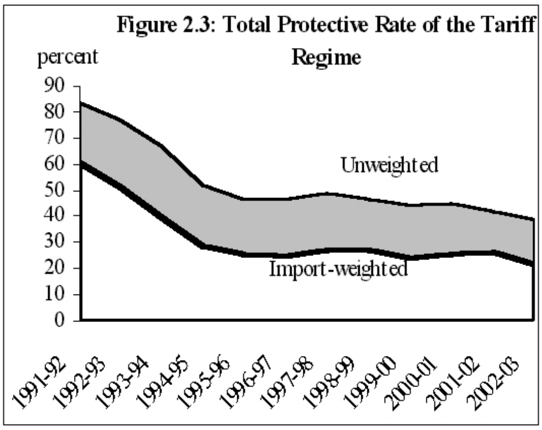
By any standard, Bangladesh's economy is now much more open than what it was before. Liberalisation makes imports cheaper and easier in the domestic economy, and by reducing disincentive to export-oriented sectors is supposed to encourage export activities. The overall impact then should be a rising share of trade in national income. As reflected in Figure 2.2, the trade integration of Bangladesh's economy has registered a significant rise from 17 percent in the mid-1980s to 34 percent in 2003. The import penetration of consumers' goods may be considered as a good proxy for real liberalisation, as the restrictions on capital goods and raw materials are usually relaxed to facilitate domestic production while final consumers' goods are liberalised at a much



later stage. Figure 2.2 shows the ratio of imports of consumers' goods to GDP increasing from 2 percent to 6 percent of GDP. Again, with intensified liberlaisation, the implicit nominal tariff rate, defined as the ratio of total customs revenue divided by total imports, has, as expected, declined from more than 18 percent in the early 1990s to less than 10 percent in 2000 (see Figure 2.2).

Policy-induced Anti-export Bias

One of the basic objectives of reforms has been to reduce the policy-induced anti-export bias. The principal route to this 'bias' is engineered by allowing the domestic prices of import competing sectors relative to those of export activities to rise under the shield of high protection granted to the former. Liberalisation of the import regime therefore contributes to the reduction of this policy bias. It is estimated that the unweighted customs duty has fallen from 57.2 percent in 1991-92 to only 16.5 percent in 2002-03 (Ministry of Commerce 2004) with the import-weighted rate registering a decline from 24 percent to 12.4 percent. One unusual aspect about Bangladesh's tariff regime has been the recent increase in the use of taxes that ideally should be incentive-neutral, but because of their discriminatory imposition against imports, mainly for raising revenues, they become protective. Consequently, such taxes as supplementary duties, infrastructural development surcharges, and VAT have some protective contents over and above the customs duties. However, the total protective rate, both unweighted and import-weighted, has also conceded significant decline (see Figure 2.3).



The downward adjustments in tariffs have resulted in reduced nominal protection for domestic import-competing activities both in the agriculture and manufacturing sectors (see Table 2.1). Protection given to net value-added, known as the effective rate of protection – considered to be a better measure than nominal protection, as the former explicitly takes into account the protection extended to the intermediate inputs – is shown to have exhibited a steady decline from 76 percent in 1992-93 to 24 percent in 2000 (see Figure 2.4).

Table 2:1 Nominal Protection by Sectors (%)

	1990-91	1998-99
Unweighted		
- agriculture	90.5	26
- manufactures	89	26
- all tradables	88.6	28.2
Import-weighted		
- agriculture	20.9	10.1
- manufactures	51.8	23.8
- all tradables	71.9	20.3

Source: Compiled from World Bank (1996 and 1999)

It then follows from the above that, trade liberalisation may have caused anti-export bias to decline. Along with the liberalisation of the import regime, Bangladesh has also provided certain benefits (such as cash and interest rate subsidies) to exporters in order to improve their price incentives relative to others (i.e. import-competing producers). Therefore, in evaluating the anti-export bias of the trade regime both the discriminatory import protection and export support will have to be taken into account. Using an incentive-relative definition based on the relative average effective exchange rate for exports (i.e. nominal exchange rate adjusted for such export incentives as subsidies) and for imports (i.e. nominal exchange rate adjusted with protective trade interventions), the anti-export bias estimated to have fallen to 18 percent in 2002-03 from 60 percent in 1991-92, when unweighted protective rates on imports are used. The use of import-weighted trade taxes results in a falling anti-export bias from 22 percent to 13 percent in 2003 during the same period.

Figure 2.4:Trends in Average ERP

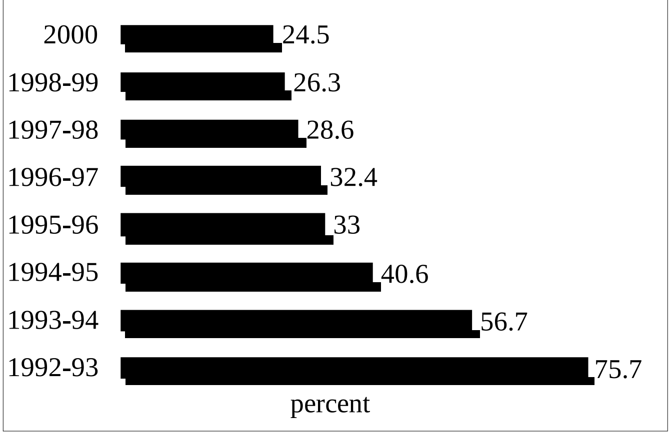
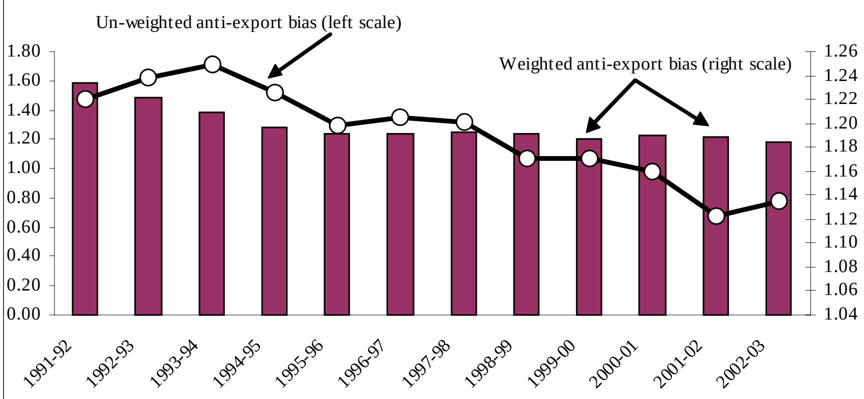


Figure 2.5: Trends in Anti-Export Bias

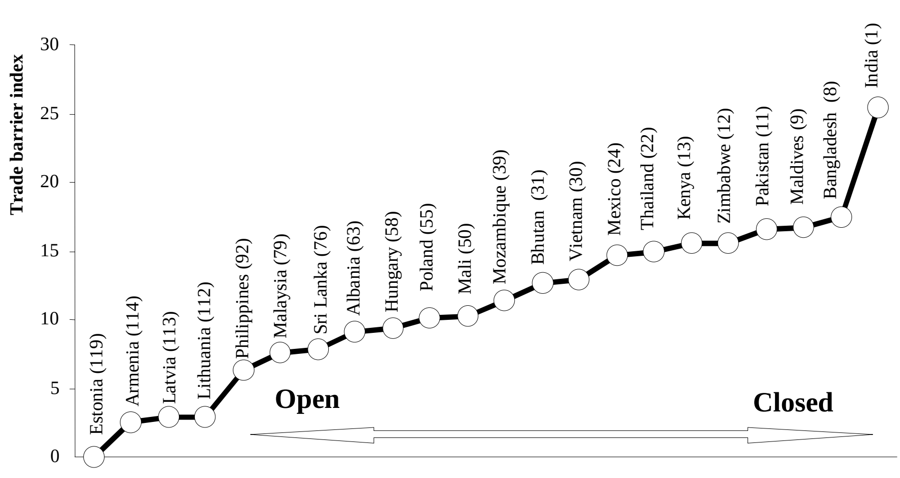


Note: The anti-export bais is defined here as the ratio of effective exchange rate for exports (EERX) to effective exchange rate for imports (EERM). All protective import taxes are used to compute EERM, while export support measures (such as interest and cash subsidies) have been used for EERX. Any ratio greater than one is the evidence of anti-export bias. Details of these estiamted measures are available in Ministry of Commerce (2004).

Bangladesh's Openness in Global Context: A Comparative Picture

How does Bangladesh compare with other countries in terms of trade barriers? In the first half of the 1990s, Bangladesh embarked on a hasty liberalisation process, recording one of the most rapid reductions in tariffs as measured by the ratio of post-reform average tariffs to pre-reform rates among a set of world economies that had undertaken trade liberalisation measures (World Bank 1999). Since the late 1990s, however, the pace of tariff liberalisation in Bangladesh has somewhat slowed down. Using the UNCTAD Trade Analysis & Information System (TRAINS) data at the 6-digit HS classification

Figure 2.6: Trade Barrier Index for Some Selected Developing Countries



Note: Figures in the parentheses indicate relative country ranking in terms of trade barrier indiex. Higher index vlaues (lower ranks) represent more closed economies. The index has been calculated for 119 countires for which information is available.
Source: Based on estimates as presented in Raihan (2005).

level, Raihan's (2005) estimation of a trade barrier index (TBI) ranks Bangladesh 8th most closed economy out of 119 world economies for which the information was available (see Figure 2.6).[8] Among the South Asian countries, only India has a TBI value higher (thus representing even a more closed economy) than Bangladesh.[9]

2.3 Assessing Trade Reforms

Policy of Trade Reforms and Poverty Alleviation

Poverty alleviation is the most important policy objective in Bangladesh and almost all development initiatives in the country either directly or indirectly intended to make contributions to this mammoth endeavour. One important motivating factor behind the trade reform measures has been their potential poverty alleviating effects. Liberalisation of trade regimes is thought to result in more efficient allocation of a country's resources, enhanced efficiency due to competition, increased capacity utilisation, expansion of employment of labour and other natural resources, and acquisition of better technology. It is through these routes, trade is supposed to influence growth performance positively, which, in turn, would ameliorate the poverty situation.

Partly because of strong advocacy by the principal multilateral donors and partly due to increased globalisation, trade liberalisation measures so far undertaken by Bangladesh is broadly perceived to be in line with the overall goal of poverty alleviation strategy. Nevertheless, there is some disagreement with regard to further trade reforms. While the multilateral donors strongly recommend for a more vigorous *across-the-board* trade reforms, many are in favour of a gradual and pro-active analytical policy regime so that effective support to the growth of activities with significant poverty alleviation effects can be provided (Mahmud, 2003). It is indeed interesting to observe that, the draft poverty reduction strategy paper prepared by the Government of Bangladesh strikes a balance between these two views as it mentions "Bangladesh is committed to setting up a domestic incentive structure which is largely non-distortionary in nature and minimises policy-induced anti-export bias" (Government of Bangladesh 2004, p.64). However, there has not been any explicit mention about the direction and pace of future trade liberalisation programmes.

Empirical Evidence on the Effects of Trade Liberalisation

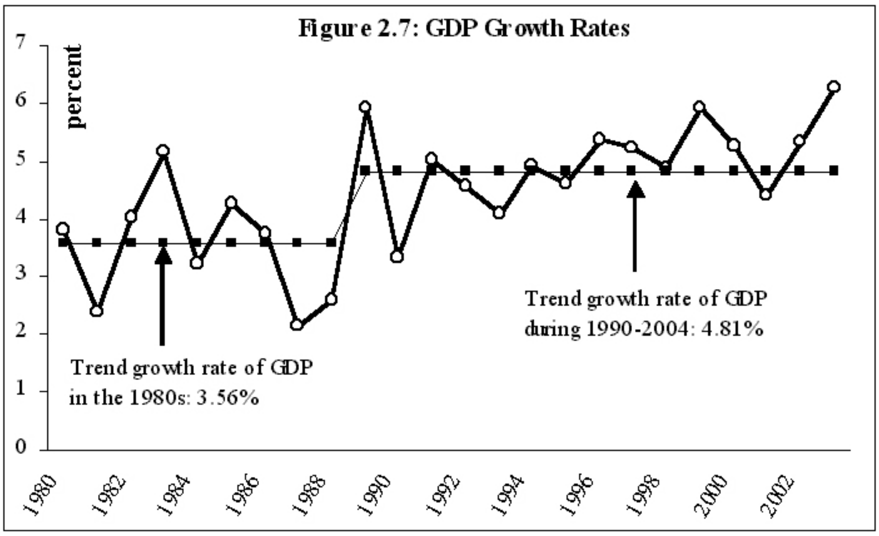
Keeping aside the theoretical arguments, how trade related measures fit with the overall policy of poverty reduction will ultimately depend on the effectiveness of reforms, for which empirical evidence is needed. In the context of Bangladesh, poverty effects of liberalisation could be studied through several routes. First, there is a strong presumption of the overall economic growth having 'trickle down' effects and thus if liberalisation contributes to economic growth, it should also have a positive impact on poverty reduction. Second, by attempting to correct the domestic incentive structure, trade reforms could lead to what is called an export-led growth. Following the most influential theory of international trade, export goods of a labour-intensive developing country are likely to be labour-intensive in nature, resulting in employment opportunities and rise in the wages of labour. Hence, by making exports an engine of growth, trade liberalisation could have important positive effects on the poverty reduction efforts of a country.

However, the most direct and comprehensive route to study the poverty effects is to consider an analytical framework, as suggested by Winters (2000), in which the effects of trade policy are linked to households via a set of important institutions, enterprises, distribution channels and government. Under this ideal framework, the first impact of trade liberalisation will be on the prices of goods and services. The second channel affecting households is through its impact on profits of enterprises and hence on employment and wages. The third important link in this specification is through the changes in government revenue and expenditure as a direct consequence of liberalisation. When trade taxation is an important source of revenue, reduced public resources as a result of trade policy reform is most likely to affect households dependent on the provisioning of the public services.

It needs to be mentioned here that, there has not been any serious government initiative to study the effects of reform measures. Whatever analyses exist have been undertaken under the initiatives of multilateral donors, research organisations, and academics. Most of the studies undertaken are descriptive in nature, and consequently, testing of specific theories or propositions concerning the link between reform measures and outcomes is not carried out. These studies do gather and analyse a large body of information about the nature of trade policy as well as the process of implementation of the liberalisation measures, from which a plausible account of the extent to which trade reforms have been responsible for the observed changes in the variables or indicators of interest is attempted.

However, the main disadvantage of this approach is its inability to test a theoretical model to validate the claims made empirically. Consequently, it is not possible to confirm whether the explanations offered by descriptive studies should hold in general or are mere coincidences or are true only to a particular sub-sample within a large sample (McCulloch et al. 2002). In contrast, the main attractive feature of the empirical approach is its ability to conduct statistical tests of the hypotheses, controlling for other factors that could have also influenced the outcomes.[10] Empirical analyses are of two types: *ex-post* and *ex-ante*. While the former is intended to examine what has actually happened, the *ex-ante* exercises simulate different policy scenarios to predict the outcomes. A simple way of assessing the effectiveness of trade reforms in Bangladesh is to compare the variables of interest (e.g., growth of GDP) in pre- and post-liberalisation periods. In such comparisons, the decade of the 1980s is regarded as the pre-reform period. The trend growth rate of GDP in the 1980s was 3.51 percent as against of 4.81 percent during 1990-2004. The difference between the two trend rates comes out to be statistically significant, indicating a better economic performance in the liberalised period, which is often flagged out strongly to demonstrate the success of trade reform measures (World Bank 1999; Ahmed and Sattar 2004).

This simple approach is, however, seriously flawed as it does not take into account the sources of growth, i.e. factors of production and Total Factor Productivity (TFP) growth. Therefore, it is not clear whether after controlling for traditional sources of growth and liberalisation would have any distinct effect. In the absence of such an analysis, skeptics, taking an extreme view, could argue that the increased rate of growth in the post-liberalisation period arose irrespective of reform measures (i.e. higher growth 'despite' rather than 'because of' liberalisation). Another serious problem associated with the above approach is its specification of one particular point in time as the separator between pre- and post-reform regimes. After all, many reforms were implemented through out the 1980s and hence the existence of such a break point is utterly unrealistic.



To overcome the above problems, Razzaque *et al.* (2003) and Raihan (2005) have employed regression methods to explain the output/growth performance using continuous time-varying indicators of trade liberalisation measures along with factors of production. In the first study, Razzaque *et al.* extended the traditional neo-classical and endogenous growth models by incorporating three widely accepted trade liberalisation measures, viz. trade-GDP ratio, ratio of consumers' goods to GDP, and the implicit nominal tariff

Table 2.2: Trade Liberalisation Measures in Growth Models

Explanatory variables	Coeff (s.e.)	Coeff (s.e.)	Coeff (s.e.)	Coeff (s.e.)	Coeff (s.e.)	Coeff (s.e.)
Constant	6.08*** (1.61)	6.35*** (0.61)	6.23*** (0.69)	3.53*** (0.43)	3.40*** (0.28)	3.31*** (0.39)
ln (Capital Stock)	0.23** (0.08)	0.22** (0.09)	0.23** (0.09)	0.50*** (0.07)	0.53*** (0.05)	0.53*** (0.08)
ln (Labour)	1.13*** (0.15)	1.15*** (0.18)	1.12*** (0.18)	-	-	-
ln (Human Capital)	-	-	-	0.90*** (0.19)	0.80*** (0.19)	0.84*** (0.22)
ln (Trade-GDP ratio)	-0.014(0.012)	-	-	0.008 (0.02)	-	-
ln (Consumers' goods-GDP ratio)	-	0.008 (0.01)	-	-	0.005 (0.01)	-
ln (import duties/imports)	-	-	0.006 (0.01)	-	-	-0.001 (0.02)

*Notes: Natural logarithmic transformation is indicated by ln. The dependent variable in each case is ln(GDP). Standard errors are represented by (s.e.). The sample period is 1980-2000 for which the revised estimates of Bangladesh's GDP were available at the time of the study. Labour is proxied by population while the literacy rate is considered as a measure of human capital. The regression analysis considers the time series properties of the variables. All variables are found have unit roots on their levels. Hence, to avoid the problem of spurious regressions, models are estimated using the Phillips-Hansen Fully Modified Ordinary Least Squares technique. Statistical significance at the one, five and 10 percent levels are indicated by respectively, ***, ** and *. For the neoclassical growth and human capital models, the null-hypothesis of no long-run relationship (non-cointegration) is rejected at the conventional statistical significance levels.*

Source: Razzaque et al. (2003).

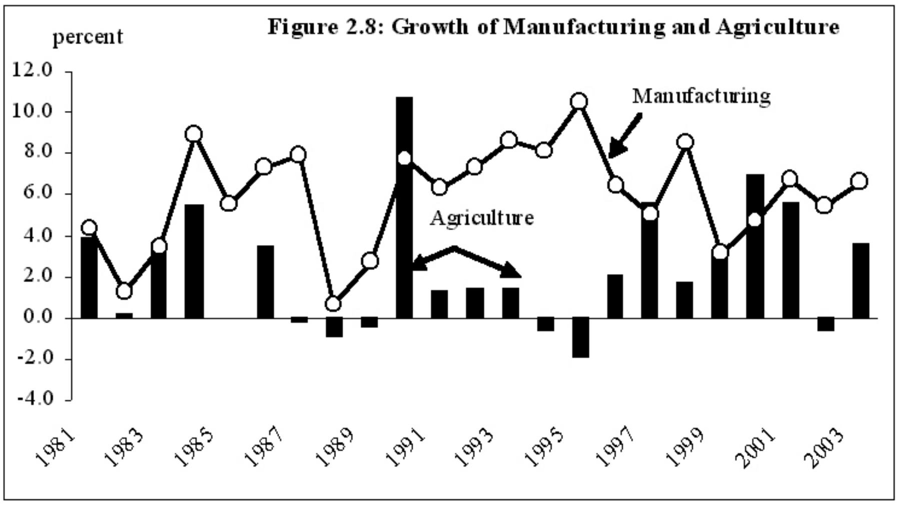
Table 2.3: Trade Liberalisation Measures in Panel Data Models of Manufacturing Output					
Explanatory variables	**Coeff (s.e.)**	**Coeff (s.e.)**	**Coeff (s.e.)**	**Coeff (s.e.)**	**Coeff (s.e.)**
ln (Capital)	0.356*** (0.074)	0.339*** (0.07)	0.286*** (0.06)	0.362*** (0.074)	0.359*** (0.07)
ln (Labour)	0.492*** (0.05)	0.493*** (0.05)	0.498*** (0.04)	0.488*** (0.05)	0.491***(0.05)
ln (import penetration ratio of consumers' goods)	-0.041* (0.015)	-	-	-	-
ln (implicit nominal tariff rate)	-	-0.146 (0.28)	-	-	-
ln (Sectoral import penetration ratio)	-	-	-0.129*** (0.04)	-	-
ln (Sectoral export-orientation ratio)	-	-	-	0.086 (-0.124)	-
Liberalisation year dummy	-	-	-	-	-0.105** (-0.05)
R^2	0.64	0.74	0.77	0.75	0.63
Observations	594	594	594	594	594

*Notes: Natural logarithmic transformation is indicated by ln. The dependent variable is ln(manufacturing output). Dynamic OLS is used in estimating the regression models. Standard errors are represented by (s.e.). Panel data of manufacturing output comprising 27 sectors for 22 years (1977-1998) are used, which come from the Bangladesh Bureau of Statistics (BBS) Census of the Manufacturing Industries (CMI). Panel unit root testing of the variables is considered and because of the presence of unit roots, panel cointegration tests have been conducted to confirm the long-run relationship amongst the variables. Statistical significance at the one, five and 10 percent levels are indicated by *** ** * and respectively. The models have been estimated using alternative estimation methods, such as, unrestricted error-correction and generalised methods of moments, but the conclusion about the effect of liberalisation indicators remain unchanged.*

Source: Compiled from Raihan (2005).

rate. While the estimated models turned out to be satisfactory, none of the indicators of trade liberalisation, quite surprisingly, achieved statistical significance in any of the regressions (see Table 2.2).[11] On the other hand, Raihan concentrated on the manufacturing sector using a panel of 27 industries over a long period of 22 years (1977-98). Extending the production function framework, the author used five indicators of liberalisation. Not in a single instance statistically significant positive effects could be found (see Table 2.2). Rather, in a number of cases significant negative effects are obtained (see Table 2.3).

The impact of trade reforms on the manufacturing sector in particular has attracted a lot of attention. Although compared to the 1980s, the sector had achieved an annual average growth 1.5 percentage points higher in the 1990s, the reason for the latter period's superior growth was to be entirely attributable to the export-oriented RMG sector, which grew rapidly. The high growth for the RMG sector would imply non-RMG manufacturing sectors declining in the post liberalisation period.[12] This has led some observers to point out that trade liberalisation has resulted in deindustrialisation (Bakht, 2001), especially when the growth of the RMG industry is unlikely to be the result of liberalisation (Rashid 2000), as is further elaborated later in this paper.[13] Even with the inclusion of the RMG sector (see Figure 2.8) manufacturing growth in the post-liberalisation period appears to be unimpressive. Turning to the other real sector, there is a general recognition



even amongst the advocates of liberalisation that agriculture did not show dynamism in the post-reform period (Ahmed and Sattar, 2004). The trend growth rate for agriculture during 1991-2003 is found to be not significantly different from that of the 1980s.

Juxtaposing liberalisation programmes and export performance Bangladesh is often demonstrated as a country that has been successful in energising exports through trade reforms. In 1979-80, the country's total exports stood at US$913mn, which increased to US$1.5bn by 1989-90 and then rocketed to US$8.6bn in 2004-05, recording an annual average growth rate of 11 percent during 1991-2005. As a result, the export-GDP ratio registered a significant rise from less than 6 percent in the late-1980s to about 14 percent in 2004. Until the end of the 1980s, no clear association between export growth and GDP growth could be detected, but since the beginning of the 1990s a co-movement of the two growth rates had been more apparent.[14]

It is, however, quite striking that, even towering growth rates of exports are associated with only slight changes in GDP. Thus, there is very little difference between the impacts of as high as more than 20 percent (as in 1995) and just about 5 percent (as in 1999) rise in exports (see Figure 2.9). A simple bi-variate relationship shows that a one-percentage point increase in GDP growth rate will require, on average, a 20-percentage point higher export growth rate (see Figure 2.10).[15]

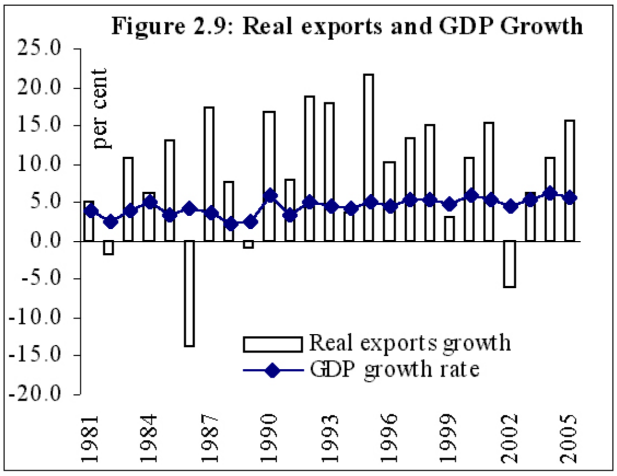
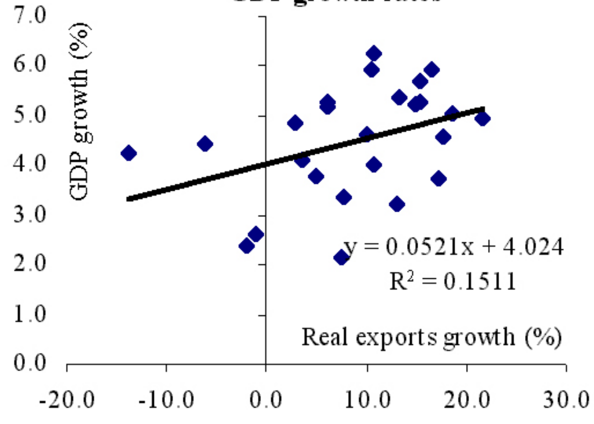


Figure 2.10: Scatter of real exports and GDP growth rates



The robust growth performance of exports has led many observers to justify the export-led growth (ELG) hypothesis for Bangladesh. The ELG theory postulates a causal effect of exports on GDP and allows for significant positive externality effects of exporting activities on the non-export sectors (Feder 1982). While pulling data over the pre- and post-independence periods of 1963-1992, Begum and Shamsuddin (1998) claim to have found evidence for exports causing GDP growth, Islam and Iftekharuzzaman (1996) and Razzaque *et al.* (2003) fail to corroborate the hypothesis using data exclusively for the independent Bangladesh. Of these three empirical exercises, only the last one has used the recently revised national income data and therefore probably provides more reliable evidence.

The same study also does not find any significant effect of trade liberalisation on the export-growth relationship. Although the absence of any causality and externality effects of the export sector may appear to be striking, there is a convincing reason to explain this empirical finding. While GDP is a measure of (gross) 'value added', a significant proportion of exports is intermediate inputs that do not comprise value added. As the growth of Bangladesh's exports is overwhelmingly dominated by RMG products, which have been critically dependent on imported inputs, if one considers just the domestic value added in exports, its share as percentage of GDP has increased only modestly from 4.4 percent in 1991 to 8 percent in 2003. This share is probably too small to make the export sector as the engine of growth for Bangladesh.

The impressive performance of the export sector has also been attributable to trade liberalisation measures in Bangladesh (Ahmad and Sattar 2004), which is difficult to support. This is because the RMG sector – the main driver of export growth – grew mainly because of a restricted trade policy regime of the developed countries. After the abolition of MFA quotas, Bangladesh's exports have now become subject to fierce competition, with a number of studies predicting adverse consequences for the country.[16] The response of other export items has been very weak. It has been estimated that of the 17 percent annual average growth in exports during 1990-96 and of 8 percent during 1997-03 the contributions of non-RMG items were respectively 1.31 percent and 0.11 percent (see Table 2.4).[17] The dismal performance of all these export commodities seems to suggest that trade reform measures may not have been successful in stimulating export response.[18]

Table 2.4: Export Items and Their Contribution to Growth: 1990-2003 (percent)						
Export Category	**Annual average growth: 1990-96**	**Share in total exports: 1990-96**	**Contribution to growth 1990-96**	**Annual average growth: 1997-03**	**Share in total exports: 1997-03**	**Contribution to growth 1997-03**
Major Export Items						
Raw Jute	1.6	4.08	0.07	0.98	1.52	0.01
Jute Goods	2.67	13.56	0.36	-3.05	4.93	-0.15
Leather and leather goods	9.67	7.73	0.75	-2.21	3.94	-0.09
Tea	-1.42	1.68	-0.02	-5.68	0.53	-0.03
Frozen Food and Shrimps	13.45	8.00	1.08	1.93	5.73	0.11
Garments	27.89	57.51	16.04	10.49	75.51	7.92
Other commodity groups						
Petroleum products	39.21	0.89	0.35	40.88	0.24	0.10
Chemical products	26.37	2.16	0.57	3.81	1.59	0.06
Paper and paper products	-39.15	0.13	-0.05	164.63	0.00	0.00
Handicrafts	12.07	0.28	0.03	1.56	0.11	0.00
Engineering	47.19	0.45	0.21	94.71	0.19	0.18
Other manufactured products	71.54	1.27	0.91	27.09	4.67	1.26
Total	**17.35**	**100**	**17.35**	**8.03**	**100**	**8.03**

*Note: Contribution to growth = annual average growth * share in total exports.*
Source: Ministry of Commerce (2004).

Finally, as regards the effects of liberalisation on poverty, there is no ex-post econometric study on Bangladesh that analyses the link between trade policy and households through changes in prices of goods and services, distributional channels and government revenues. Unavailability of data, as poverty estimates are only available intermittently and often the available estimates between two periods are not comparable because of changes in survey methods and poverty estimation techniques, is the main problem for implementing such an integrated and comprehensive analytical framework. In the absence of such an analysis, poverty assessment is to be made on the basis of observation of simple trends. The comparable poverty estimates by Bangladesh Bureau of Statistics (BBS) for the 1990s show some significant decline in poverty incidence from about 59 percent in 1991-92 to 50 percent in 2000 (see Table 2.5).

However, most of this apparently impressive record has been shown to have taken place by 1995-96, when the proportion of population living below the poverty line reached 51 percent. Therefore, between 1995-96 and 2000, absolute poverty reportedly fell by 1.3 percentage points only (i.e. about 0.3 percentage points per annum).[19] Although different estimates are available from the Poverty Monitoring Survey (PMS), the evidence of very low rate of decline in poverty incidence during the most recent periods is clearly borne out. According to the PMS, the annual poverty declining rate during 1999-2004 was 0.5 percentage points. One serious cause for concern is the considerable rise in income inequality in the 1990s. According to the BBS HES, the inequality in the distribution of private per capita expenditures, as measured by the Gini coefficient, increased from 0.26 in 1991-92 to 0.31 in 2004, while the PMS shows the similar rise from 0.42 in 1999 to 0.45 in 2004. Currently, it is not known whether the trade liberalisation measures have had any effect on the slowing down of the declining rate of poverty incidence and the rising inequality.

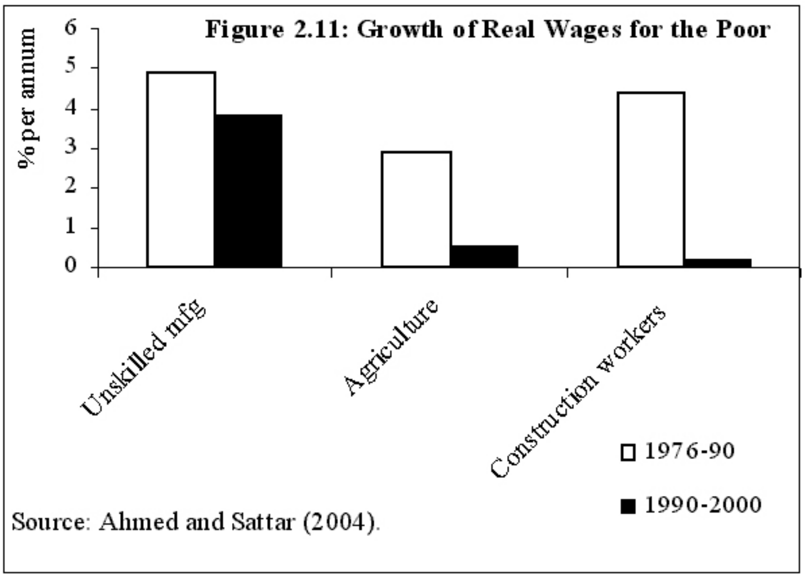
Very recently the poverty incidence data for 2004 have been made available, which show that during 2000 and 2004 the headcount ratio has declined by about six percentage points. Therefore, it seems that after the sluggishness towards the end of the 1990s, the rate of poverty reduction has picked up pace. It is still not clear what factors contributed to this improvement. Some suggest that in contrast to previous periods' hyperactive measures, reforms programmes since the late 1990s have been only modest and this might have contributed to consolidation of economic activities with positive results for poverty. Serious research, however, awaits to validate this hypothesis.[20]

Employment and wages are two important indicators of poverty situation. According to the Labour Force Survey (LFS), employment expansion during the 1990s (2.1 percent per

Table 2.5: Incidence of Poverty

Year	Headcount Ratio (per cent)		
	Rural	**Urban**	**Total**
BBS Household Expenditure Survey (cost of basic needs method)			
1991-92	61.2	44.9	58.8
1995-96	55.2	29.4	51.0
2000	53.0	36.6	49.8
2004	-	-	44.2
Poverty Monitoring Survey (food energy intake method)			
1997	46.8	43.4	46.0
1999	44.9	43.3	44.7
2004	43.3	39.2	42.1

Note: The poor in the BBS Household Expenditure Surveys are estimated using the cost of basic needs (CBN) methods and are taken as those living below the poverty line which corresponds to an intake of 2122 kcal per person per day and a non-food allowance. On the other hand, the poverty line in the Poverty Monitoring Survey uses the food energy intake (FEI) method and refers to calorie intake of 2122 kcal per person per day in rural areas and 2112 kcal per person per day in urban areas.



annum) has been much slower than that of the 1980s. More importantly, manufacturing employment is reported to have fallen from 5.9 million in 1990-91 to 4 million in 1999-00, despite the robust growth of the employment intensive RMG sector, while jobs in services sectors are found to be expanding. Therefore, the available data seem to suggest that the manufacturing sector has shrunk following the liberalisation programmes.[21] The growth of real wages of unskilled workers in manufacturing, agriculture, and construction has also slowed down during 1990-2000 (see Figure 2.11).

Although *ex-post* poverty impact analysis using a comprehensive framework is not available, efforts have been made to simulate the likely consequences of trade reforms utilising the computable general equilibrium models. There are several advantages of these *ex-ante* exercises, as they can deal with a large number of sectors and can simulate the effects of various policy shocks for different types of households and factors of production. In this regard, results from two studies are interesting. In the first study, Mujeri and Khondker (2002) used a Social Accounting Matrix (SAM), comprising 26 production activities and seven factors of production (with six different types of labour), to simulate the effects of a complete liberalisation (i.e. all tariffs are completely abolished) of Bangladesh's import regime. The results showed improved poverty situation for all types of households. In the other study, Annabi *et al*. (2005) employed a sequential dynamic, e.g. Computable General Equilibrium (CGE) based on a SAM constructed for 2000 that included 15 production sectors, 4 factors of production (skilled and unskilled labour, agricultural and non-agricultural capital) and 9 household groups (5 in rural areas and 4 in urban areas based on the BBS household survey for 2000). The authors' simulation of 100 percent tariff reduction shows adverse welfare consequences in the short-run, which are ultimately more than offset by long-run gains.

While CGE analyses are useful tools for informing the policy makers about the potential implications of any particular policy, one has to exercise a great deal of caution in analysing the dynamics that generate the results. While the use of calibrated parameters and questionable elasticities have long been the known shortcomings of CGE models, how adjustment mechanisms are designed in those models will have far more implications for a least developed country (LDC) like Bangladesh. Simulation exercises usually allow for easy and rapid adjustment between sectors. For example, tariff-cuts in one sector, leading to reallocation of resources of resources according to the static comparative advantage, will surely result in welfare gains, but in reality because of inertia and rigidity such reallocation may not be as straightforward as these models would predict.

How the lost revenues (as a result of tariff liberalisation) of the government will be recouped is also likely to affect the simulation results. The assumption that government can readily access alternative sources of revenues is also to be regarded as a serious limitation. When public expenditures benefit the poor, any shortfall in government revenues following the tariff-cuts could deteriorate the poverty situation despite the overall positive welfare effects.

It is rather striking to observe that simulation exercises introduce unrealistic policy shocks. Setting all tariffs to zero is no pragmatic policy option for any LDC government and there is no guarantee of obtaining linear relationships between the magnitudes of tariff reductions and welfare gains. Therefore, policy makers will be better advised if realistic policy scenarios (including the possible alternative sources of government revenues) are simulated. Last but not the least, CGE simulation exercises are merely predictions; it cannot depict what has actually happened. Therefore, when it comes to evaluation of trade-poverty nexus, *ex-post* exercises are more useful.

2.4 Way Forward for Making Trade Policy Effective for Poverty Reduction

Although the evidence on the beneficial impacts of trade liberalisation is inconclusive for Bangladesh, the idea of going back to the old days of protectionism is discarded by all. A more pragmatic option is to make trade and the liberalised regime work for the poor. There are then basically two issues: whether to go for further liberalisation and what are the ingredients for making trade policy effective in alleviating poverty. In these respects, several important points need to be considered, some which are touched upon in the following sections.

Development-driven Approach to Trade vs Trade-driven Approach to Development

The direct effect of trade on poverty is through its impact on the cost of living, jobs and wages, and government revenue for public goods, while the indirect links occur through the development and utilisation of productive capacities. The direct link is important for short-term poverty alleviation, but the latter types are needed for sustained poverty reduction (UNCTAD, 2004). Productive capacities encompass a large number of factors – development of skills, technological progress, savings for investment, quality of investment, etc. These factors are more related to overall development than trade. That is why it is argued that the national and international policies facilitating the development of productive capacities must be rooted in a development-driven approach to trade rather than a trade-driven approach to development (ibid). This argument has recently been emphasised by observing that "an exclusive focus on trade, which assumes that poverty is reduced through trade rather than through development, is likely to prove counter-productive".[22]

Policy of Trade Liberalisation and Trade Policy

The discussion on trade and poverty often becomes an issue of trade liberalisation and poverty relationship. In trade and poverty relationship one needs to consider a large number of issues of which trade liberalisation and poverty is just one – albeit an important one. However, frequently one hears the proposition that associates liberalisation with growth and reduced poverty incidence. In reality, the link between trade and poverty is shown to be quite complicated depending on price changes, income and employment effects, and changes in government revenue position affecting transfers and provision of public goods (Winters 2000, McCulloch *et al*. 2002). In fact, by adopting a pro-active trade policy regime it may be possible to provide effective support to the growth of small and informal sector activities with significant poverty alleviation effects (Mahmud, 2003). This, however, in no way to suggest that the policy of liberalisation is to be discarded. The bottom line is that liberalisation should not be prioritised over poverty alleviation. Liberalisation may be an integral policy component of a range of policy options that are together designed to achieve the growth and poverty reduction objectives. The other policies (such as macroeconomic, fiscal, financial, sector-specific productive development policies etc.) should not be regarded as complementary to the policy of liberalisation; rather, all need to complement one another.

Selective Interventions

A pro-active trade policy calls for selective interventions, which are usually undertaken in response to the need for protecting the infant industry, correcting the market failure and pursuing strategic trade policy. However, if there are no dynamic gains to obtain, such interventions are likely to be futile with adverse societal welfare consequences. Another important problem is that policy makers may not *a priori* identify the would-be dynamic sectors for selective support, in which case the intervention schemes will only distort the incentive structure within the economy, inducing misallocation of resources. Identifying a sector with a large employment is appealing from poverty reduction point of view. However, it may lead to even greater misallocation of resources and efficiency losses, if the sector continues to depend on protection. Therefore, the support system needs to be time bound and should be declared in advance. Under these considerations, selective interventions could be designed in such a manner to have a maximum impact on poverty alleviation.

Evaluating Trade Policy

In the previous section, problems associated with assessing the effects of trade liberalisation were pointed out. In the absence of comprehensive and accessible empirical analyses, trade policy may be evaluated from a wrong perspective. This is because losers of trade policy changes are easily identified, either because they organise themselves or lobby for policy support or attract newspaper headlines. On the other hand, gainers are difficult to recognise as either they do not realise the beneficial effects or do not have the incentives to communicate their experiences with trade reforms. In addition, the demand side for the liberalisation is generally not visible. While protection-seekers through their associations press home their demands, consumers suffer from free riders' problem in effectively pursuing their case. Under these circumstances, trade policies could be evaluated from wrong perspectives.

Trade Policy Reform as Institutional Reform

Trade reform measures such as removal of QRs, tariff cuts, withdrawal of subsidies are easy to implement. More difficult reforms relate to changes in ways institutions operate. In recent times, it has been very strongly argued that the effectiveness of trade reform should not be evaluated by the criterion of openness of the economy. Rather, the yardstick that matters is the degree to which trade reform contributes to the construction of a high-quality institutional environment (Rodrik, 2002). Effective participation of the poor in the growth activities may be preconditioned by efficient institutions that can send clear signal to economic agents, ensure law and orders, regulate anti-competitive behaviour, enforce property rights, and put into effect the rules of the game. In the context of Bangladesh, there is hardly any denying that trade reform measures have failed to bring qualitative changes in institutions. This probably explains why Bangladesh did not achieve sufficiently higher growth rates to bring down the poverty incidence considerably.

Trade Reforms and Supply Response

Mere liberalisation of the trade regime should not be considered as an automatic export stimulus. Indeed, the tendency of equating liberalisation with export response should be treated with caution and backed by a pragmatic analysis of the trends in the country's exports of individual items. In the previous section it has been shown that apart from RMG, the contribution of all other items to Bangladesh's export growth either has been negative or insignificant. The implication is that only removal of anti-export bias will not be enough in stimulating export supply. Even without undermining the benefits of trade reform measures, it needs to be emphasised here that, a policy of liberalisation cannot guarantee an invigorated export response. Similarly, lack of dynamism in the real sectors (agriculture and manufacturing) is a clear indication of other factors inhibiting growth activities, which calls for urgent attention.

Adequate Export Growth Rather than Export-led Growth

The relationship between trade and poverty is often envisaged through an export-led growth strategy. However, export expansion is 'no guarantee' for improvement in poverty situation (UNCTAD 2004), while the experience of Bangladesh shows potentially large poverty alleviating effects of a highly employment-intensive sector, RMG, which has a relatively small share (five percent) in the country's GDP.[23] Therefore, even without becoming the "engine" of growth, export activities can contribute to poverty alleviation. The link between export and poverty reductions through growth is indirect, but through employment generation is not only direct but also supportive of the development of productive capacities. Therefore, an appropriate approach to achieve a more virtuous trade-poverty relationship may be an open development strategy that strives to attain adequate export growth rather than export-led growth.[24]

Trade Reforms and Domestic Investment Climate

One of the principal objectives of the trade reforms is to attract investment – both foreign and local – in the export sector by correcting domestic incentive structure. However, businesses in Bangladesh have to embrace invisible costs arising from widespread corruption and malpractices and destructive political activities. All this makes domestic environment business-unfriendly, which discourages new investment thereby affecting economic growth. Trade reforms could have been more effective had it been accompanied with a healthy domestic investment climate.

Considering the Impact of Adjustments

Liberalisation programmes do not consider the distributional consequences of welfare gains, concealing its potential negative consequences which are often borne by the most vulnerable socio-economic groups of the country. Introducing the complementary support system to mitigate the adverse implications on the poor should be an integrated part of any poverty reduction strategy. These safety-net measures need to appropriately designed to reach the target groups and to prevent leakages.

Supportive International Policies

Whatever may be results of domestic trade liberalisation, supportive international policies (in terms of better export market access both in the developed and relatively advanced developing countries) in strengthening trade-poverty link in Bangladesh's economy cannot be overemphasised. The rise of RMG industry, which transformed Bangladesh into a trading economy and generated thousands of productive jobs, underscores the need for having a supportive international policy regime for stimulating export response from a poor country. A national poverty reduction strategy will work best if the international trade regime is enabling and if increased and effective international financial and technical assistance is provided to the LDCs to help develop their production and trade capacities.

2.5 Conclusion

During the past two decades or so, Bangladesh has implemented many important liberalisation measures to make its economy more outward-oriented. These reform measures led to a significant decline in QRs, opening up of trade in many restricted items, rationalisation and diminution of import tariffs, and liberalisation of foreign exchange regime. How trade liberalisation has influenced economic growth and poverty in Bangladesh has been a subject of great interest to researchers, academics and policy makers. The evidence reviewed in this paper shows a higher overall economic growth (by 1.3 percentage points) to be associated with the decade of the 1990s, when most of the reforms were carried out, but the link between trade liberalisation and superior growth performance cannot be supported statistically.

There is no statistically significant difference between the growth rates during the 1980s and 1990s. Altogether the manufacturing sector grow at an annual average rate of 6.5 percent during 1990-2003 in comparison with 5.0 percent of the 1980s, the superior growth performance of the post-reform period is most likely to be attributable to the export-oriented RMG sector. The non-RMG manufacturing sectors may have actually declined after the liberalisation of the trade regime. It is difficult to establish a causal relationship between the policy of liberalisation and the growth of RMG industry, as the sector expanded taking the advantage of MFA quotas. With the end of the MFA regime, there is a lot of apprehension about the future prospect of RMG exports from Bangladesh. The lackluster performance of the non-RMG export sectors is a pointer to the fact that trade reform measures may not have been successful in energising export supply response.

Mainly because of lack of data, empirical investigation linking trade with poverty alleviation is currently not available. According to available estimates, between 1991-92 and 2000 the proportion of population living below the poverty line had declined, on average, by one percentage point per annum. However, going beyond this average figure it is found that, the annual rate of decline in poverty incidence in recent years has fallen to only 0.3-0.5 percentage points along with rising inequality. To what extent liberalisation has contributed to these trends is not known. Data from the national labour force surveys seems to suggest a deceleration in the rate of employment expansion during 1991-2000 in comparison with the growth of employment during the 1980s. There is also clear evidence of growth in real wages of unskilled workers slowing down during 1990-2000.

Given the above, the question is what it implies for policy implications. First of all, trade liberlisation is to bring efficiency gains, which may result in displacement of some sectors. Therefore, despite the existing inconclusive evidence, the importance of liberalisation should not be undermined. In fact, the most critical challenge facing Bangladesh is to make trade liberalisation effective. This has now become even more challenging given the post-MFA intense competition faced by the country's RMG industry, which has established a direct link between trade and poverty.

Linking trade with poverty reduction strategy is a difficult task, particularly in terms of formulation of policies. Focusing only on trade for poverty alleviation may not be meaningful, rather trade should be considered as a component of overall development policy. Often the trade-poverty link is envisaged through an export-led growth strategy, which fails to recognise that it is the adequate export growth with employment opportunities rather than export-led growth is a more virtuous trade-poverty relationship. Sometimes, no distinction is made between trade policy and trade liberalisation, which is unrealistic and more pragmatically trade liberalisation policy should be considered just as one component of the whole set of policy options. The Bangladesh experience suggests that mere liberalisation may not stimulate supply (both export and non-export) response and thus there is a need for developing productive capacities and removing other supply-side bottlenecks.

When exercising a pro-active trade policy, careful attention is to be given so that sectors that are unlikely to achieve dynamic gains are not chosen for policy support. Identifying such sectors is also a difficult task. Trade policy needs continuous evaluation. However, as losers and protection-seekers are active, while gainers and consumers are likely to be passive there is a risk of assessing the situation from wrong perspectives.

Institutional reforms are increasingly considered to be precondition for successful trade liberalisation programmes, which have so far not been given much attention in Bangladesh. By sending clear signals to economic agents, ensuring law and order, regulating anti-competitive behaviour, enforcing property rights and putting into effect the rules of the game, efficient institutions facilitate the participation of the poor in the growth process. As trade reforms are likely to generate disproportional distributional consequences, appropriate safety net measures are required to help the poor adjust.

On the external front, external support is essential for strengthening the trade-poverty link. By ensuring generous market access and providing financial and technical assistance to promote productive capacities, the international trade regime can be effective in materialising the national strategy of poverty alleviation. In fine, trade, development and poverty interaction is a complicated one and policies to influence it need to be carefully designed, delicately managed, intensively monitored, and methodically evaluated. There is a need for undertaking serious research to facilitate informed policy discourse involving all the aforementioned aspects.

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Endnotes

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2 Ravallion (2005) shows that even for China, the link between trade openness and poverty reduction cannot be supported statistically despite a strong presupposition for it.
3 Along with the rising significance of exports, the share of foreign aid in the national economy has declined from 7 percent of GDP in the early 1980s to about 3 percent in 2004.
4 The trade in textiles and clothing was long restricted in developed countries under the MFA quotas. While the intention was to provide protection to domestic manufacturing units in he importing countries from the relatively efficient producers in developing countries, the operation MFA quotas led to exporting opportunities in countries (including Bangladesh) where textile and clothing were not traditional export items. According to WTO Agreement on Textiles and Clothing, the MFA regime was abolished from the beginning of 2005. This is supposed to result in fierce competition as the relatively efficient countries that have so far been constrained with quotas will now have the opportunities for unrestricted exports. There is a serious apprehension that Bangladesh might lose out of this world-wide liberalisation of the textile and clothing trade.
5 Actually, at the time of independence in 1971 Bangladesh inherited an inward looking trade regime, which continued to be followed until the early 1980s.
6 One can, in fact, think of another phase, which began with the initiation of the poverty reduction strategy for Bangladesh. In this on-going phase, multilateral donors' support and liberalisation programmes are to be coordinated in line with the goals specified in poverty reduction strategy paper. Although supposed to be a home-grown initiative, there is a general recognition that the preparation of the PRSP was to be a precondition for continued support from the multilateral donors.
7 Bangladesh has received preferential access under various GSP schemes of 16 countries, viz. the US, the EU, Japan, Canada, Russia, Australia, Austria, Finland, New Zealand, Norway, Poland, Sweden, Switzerland, Hungary, Bulgaria, and former Czechoslovakia (Rahman 1997). Preferences offered by different countries, however, differ a lot.
8 Note that indicators like average tariff rate may be problematic since there are widespread non-tariff barriers in many countries. Also, low average tariffs conceal high protection in 'sensitive' sectors. For example, while the average protection rate in the US is quite low (3.5 percent), tariffs on textiles and clothing imports are subject to an average MFN duty of 16 percent.
9 More recently it has been shown that while the unweighted average MFN duty in Bangladesh (16.5 percent) is still lower than those of in India (22.2 percent) and Pakistan (18.2 percent), because of other protective import taxes, total protective import duty in Bangladesh is the highest in South Asia (average MFN duties in Sri Lanka and Nepal are lower than those of in India and Pakistan).
10 Failure to consideration of these variables might result in biased estimates of the variable of interest. Note that unavailability of data is the most important problem associated with empirical approaches. Discussions on the weaknesses and strengths of alternative approaches may be found in McCulloch *et al*. (2002).
11 Razzaque et al. also examined the relationship between total factor productivity growth and the liberalisation measures. But, again no statistically significant relationship could be found.
12 This probably explains the significant negative effects of liberalisation found by Raihan (2005) in some of his regressions.
13 According to Rashid (2000), apart from pharmaceuticals most other import-competing sectors have been adversely affected by liberalisation.
14 A close look at Figure 2.9 would reveal this. For example, while the export growth rate falls in 1984 followed by a rise in 1985 before falling again in 1986, the corresponding movements in the GDP growth rates have been completely opposite. In contrast, for the 1990s, there

are only a couple of instances (2001 and 2005) of opposite movement in export and GDP growth rate is noticed.

15 Note that, this simple bi-variate relationship is likely to be subject to a number of shortcomings. Particularly, the role of other factors is not considered here. In addition, exports itself is a part of GDP and thus are not exogenous.

16 In a widely cited IMF study, Mlachila and Yang (2004), using a global general equilibrium model shows that liberlisation of MFA regime might result in 25 percent decline in Bangladesh's RMG export.

17 There are a number of such items as other manufactured items, petroleum, chemicals, and handicrafts that have shown some impressive growth rates, but it is their low base that can hardly generate any mentionable effect on overall export growth.

18 Because of the reason mentioned just above, the growth in employment in RMG sector is unlikely to be the result of the liberalisation programmes.

19 The poverty gap – a measure of how far below the poverty line the poor are – declined from 17.2 percent in 1991-92 to 12.9 percent in 2000. Similarly, the squared poverty gap, which considers the distance from the poverty line as well as the inequality among the poor, fell to 4.6 percent in 2000 from 6.8 percent in 1991-92. The rates of decline of these two estimates between 1991-92 and 1995-6 and between 1995-96 and 2000 largely reflected the trend in the head-count ratios.

20 Nevertheless, there is a general consensus that liberalisation measures have slowed down since the late 1990s. World Bank (2003) seems to suggest that in some cases the reform process was actually reversed.

21 Ahmed and Sattar (2004), however, argue that the loss of 1.9 million jobs is unrealistic given the overall modest growth (around six percent) of the manufacturing sector.

22 See the Least Developed Countries Report 2004, UNCTAD, Geneva.

23 Evidence presented in UNCTAD (2004) shows no statistically significant relationship between export growth and growth in average private consumption per capita (as an indicator of declining poverty incidence) in either the first half or the second half of the 1990s.

24 This is what is also recommended in UNCTAD (2004) – according to which, in an export-led growth strategy export expansion is the major demand-side component of economic growth. By contrast, in a strategy that seeks adequate export growth, both export expansion and domestic demand expansion are important demand-side components of economic growth. There is thus more balance between domestic demand and export expansion in the process of growth.

3 CHAPTER

Cambodia's Economic Development in the Integration Process: *Lessons Learned and Policy Implications for the Future*

– Sok Hach[1]

3.1 Introduction

Following the formation of the coalition government in mid-1993, Cambodia intended to re-establish itself as a democracy aimed towards attaining prosperity. Fundamental human rights were stipulated in the Constitution and social justice and human development were to be promoted. These political aims were decided to be achieved through a process of market-oriented economic policies. In 1994, a medium-term adjustment and reform programme aiming to restore macro-economic stability was launched, and a process of institutional strengthening supported by the international community was undertaken.

A very liberal investment law was promulgated in 1994, whereby trade was liberalised. The private sector was promoted and longer-term structural reforms were also undertaken to boost sustainable economic growth and help alleviate poverty. As a result, foreign investment sharply increased during the first years of reforms, boosting a rapid development of emerging industries such as the garment industry, telecommunications and tourism. External trade significantly expanded and has become the main source of economic growth and job creation.

Although these initial market-oriented reforms have yielded some positive results, Cambodia has not yet seen the full benefits of these reforms, or an equitable distribution of benefits. The economic recovery has been largely confined to urban centres and little has trickled down to the rural areas where the vast majority of the population lives. Though the overall economic growth has been very strong (about nine percent per annum during 1994-2005), this growth has been narrowly based – very fragile and unevenly distributed. Growth remains elusive in areas such as education and health. Today, even though trade and investment regimes are very much liberalised, Cambodia remains one of the poorest countries in East Asia and has some of the worst human development indicators in the world.

In October 2004, Cambodia became a member of the World Trade Organisation (WTO). As a least developed country (LDC), Cambodia can export most of its products duty-free to most other developed WTO members. This opportunity will be of benefit only if the Cambodian economy is competitive. Under its WTO accession agreement, Cambodia, however, has to fulfill a large number of reforms, especially legal reforms.

The objective of this paper is to identify domestic reforms under the integration process in Cambodia, which is critical to the sustainable development of the country. It makes an assessment of microeconomic performance and policy of Cambodia since 1994, when trade and investment were liberalised and economic reforms were started. It examines the poverty trend and its implications in Cambodia. The paper sums up the lessons learned from past experiences and recommends future policy on key issues that need urgent attention.

3.2 Macroeconomic Performance and Policy Since 1994

During the first years of economic liberalisation and reforms, foreign direct investment (FDI) in Cambodia significantly increased – starting from 3.5 percent of gross domestic product (GDP) in 1994 to about eight percent of GDP in 1996. The investment covered almost all sectors of the economy. Economic growth was strong, reaching the government target of seven to eight percent per year and generating significant employment.

However, persistent weak governance and a political crisis in 1997 over power-sharing, combined with the simultaneous Asian financial crisis during the same period led to a sharp economic slow down. Some critical reforms, such as civil service reform were shelved and investor's confidence was shaken. Despite large investments in the garment industry since 1997 and in the tourism industry since 1999, Cambodia's FDI has continuously declined, sinking to about two percent of GDP in 2003, before recovering to four percent in 2005. As a result, Cambodia's real GDP growth steadily slowed – from 12.5 percent in 1999 to 6.2 percent in 2002, before picking up again to about 10 percent in 2004 and 13.4 percent in 2005.

Investment has played a crucial role in improving workers' productivity and in generating income. Statistics compiled by the Economic Institute of Cambodia (EIC) from various sources show that stocks of capital in the agriculture sector, which employs more than 70 percent of Cambodia's labour force, were estimated in 2005 to reach only US$295 per worker, generating a modest value added of US$390 per worker (or just above US$1 per day). This productivity has been basically flat since 1995, resulting in a very slow increase in rural income. Lack of investment – both public and private – in the agriculture sector is a serious concern for sustainable economic development and social stability.

Though investment started slowing down in 2001, it has been relatively strong in the garment sector during the last seven years. Workers' productivity in this sector has sharply increased, reaching US$2,800 in 2005, from about US$700 in 1995. However, according to a World Bank study on the investment climate in the region, Cambodia's productivity remains low compared to other countries, such as China and India. In the backdrop of huge competition following the elimination of the quota system in 2005, this study recommends that Cambodia needs to improve its public governance to support the sector.

However, this relatively good performance will diminish if the garment industry and tourism lose their competitiveness in the wake of the WTO agreement, and/or the international environment becomes unstable. In addition, although export trends in the garment and tourism industries are very high (51 percent of total GDP in 2003), it is estimated that less than 15 percent of these amounts remained with Cambodia. Raw material imported represents the most important share in the production cost, which means that Cambodia's garment industry is still largely dependent upon foreign suppliers in terms of textile and semi-finished garment products. The labour cost in Cambodia's garment sector represented only 13 percent of sales. A similar situation will be there in the tourism industry, if Cambodia does not develop its own national carrier. The labour cost in the tourism sector is estimated to reach only three percent of the total foreign tourist visiting Cambodia.

Inflation stabilisation has been viewed as the most successful government action during the reform period. After experiencing a very high rate of inflation during 1989-1993, Cambodia's inflation has been basically under control since 1994. This was true even during the aftermath of the political crisis in 1997 and 1998. During 2000-2003, inflation was basically nil. However, this recent good performance was mainly due to the decline in the price of agricultural products, while the price of imported energy significantly increased. This means that the income of rural people also declined because of low agriculture market prices and high production costs due to high energy prices.

The monetary system in Cambodia is characterised by a high degree of dollarisation and cash transactions, which limit the government's scope for active and effective monetary intervention. The total money supply recorded by the National Bank of Cambodia (NBC) was only about 20 percent of the GDP in 2005. This included the liquidity in Cambodian Riel (five percent) and the amount of foreign currencies (mainly US dollars) circulating through the banking system (15 percent). The amount of foreign currencies circulating outside the banking system is unknown, but is widely supposed to be at least three or four times higher than that circulating through the banking system. With the exception of small transactions and wage payments, the use of the Riel is confined largely to the government and the poor in rural areas. Hence, large financial transactions are conducted in foreign currencies, particularly the US dollar.

The financial development in Cambodia is also characterised by a severe lack of credit to the private sector, resulting in a very high interest rate, especially in the poor rural areas. Policies to improve public confidence in the country's banking system still seem a long way off. In addition, despite a rapid development of some emerging industries, the banking system in Cambodia is still quite weak. The large number of commercial banks poses particular challenges to banking supervision. And above all, no financial instrument has been established in Cambodia as yet.

Fiscal policy has been the core of the government's adjustment and reform strategy. The aim was to strengthen the role of the budget as a key tool for economic management and also to develop a fiscal structure that could generate the domestic resources required for increasing public spending in priority areas, such as social development and infrastructure. Unfortunately, this target has not been met. Despite many fiscal reforms undertaken since 1994, the government budget revenue has remained mostly flat. The introduction of value added tax (VAT) in 1999 allowed the government to increase its revenue by about two percent relative to GDP. However, five years later, this gain mostly disappeared, reflecting the acceleration of problems caused by weak governance and the lack of a clear fiscal policy.

As a result, the government budget revenue reached only about 10 percent of the GDP in 2005, the lowest in the region. Implementation of a very generous investment law and various *ad hoc* tax exemptions cost the country millions of dollars per year in revenue. To compensate for this loss, the government has repeatedly increased taxes on gas and utilities. But these increases have not generated sufficient revenue. On the contrary, they have encouraged smuggling and tax evasion, strongly penalised local producers and served to weaken national competitiveness.

Concerning expenditure, given the limited domestic revenue, the government's first priorities were to pay the existing very meagre public sector salaries on time, and if possible to contribute to the foreign financed investment counterpart funds. These minimal targets were basically reached; however, public investment and social development were left to the funding sources of foreign aid. Expenditures on defence and security remained a heavy burden within the national budget, although official figures attempt to show some decline *vis-à-vis* the total expenditure. The official figures have not shown, within the defence portion of the budget, a large amount of extra-budgetary revenue granted to the military since 1995. This included revenue generated from military logging concessions and lands provided to the military.

To help stimulate Cambodia's economic recovery, the international community has pledged at every Consultative Group (CG) meeting to provide the country with an average of about US$600mn per year in aid. This amount represents about 12 percent of nominal GDP, or 20 percent higher than Cambodia's domestic budget revenue. Meanwhile, the balance of payments (BoP) figures compiled by the International Monetary Fund (IMF) from 1994 to 2004 show that real aid disbursements in Cambodia reached only about 70 percent of what was pledged. Of this amount, the World Bank and the Asian Development Bank (ADB) were the two biggest lenders, providing about 20 percent of foreign assistance.

Although foreign aid to Cambodia is very substantial and has helped the country rebuild or rehabilitate economic and social infrastructure and facilitated some structural reforms, a recent report released by the Council for Development of Cambodia (CDC) noted that an increasingly-large proportion of external assistance goes to technical assistance (45 percent in 2005, up from 19 percent in 1992). Gradually, reducing the proportion of technical assistance and using it for other purposes would be very beneficial for Cambodia's sustainable development.

With regard to Cambodia's external debts, the outstanding amount is not clear. After 1993, the Cambodian Government started to borrow again from the World Bank and the ADB to rehabilitate the country's infrastructure. At the end of 2005, these new external debts were estimated at US$1bn (or 20 percent of GDP). However, debts received from some bilateral countries, such as China remained unclear since the government holds this information confidential. As all Cambodian debts contracted after 1993 are concessional (low interest rates with long grace periods), debt services should remain relatively low as a percentage of GDP or government budget incomes. However, if the government revenue does not significantly improve, and new loans continue to be contracted at current trends, Cambodia's debt services ratio will reach a worrisome level in the next 10 years.

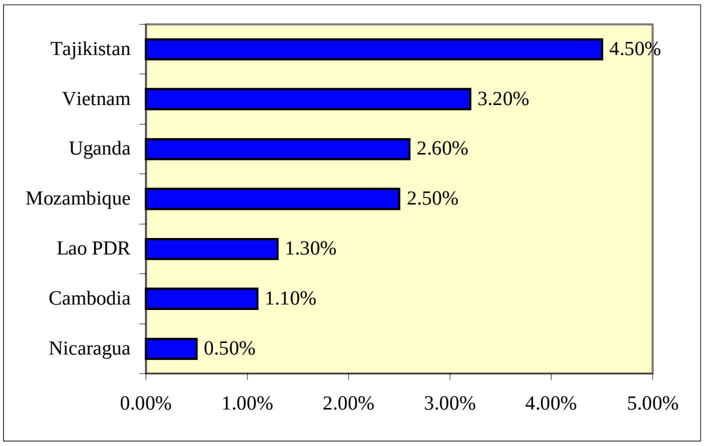
3.3 The Poverty Trend and its Social Implications

Poverty alleviation is supposed to be the overarching goal of the government's development plan. But, with an estimated per capita income of US$450, Cambodia remains one of the poorest countries in the East Asian region. According to a recent World Bank report, although the country experienced high economic growth (about seven percent per year on average during the last 10 years), the poverty rate has been reduced only by 1.1 percentage point per annum, while this rate significantly declined in Vietnam (3.2 percentage point per annum) during the same period.[2] In 2004, the poverty rate in Cambodia still reached 35 percent of the total population.

In addition, successive socio-economic surveys and poverty assessments made by the government showed that the poverty rate in rural areas was particularly high (40 percent) compared to urban areas (10 percent).[3] This gap is likely to be explained by the very low incomes earned by rural people *vis-à-vis* urban people because of low productivity, uneven land distribution and lack of public infrastructure, such as roads and irrigation.

High levels of underemployment, especially in the rural areas constitute another poverty factor in Cambodia. Based on a population structure that has been affected by years of war, Cambodia's labour force is estimated to have been increasing at an accelerating rate every year since the mid-1990s. And this trend is expected to be stabilised only in the next 15 years. Drawing on the 1998 census, the Economic Institute of Cambodia estimated that new entrants to the labour market increased to about 250,000 people in 2005 from an average of 150,000 in the mid 1990s. The number of new entrants is expected to remain high during the next 10 years because of the baby boom during the 1990s. Consequently, Cambodia could face a huge medium-and long-term challenge in generating adequate employment in rural areas for the new labour force. This expansion of the labour pool could be a driving force for economic growth or a significant burden if adequate employment opportunities are not created.

Figure 3.1: Average Annual Reduction of Poverty in Selected Countries (%)



Source: The World Bank (2006)

In order to prevent farmers from becoming poorer, the size of farms per farming household should not decrease. However, going by the current small size of most Cambodian farms, when farmers' children reach working age, they will have to find employment elsewhere. In order to provide employment for the rapidly-expanding numbers of rural youth reaching working age, private investment in Cambodia must increase at least three times the total from that of the past 10 years. Cambodia's BoP statistics shows that private investment in the modern sectors averaged about US$200mn per year from 1995 to 2005. Of this amount, less than US$100mn per year was invested in the productive sectors (mainly garments and tourism), which created labour-intensive employment. Moderate private investment has had a significant impact on employment and revenue. Between 1995 and 2005, Cambodia's labour force increased by an estimated two million people.

However, the modern sector absorbed only about 20 percent of this labour force, and perhaps another five percent migrated to neighbouring countries, particularly to Thailand. The other 75 percent remained in rural areas and shared small portions of land owned by their families, or they have been obliged to accept informal jobs in the cities. Furthermore, based on the current level of land and productivity, the Cambodian agricultural sector can efficiently support only about one to two million workers where currently about four million are employed. In order to provide employment for two or three million of the young unemployed, investment in non-farm activities in rural areas should be strongly encouraged.[4]

Landlessness is increasingly recognised as a critical development issue in Cambodia. According to Oxfam, which has contributed several studies on land issues, the number of landless people in rural areas has increased at an accelerated rate over the last few years.[5] In 1984, landless families represented about three percent of the total number of households. This was slightly lower than what was there in 1969 (about four percent). In 1999, however, this ratio jumped to about 12 percent (equivalent to about 1.2 million people), while landlessness in female-headed families was much higher (21 percent). Oxfam also estimates that this trend will worsen in the near future.[6] Oxfam surveys also showed that landlessness is one of the main causes of migration. In 2000, about 22 percent of families left their village after becoming landless.

3.4 Lessons and Policy Implications for the Future

During the past 10 years, Cambodia has taken many steps to have open economic policies and to foster growth and development. In 1994, a medium-term adjustment and reform programme aimed towards restoring macro-economic stability was launched, and a process of institutional strengthening supported by the international community was undertaken. Private sector growth has been promoted and efforts have been made at longer-term structural reforms that would allow sustainable economic growth and poverty alleviation. A liberal investment law was promulgated and trade was liberalised.[7] As a result, foreign investment flowed into Cambodia during the first years of these reforms; this, in turn, allowed rapid development of some emerging industries, such as garment industry and tourism. External trade significantly expanded and became the main source of economic growth and job creation.

However, income distribution has been uneven. According to estimates by the EIC, income disparity between rich and poor is growing, and income disparity is also growing in various provinces.[8] Globalisation is primarily benefiting higher-income people in urban areas, whereas traditionally poorer people in rural areas are not only seeing fewer benefits but are in a larger sense being left behind as globalisation moves on. In 2004, Cambodia became a member of the WTO. The fear is that this membership will result in even wider income distribution inequalities unless there are clear economic and institutional reforms. According to a recent EIC study on the impact of foreign investment on human development, the poor will unlikely be able to seize the opportunities provided by liberalised trade without government support in implementing strict rules and regulations.[9]

This is because the poor are often uneducated in general and unaware of specific opportunities in particular. Besides, trade liberalisation might serve to further expand their vulnerability and missed chances to be exploited. If private sector development occurs in a vacuum, without concurrent attention by the government to the provision of good quality public sector services, poor people will be increasingly worse off, especially as measured by growing income inequality.[10] Globalisation and economic liberalisation will have potentially huge impacts on social development in Cambodia.

The recent history of Cambodia shows that this country has the capacity to develop rapidly and that the fruits of development can be distributed equitably when government actions are consistent with its policy. During 1954-1963, Cambodia's economic and social development had been rapid and sustainable within a free market system. Cambodia was even more prosperous than its neighbours, which is hard to believe today. More recently, during 1994-1996, the living standards of many Cambodians sharply improved, reflecting the dynamism of reforms. During that period FDI almost tripled that contributed significantly to generating enough employment for new labour force entrants.

The overall situation started to deteriorate in early 1997. A power sharing arrangement between the two main political parties in the coalition government reached crisis point, which led to factional fighting in July 1997. An unsustainable exploitation of natural resources, such as forestry intensified. Corruption was widespread. Economic reforms were interrupted. As a result, economic activity stalled and social development significantly deteriorated. Since the formation of the second coalition government at the end of 1998, the government's rhetoric has pledged reforms and as a result huge amount of foreign aid resumed flowing in. However, previous in-flows of FDI have not returned and key structural problems remain. Some of the crucial soci-economic issues are given below:

- Economic recovering is taking place. But the growth rate is unevenly distributed, and not enough to curb growing under-employment. FDI is stagnating. To date, government budget revenue remains very low, and the national budget is structurally inadequate to support economic and social development programmes.
- From a social perspective, landlessness and the subsequent migration from rural to urban areas are accelerating. Land disputes are widespread around the country. Poverty is visibly and measurably increasing in rural areas.
- State institutions continue to grow and expand their influence. Corruption is widespread with the judiciary particularly carrying a dismal reputation. Civil service reforms move on very slowly and military demobilisation has been stalled.

- Facing these challenges, what should the development strategy be? What are the priorities? Restructuring public administration is the highest priority, starting with civil service reforms. Economic and social development cannot be achieved without an accountable and efficient public administration, which is becoming a cliché, but good governance is key.
- Re-adjusting fiscal policy is crucial to improve private sector competitiveness and service delivery performance. Strengthening the monetary system and financial sectors is essential. In lieu of adequate levels of FDI, there is a pressing need to mobilise domestic savings to support productive sectors for rapid and sustainable economic growth.
- And, last but not the east, there must be a review of the role of foreign assistance to Cambodia in support of economic development and the reform programme. Since 1993, according to the CDC and the Ministry of Economy and Finance, foreign assistance to Cambodia has amounted to about US$5bn, of which about US$1bn was in the form of loans. The amount of foreign assistance to support economic development and reforms in Cambodia has been substantial. However, with the pace of poverty reduction actually very slow, questions are arising *vis-à-vis* the real impact of this foreign assistance. According to a World Bank study, most economic infrastructure development was financed directly by donors.[11] Moreover, most social and community development was also financed by donors mainly through non-governmental organisations (NGOs). Given the weakness of the Cambodian public administration, another large portion of foreign aid was given in the form of technical assistance.[12]

However, foreign assistance focused on institutional reforms has been very limited. The IMF's funds, through its Enhanced Structural Adjustment Facility (ESAF) and Poverty Reduction and Growth Facility (PRGF) programmes, are earmarked to support monetary policy and cannot be used for financing reforms. The World Bank has been active in financing the structural reform programme. To support the ESAF programme, particularly in the fiscal area, the World Bank provided substantial non-earmarked budget support (US$102mn), without any conditions, to the government from 1994-1997. But results have been very poor, as domestic revenue related to GDP declined during that same period. In 1999, the World Bank implemented a new structural adjustment programme aimed at fighting corruption, reforming the civil service and accelerating demobilisation. Despite the support, the achievements of these critical reforms, efforts seem strikingly meagre over the last five years.

As stated above, Cambodia's economic development cannot be sustainable without restructuring the public administration and drastically reforming the fiscal and monetary systems. For these reasons, foreign assistance should focus more on a structural adjustment programme aimed at improving good governance and transparency. Credit allocated to this programme should be strictly earmarked. To increase the effectiveness and public credibility of these reform efforts, the transparency of foreign assistance should also be enhanced.

3.5 Concluding Remarks

Strengthening public administration and fighting corruption are important for sustainable economic development and effective poverty alleviation in Cambodia. But this will only happen if Cambodia's leaders have the political will to develop rule of law in the country that must be dominant over the rule of man, which should be in conjunction with a sound economic development strategy. The rule of law means a real reform of the judicial system, police force and the army. A sound economic development strategy includes drastic fiscal and monetary reforms, better natural resource management, good governance reform and decentralisation.

By successfully implementing these fundamental reforms, Cambodian administration will become more efficient, transparent and credible. This way Cambodia will be able to mobilise savings – externally and internally – for development. Moreover, economic growth will be strong enough for formal sectors to absorb new entrants to the labour market. And foreign reserves will grow steadily, reducing potential volatility in the exchange rate and inflation will be low. Overall, the Cambodian economy's competitiveness will grow.

With the rule of law and consistent macro-economic stability in place, a stock market could be introduced. The banking and other financial systems, as the main actors in mobilising private savings, will be revived and strengthened. A virtuous cycle will boost private investment. Incomes will broadly rise for all, and the nation's basic infrastructure – physical, economic and social – will be rehabilitated in about 10 years. And the core economic goal, i.e. to reduce poverty in Cambodian on a sustainable basis can be achieved.

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4 CHAPTER

Trade, Development, and Poverty Reduction: *Perspectives from China*

– He Yin[1]

4.1 Introduction

Countries have been engaged in international trade for centuries. Theoretically and empirically, trade provides consumers more varieties and higher quality of goods and services in addition to giving firms a bigger market. More importantly, trade can create a win-win situation and raise the welfare level of all countries engaged in it. During the past 30 years, increased trade has been associated with fast economic growth in Latin America, China, India, and many other developing countries. However, it is not always true that every nation benefited equally from trade. Besides, even if a country is better off as a whole due to trade liberalisation, the income redistribution effect of trade might make some people better-off at the cost of the other groups in the same country. Therefore, it is interesting and important to take a closer look at the relationship among trade, development, and income distribution. More specifically, the question of whether trade liberalisation is an important factor affecting economic growth or this growth is pro- or anti- poor. This paper analyses all these questions through a case study of China.

4.2 Domestic Economic and Trade Reforms in China

The economic development in China can be divided into two sub-time periods: 1949-78 and 1978-present. During the first period, the economic development in China was impressive. Apart from the three years of great famine in 1959-61, the living conditions of the population were generally much better than they had been in the pre-1949 period. However, due to a variety of political struggles, especially the Great Leap Forward Movement (1958-61) and the Cultural Revolution (1966-76), production incentives were suppressed and the economy performed far from its potential. Moreover, the government, although frequently publishing its "agriculture first" policy in the press, had undercut investments in agriculture and suppressed price for agriculture products to finance urban and industrial development. This, coupled with urban-biased policies, such as excessive taxation on agricultural production to prop up urban living standards, made the majority of the rural population lived in absolute poverty by the end of the Cultural Revolution. The per capita disposable income in rural areas in 1978 was only 285 Yuan (US$39.29) in 1990 prices, which was significantly lower than the official poverty line of 318 Yuan (US$43.84) set by the Chinese government; say nothing of the poverty line of 454 Yuan (US$62.59) applied by the World Bank.

The Chinese Government initiated its domestic economic reform from the agricultural sector by introducing the household contract responsibility system in 1978. This system allowed farmers to retain a certain proportion of their outputs after fulfilling a production quota set by the government. As a result, incentives for production in the agricultural sector were dramatically spurred, production in the agricultural sector skyrocketed, and the living standard of Chinese people increased enormously. From the late 1980s onwards, non-state enterprises, private, collective, and foreign join ventures were greatly encouraged. The best example is the development of the township and village enterprises (TVEs) in rural areas, which quickly became a new powerful economic force in the economy and its output value exceeded in the agricultural sector in the early 1990s. Since the 1990s, as TVEs gradually went to pot, the Chinese Government engaged in more comprehensive economic reforms in all areas, such as reforms and privatisation of State Owned Enterprises (SOEs), liberalisation of the price of agricultural products, and promotion of domestic labour-intensive industries.

During the period that China engaged in its domestic economic reforms, its government also put great efforts in initiating and promoting trade liberalisation since 1978. The Chinese Government realised that, in order to achieve the most important and ultimate goal of raising the living standard of its people, besides domestic economic reforms, liberalisation to the world economy and globalisation are another efficient channel. Since China had closed its economy to the world for more than 10 years and its economy was damaged to a certain degree, domestic firms in China had no competitive capacity at all, the Chinese Government chose a gradual liberalisation path in order to bring moderate competition into the domestic market while prevent its industries from being destroyed by powerful foreign ones.

The main trade policies in China can be divided into five parts. Firstly, the government decentralised the authority engaged in foreign trade, gradually shifted the system of central planning and commanding to guiding in trade, and liberated the management of foreign exchange step by step. Secondly, since 1979, the government has formulated a series of polices stimulating exports one after another, such as subsidising exports, devaluating Renminbi, returning export tax, granting the export credited, and constructing favourable tax policies and special regions for export processing firms. Thirdly, the government has been encouraging foreign direct investment (FDI) and advanced technologies. Many favourable polices, such as tax reduction and creating special economic districts with great infrastructure. More importantly, the government especially encouraged the introduction of more advanced technology. Fourthly, the policies of trade liberalisation were carried out progressively. In 1985, China revised the regulations of tariff comprehensively. From 1986 to 1991, the tariff rate was adjusted in a small scale for several times. During the period of 1992-1997, the tariff rate in China was adjusted down from an average rate of 47.2 percent to 17 percent, then down to 15.3 percent in 2001. At the same time, the government reduced many non-tariff barriers (NTBs), such as eliminating all import quotas and the licence system. And, fifthly, the government has been encouraging the develoment of labour-intensive industries, while protecting and supporting the capital/technology-intensive industries inceasingly.

During a short period before and after entering the World Trade Organisation (WTO), China greatly revised more than 2,500 laws and regulations, including the foreign investment law and the foreign trade law. Moreover, the State Council cancelled or adjusted the administrative examination and approved more than 1800 projects. The tariff rate was adjusted downward for three times in order to further open the national market and many NTBs were cancelled.

The Chinese Government not only established numerous trade polices but also took real actions to realise them efficiently. For example, the financial institutions, such as the development fund and the risk fund, serving for international trade, were set up and perfected progressively. Export credits and export credit insurance were offered by national commercial banks and part of the tax was returned to exporters. The government created special trade areas at the border and coastal regions by providing trade information, financial support, and other favourable policies. In order to introduce foreign investment, especially the ones with advanced technology, the government provided tax reduction policies and created special economic districts with better infrastructure and information services in the coastal regions. For example, the revenue tax for an inland Chinese firm is 33 percent and for a coastal or border firm is 24 percent, while for a firm in special economic district is 15 percent. However, wherever the firm is, the tax for a foreign firm is one half of that of the domestic firms. In addition, enterprises invested by foreigners can enjoy a two-year zero revenue tax credit. Finally, in order to introduce the high technology, equipments imported from foreign countries can be free of tariff and other import value-added taxes.

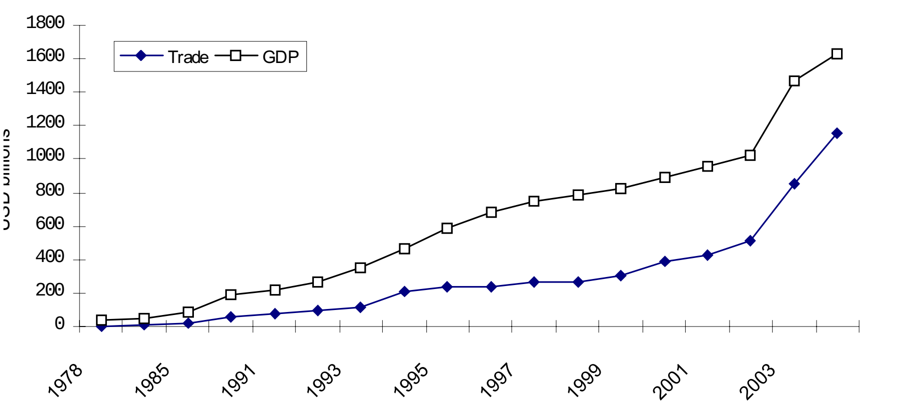
4.3 Trade, Development and Poverty

From the 1950s to the 1970s, the goal of the Chinese Government had been to create a strong and modernised industrial country by itself. In order to fulfill the goal, the government had kept emphasising the development and modernisation of its manufacturing industry by systematic and favourable policies while taking the agricultural sector for granted. For example, most natural resources and highly skilled workers were allocated in the manufacturing sector and prices of the agricultural products were set much lower than those of the manufacturing ones. As a result, manufacturing workers and the industry were largely subsidised nationwide at the cost of farmers and the agricultural sector.

More than 80 percent of the population in China was living in the rural areas till 1978. As a result, residents in rural areas that had relatively low education and skill level had a much lower living standard than people in the urban areas. In 1978, the per capita income of rural residents was only 134 Yuan (US$10.50). More than 250 million people (30.7 percent) in the rural area in China were below the absolute poverty line. In the same year, although there were about 20 percent of the population in urban areas who mostly worked in the manufacturing sector, the per capita disposable income for urban residents was 343 Yuan (US447.35), or 2.57 times the level of the rural residents. The phenomenon that almost all absolute poverty population was in the rural area and the agricultural sector and the large wage premium for workers in the manufacturing sector at the cost of farmers completely came from the historical reasons described above.

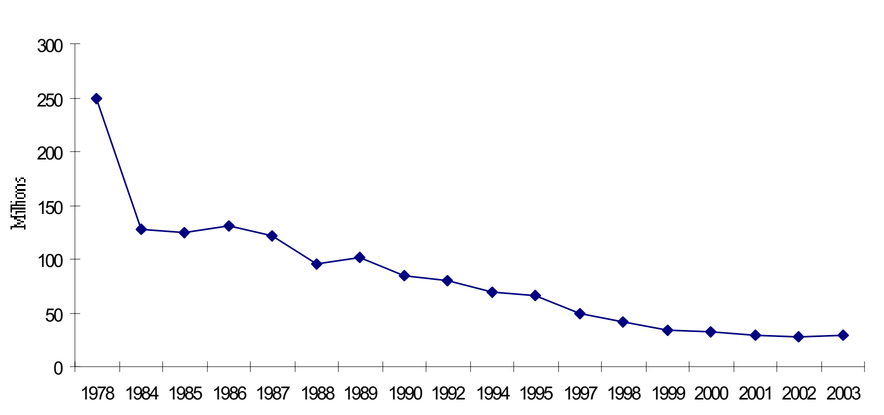
When it comes to the question of whether these trade policies fit the overall policies of poverty reduction, it is not easy to answer. Figure 4.1 shows the levels of gross domestic product (GDP) and international trade, and Figure 4.2 shows population in absolute poverty in China since 1978. It is obvious that as GDP and trade are steadily increasing, population in absolute poverty in China has been steadily decreasing.[2] However, the time period of most significant poverty reduction, from 1978 to 1984 was the period with dramatic domestic economic reforms but no large scale of trade liberalisation. After 1984, although the population in absolute poverty continued to decrease, the rate became much smaller, especially after China entered the WTO.

Figure 4.1: GDP and Trade in China



Source: China Statistics Yearbook, various years.

Figure 4.2: Population in Absolute Poverty in China



Source: World Bank.

The relationship between poverty reduction, economic reform, development, and trade liberalisation in China is analysed below. Trade policies that are pro-growth and pro-poor, as well as factors hindered poverty reduction in China are also discussed.

1978 – mid-1980s

The first phase of the poverty reduction by the Chinese Government mainly focused on domestic economic reforms from the late 1970s to the mid-1980s. By introducing the household contract responsibility system in 1978, incentives for production in the agricultural sector were dramatically spurred, production in the agricultural sector skyrocketed, and the living standard of Chinese people increased enormously.

At the same time TVEs emerged. These small collective or private firms engaged in processing agricultural products or low skill labour-intensive handmade light industrial goods. TVEs absorbed a large amount of surplus labour that was freed from the agricultural sector under the new system and kept these farmers in the same areas. From 1978 to 1985, TVEs in China had a high level of capital investment as well as labour employment: the average growth rate of investment was 18.85 percent and the empirical study shows that for every one Yuan investment in the investment in TVEs 1.005 unit of labour was absorbed on average in TVEs in China.

Thanks to the adoption of the household contract responsibility system and the flourishing of TVEs, the per capita output of crops increased by 14 percent, cotton by 74 percent, oil seeds by 176 percent, meat by 88 percent, and the real per capita income increased by 2.6 times from 1978 to 1985. In addition, the population living under the absolute poverty line in rural areas was reduced from about 250 million to 125 million, or from 30.7 to 14.8 percent of the rural population, and the ratio of per capita income of urban to rural households dropped from 2.57 to 1.88.

Mid 1980s – mid 1990s

After the mid 1980s, the Chinese Government decided to liberalise its economy to the world in a large scale. The furious competition from the global market, the intrinsic disadvantages, and the domestic policies almost completely suffocated TVEs in China in the late 1980s. The reason was that the technology in TVEs lagged too far behind compared to that of the world level, so that the efficiency of the enterprise and the quality of their products gradually lost competitive ability. As the economy of China became more open and more efficient, foreign firms entered China in the form of FDI. The growth rate of investment in TVEs dropped to 8.38 percent on average from 1985 to 1990. AT the same time, its capability of labour absorbance dropped dramatically: for each Yuan of investment, the number of workers TVEs absorbed dropped from 2.21 in 1985 to -0.74 in 1990.

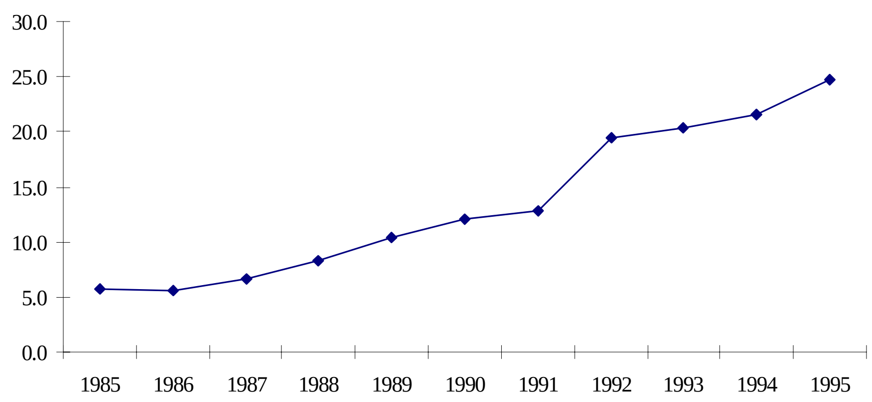
In late 1991, Deng Xiaoping gave a significant policy direction during his visit in southern China. Deng emphasised that the economic reform of China should be carried on with a more rapid pace and China should be liberalised to a larger degree to the world. After this, TVEs boomed again with an average 29.7 percent annual increase in the investment in TVEs. It provided an alternative way of production in the rural area, created many opportunities for employment and greatly raised the income level for the rural population. In 1992, TVEs employed more than a quarter of the total rural labour force and contributed about 40 percent of the per capita income for the rural population.

In addition, the special economic zones (SEZs) in the coastal areas began to flourish. Export oriented firms and joint ventures dominated the SEZs that rushed in to enjoy favourable tax policies and more advanced and complete infrastructures. Along with surplus labour from the rural areas, TVEs rushed into the urban areas, especially the coastal regions in southeastern and southern China. Trade liberalisation took the responsibility of poverty reduction from then on and the task of poverty reduction of the Chinese Government entered its second stage.

One of the greatest achievements of trade polices in China, especially its poverty reduction related trade policies, is that they are consistent with the domestic endowments and other economic situations. From the mid 1980s, rather than completely liberalising the economy in all aspects and all industries, the Chinese Government started to partially privatise SOEs, provide better infrastructures and favourable tax polices, as well as set up favourable trade policies to promote the development of export oriented mid- and small size labour-intensive enterprises. In addition, it introduced a very small amount of FDI in very limited industries.

The exports in the secondary industry grew from about 50 to 85 percent from 1985 to 1995. Most importantly, the government encouraged both domestic and foreign firms to engage in production in labour-intensive industries, such as textiles, shoes, garment, toys, machinery and transport equipment. Figure 4.3 shows exports in machinery and transport equipment as a percentage of total exports in manufactured goods.

Figure 4.3: Exports – Machinery and Transport Equipment As a Percentage of Manufactured Goods)

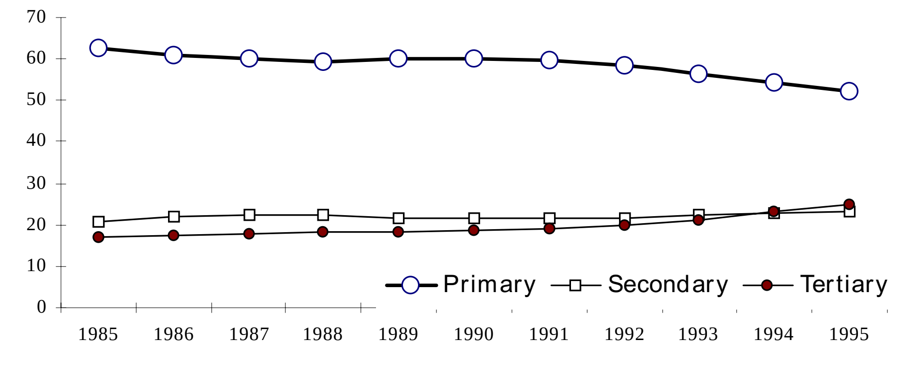


Source: China Statistics Yearbook, various years.

Thus, these processing export-oriented enterprises became one of the major channels absorbing excess labour released from the primary sector in rural areas. The migrants, many of whom used to live in poverty in the rural areas, got the chance for employment in these enterprises and finally divorced poverty. They sent a large portion of their income back home for the family in rural areas, to support the elderly and children and to build new houses for better living standards.

However, the official statistics did not pick much of the effect in either employment or income. Figure 4.4 shows that the percentage of labour employed in the primary sector decreased by 10 percentage points but labour employed in the secondary sector only increased by about 2 percentage points. In addition, statistics show that the income ratio of urban to rural residents increased from 1.88 to 2.75.

Figure 4.4: Employments by Sectors in China 1985-95 (percentage)



Source: China Statistics Yearbook, various years.

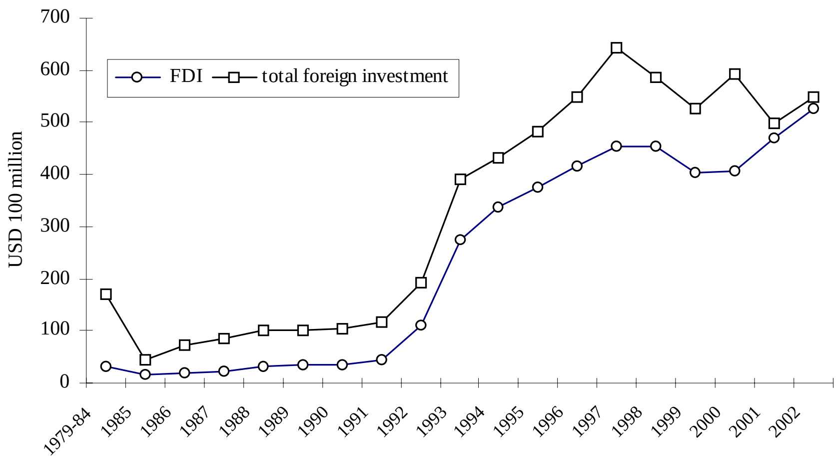
The major reason is that one of the important ways for employment in China, especially in these processing export-oriented enterprises, is "informal employment". From the late 1980s onwards, employment no longer belonged to one of the tasks of the government. People started to look for jobs by themselves and that provided the chance of emergence of "informal employment" (Cai, 2005). People who were released from the agricultural sector and moved out of the rural areas rushed into cities, especially the coastal areas with a large number of export-oriented processing industries. These people did not have registered permanent residence in cities. Therefore, their employment had to go through informal channels and that is why the real number of employment in the manufacturing sector could not be precisely captured in official statistics. But it is true that these people actually got rid of poverty through such employment opportunities.

Besides the pro-growth and pro-poor trade policies, the bar for poverty counties was set up, special funds were allocated to these counties from all levels of the administrative system, and special organisations, for example, China Foundation for Poverty Alleviation (CFPA) were funded. As a result, the task of poverty reduction aimed at the exact group of poorest people and functioned to its most efficiency. From 1986 to 1993, the average per capita income in poverty counties rose from 206 to 483.7 Yuan (US$28.44 to US$44.82), the population under poverty line in the rural areas dropped from 125 to 80 million, and the ratio of poverty population to total rural population decreased from 14.8 to 8.7 percent.

Mid 1990s – present

The large scale of trade liberalisation was followed by large inflows of foreign investment in China, which started to invite FDI almost as soon as the domestic reform began, but with very few cases carefully selected and only in the form of joint venture. Since the early 1990s, as the establishment of the SEZs and the construction of a better investment environment, FDI grew dramatically. The total FDI grew from US$1.66bn to US$52.74b from 1985 to 2002 (see Figure 4.5). Among all foreign investment in China, the share of FDI rose from 37 to 95 percent from 1985 to in 2003. In addition, although the total

Figure 4.5: Total Foreign Investment and FDI in China



Source: China Statistics Yearbook, various years.

amount of FDI was only 7.95 percent of the total investment in fixed assets, the value-added created by foreign firms reached 27.22 percent of the total industrial value-added in 2003. FDI has contributed a great deal to China's overall growth and trade. This is not only because investors introduced capital and technology, but also because they introduced business experience and management know-how. The Chinese absorbed this experience with low learning costs. Such a spillover effect of FDI is critical for developing countries to catch up in technology and institution building.

It is true that countries should specialise in the industries that they have comparative advantage in so as to allocate their limited resources efficiently, either due to different factor endowments or technologic differences. It is also true that domestic firms in developing countries could learn "new" technology from multinational firms. However, the capital and technology travelling to the developing countries are usually to use the cheap labour, and industries transferred to developing nations are usually the low-end, labour-intensive ones. Thus, the spillover effects of FDI and international trade may improve the knowledge endowments of a developing nation, but the differences may widen over time. As a result, developed countries become so competitive and advanced in production and management in all industries that trade and investment liberalisation may lead to a complete crash in domestic industries in developing countries.

China fought hard to protect its infant industries in its early stages of economic take-off. This can be seen from the 13 years' WTO accession negotiations and the gradual lowering of China's tariffs. But the most important factor that promises the success of the protection is the invitation of FDI with technology transfers. In the 1960s and 1970s, there was barely FDI, so that the development of the infant industry protected by the government had to depend completely on domestic technology, capital, and management skills. Developing countries initially lagged behind in these aspects, so that there was little possibility that the infant industries protected by the government could ever grow with protection, saying nothing of competing with their counterparts in developed countries. However, with the presence of FDI, the problem of capital scarcity is solved. In addition, the encouragement of FDI, especially joint ventures governed by technology transfer and local component requirements help domestic firms to get spillover effects and demonstration effects. Hence, the market size grew with income growth, producers benefited from economies of scale, the supply chains were built up, the local-component ratio got increased, and institutional efficiency were improved. Finally, while maintaining trade protection for most consumer goods, China adopted tariff-preferential policies towards imported technology and equipment. Thus, domestic companies and joint ventures benefited from these policies for speeding up technological upgrading and transfers. This policy has obviously helped Chinese companies to be quicker in their catching up. As a result, the infant industry succeeded in development and their competitiveness grew dramatically under the protection from the Chinese Government through trade barriers, such as tariffs and quotas.

The best examples are electronics and automobiles. Over the past 20 years, the policy combination for these two industries included the two key elements as described above: inviting FDI to undertake joint ventures, governed by some technology transfer and local component requirements; and maintaining trade protection barriers (tariffs and quotas). Table 4.1 shows the tariff rates for electronic products for the past 10 years or so.

Table 4.1: Tariffs on Electronic Products (percent)

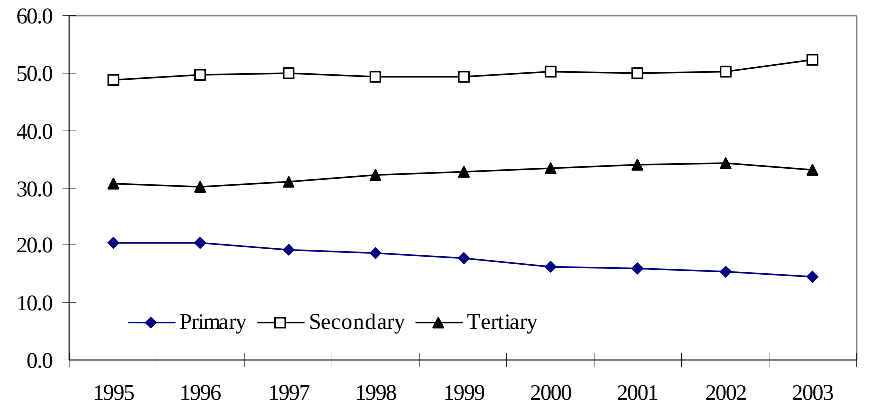
	1992	1994	1996	2002
Home electronic tools	80	68	40	30-35
Microwave	100	50	50	35
Recorder	100	90	60	35
Video recorder	100	90	60	45
Color TV	100	50	50	35-45
B/W TV	80	70	50	20

Source: Gang Fan (2005).

As a result, the production capacity of the secondary industry has been skyrocketing since the early 1990s (see Figure 4.6). However, the employment structure, recorded by official statistics, has no obvious change in the same period (see Figure 4.7). One of the reasons was the problem of "informal employment" as mentioned before, so that, although lots of surplus labour from the rural areas were observed migrating into the foreign and domestic firms in the southeastern and southern China in real life, the formal statistics did not show any large change in the structure of employment after 2003 (see Figure 4.6).

However, there might be another reason for it. After the early 1990s, the Chinese Government has been emphasising technology upgrading in the manufacturing industry. The Chinese Government had also established favourable trade and other economic

Figure 4.6: Structure of the Economy in Terms of Total Output (percentage of the GDP)

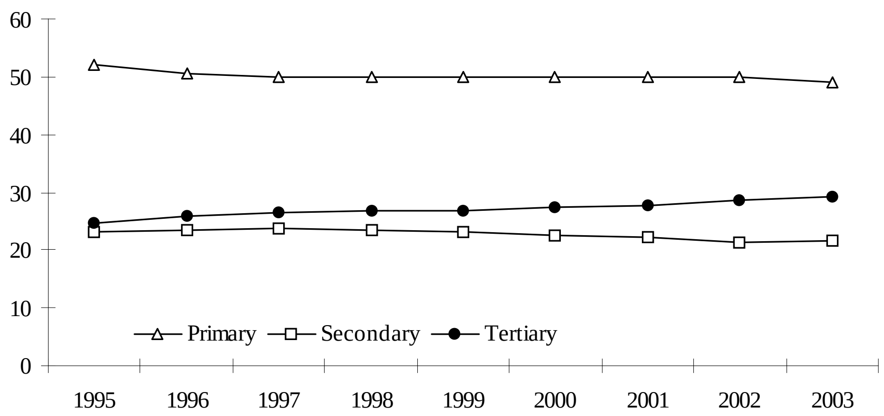


Source: China Statistics Yearbook, various years.

policies to encourage technology improvement, such as providing tax reduction for domestic high-tech firms and offering foreign firms better deals for co-operation if they bring more advanced technology. As a result, modern technology, machines, and management skills replaced handmade workshops, like TVEs and also reduced the number of employment of foreign firms and related domestic firms. Between 1995 and 2000, the annual investment in TVEs was only 0.9 percent. Moreover, on an average, any investment during this period would destroy some of the initial positions in TVEs.

However, though there has been too large a number of population moving out of the rural areas and out of the agricultural sector, the average wage for these informal employed people did not increase much for the past 10 years or so (Fang Cai, 2005). Thus, although

Figure 4.7: Structure of Employment (percentage of the GDP)



Source: China Statistics Yearbook, various years.

these people who used to live in the rural areas and in poverty got employed in these low skill labour-intensive enterprises and got a much higher income than they used to have, their standard of living has not risen much after their lives first got changed. The income gap became even larger between the developed regions in southeastern and southern China and mid- or western China, and between the urban and the rural areas. By the end of 2004, among the 26 million people who still lived below the absolute poverty line, the absolute poverty rate in eastern China was one percent; in mid-China, it was 2.8 percent; and in western China, it was 5.7 percent. And the ratio of the poor to rural population was 2.2 percent in the east, 5.3 percent in the middle, and 10.5 percent in the west of China. It is obvious that the more liberalised regions had higher growth rates, higher average income levels, and lower poverty rate.

Does it mean that regions and industries that were relatively close did not enjoy the benefit of trade and FDI liberalisation? The answer is “no.” Although these regions and industries could not enjoy the benefit directly, the Chinese Government put a lot of efforts to transfer a part of the gains from liberalisation to the less developed regions. The special funds to fight poverty was 30 times the level in 1980; the population in extremely poor counties decreased from 58 million in 1994 to 12 million in 2000; 96 percent of the counties got electricity, 89 percent were connected by roads, 69 percent had post services, and 68 percent had telegraphic services by the end of 2000. In addition, more than 10 billion Yuan (US$1.3bn) were invested into compulsory education in these poor counties.

4.4 Summary and Policy Implications

Economic reforms and the trade and investment liberalisation in China seem to have generally been pro-growth and pro-poor. The most significant experiences are developing and encouraging export-oriented labour-intensive processing industries and gradual liberalising while protecting infant industries through FDI with advanced technology and spillover effects till the infant industries would catch up and get competitive enough. Trade liberalisation has played an important role in China’s growth and has significantly improved the income of the Chinese people. More open areas enjoyed the development and income increase directly from trade liberalisation, while the less open areas in inland China also shared the benefit of liberalisation through labour migration and cheaper products from the more developed regions.

However, since the liberalisation in China was uneven geographically and among economic sectors, the income gaps between the east and the west and between agricultural and non-agricultural workers have been growing wider. In order to narrow the gap and alleviate the problem of inequality, the Chinese Government should, and it has decided to, take actions right away.

Since the most undeveloped regions and poorest people are still in the agricultural sector and the rural area, further trade policies should consider more of these groups as disadvantageous. However, since China made a lot of compromises during its negotiation of re-entering WTO, the tariffs for agricultural products have been decreasing dramatically after 2001 and the government cannot use export subsidy or import quota to protect the agricultural industry and farmers. One of the alternatives is to use some of the yellow or green box measures under the WTO framework before the binding period, such as subsidies on seeds and fertilisers, subsidies on sales loans of agricultural products, education on farmers, and technology transfer to the agricultural sector. In addition, the government should also support the construction of infrastructure, as well as take actions in institutional reforms in the rural areas and western regions, so that international merchants would go further to the west and down to the rural areas for stocking and marketing. Hence, the foreign investment would be attracted in these regions to set up affiliates. The government should keepup its efforts in providing compulsory education in the rural areas so that human capital would be accumulated and the modern production in agriculture can be achieved which will entice more domestic and foreign investment. Part of these actions is the chief goal for the next five years as set by the Chinese Government earlier this year. And it is hoped that a brand-new developed rural areas with thriving agriculture and civilised farmers with no absolute poverty would be built in the near future.

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Endnotes

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2 However, analysis carried out by Ravallion (2007) shows that despite their apparent co-movement, the trade-orientation and the poverty incidence in the Chinese economy do not have any long-term statistical relationship.

5

CHAPTER

Trade Liberalisation and its Impact on Poverty Reduction: *The Indian Experience*

– Pranav Kumar[1]

5.1 Introduction

After World War II, India, along with other developing countries, chose a strategy of import substitution as a means of industrialisation. The economic policy followed by India resembled the Soviet model of socialist planning. The principal objective was to give emphasis on indigenous production of goods and services to boost domestic industrialisation. It followed the principle of import control and import substitution to reduce foreign dependence and become self-sufficient. To facilitate such import substitution policy within the economy, India maintained a high tariff wall, complicated system of licences and quantitative restrictions (QRs). By and large, the investment strategy was envisaged by the government that set the pace of development through public sector investments via Five Year Plans and directed the volume of private sector investment through the rigid state regulations on financial institutions, licensing, foreign exchange control, and tax policy etc.

The inward-looking strategy was largely in practice till the 1980s, which had been maintained for the first three decades since the beginning of the national planning in 1951. After that, India slowly started shifting its focus towards export-led growth. The import-substitution strategy might not have yielded the desired outcome as envisaged at the beginning but nevertheless its contribution to the development of the Indian economy cannot be undermined altogether. It helped in creating a reasonably good industrial and financial sector base led by public sector enterprises. Preference was given to small-scale industries (SSIs), which contributed significantly to employment generation. In the agriculture sector, the Green Revolution of the mid-1960s helped India to become self-sufficient in food production. However, this growth model failed to transform India into a high-growth economy. Up to 1990, India's Gross Domestic Product (GDP) grew by an average of a little under four percent a year known as "Hindu rate of growth"[2] , which was much lower than that of South Korea, Taiwan and other emerging economies at that time.

As already mentioned, since the mid-1980s, India gradually shifted the focus of its developmental strategy towards export led growth. In other words, the process of liberalisation of the Indian economy began. However, the full-fledged radical reforms started only in 1991, when India confronted with severe macro-economic and balance of payment (BoP) crisis. The sudden increase in oil prices due to the Gulf War in 1990, the drop in remittances from Indian workers in the Middle East, and the slackened demand of important trading partners further exacerbated the problem (Topalova, 2004). To deal with its external payments problems, the Government of India requested a stand-by arrangement from the International Monetary Fund (IMF) in August 1991. The IMF support was conditional on an adjustment programme featuring macro-economic stabilisation and structural reforms. The Government of India had to undertake a comprehensive policy reforms covering industrial, external, financial and fiscal sectors. The agriculture sector was kept outside the agenda of economic reforms at the beginning. However, the agriculture sector was also liberalised in order to meet the obligations of the WTO Agreement on Agriculture (AoA).

The economic reforms of the last two decades did bring positive results in terms of higher economic growth; expansion in exports, more disciplined crucial economic indicators such as fiscal deficit, inflation, and current account balance, which went haywire at the end of 1980s. The GDP growth in India rose from a rate of 3.5 percent that prevailed during the 1960s and 1970s to 5-6 percent in the 1980s and 1990s, touching an all time high of 8.2 percent in 2003-04. India managed to recover though marginally its lost share in world trade, which was at whopping 2.5 percent of world merchandise exports in 1950, was much larger than the share of China and Japan. The share of India in world merchandise export increased to 0.8 percent.

The big question is: how far did this new found higher growth regime translate into poverty reduction and employment generation? The impact of higher economic growth on employment and poverty reduction is not very encouraging. The pace of employment growth slowed down in the 1990s. The population below poverty line (BPL) declined in 1990s – both in absolute and percentage terms – but it fell short of plan projections. Moreover, the export-led growth did not leave much impact on the major pockets of poverty, viz. Bihar, Uttar Pradesh, Assam and Orissa. This has further accentuated the regional disparities, particularly during the last 15 years.

This paper tries to investigate the impact of trade-led growth on poverty, employment generation and regional disparities in India, based on secondary data and literature. The paper is organised as follows: Section 5.2 describes the Indian economic policy reforms of 1991 with focus on trade liberalisation; Section 5.3 presents the measures taken to liberalise agricultural trade; and Sections 5.4 and 5.5 examine the impact of trade-led growth on the economy as a whole including its effect on employment generation and poverty alleviation.

5.2 The Trade Policy Reforms of 1991

India's post-independence development strategy was one of national self-sufficiency, which stressed the importance of government regulation of the economy. In particular, India's trade regime was amongst the most restrictive in Asia, with high nominal tariffs and non-tariff barriers (NTBs), including a complex import licensing system, an "actual user" policy that restricted imports by intermediaries, restrictions of certain exports and imports to the public sector ("canalisation"), phased manufacturing programmes that mandated progressive import substitution, and government purchase preferences for domestic producers.

The current account deficit rose to 3.2 percent of GDP in 1990, and debt-service payments amounted to as much as 35.3 percent of current foreign exchange receipts. Foreign exchange reserves were down to a level barely enough to finance imports for two-and-a-half months. Short-term debts amounted to a dangerously high level of 146.5 percent of foreign exchange reserves by the end of March 1991. The rate of inflation soared, exceeding 10 percent in 1990. Expectations of an imminent devaluation of the rupee led to the withdrawal of deposits by non-resident Indians (NRIs). A specter of default on short-term loans and a downgrading of India's credit rating loomed.

The severity of the economic crisis of 1991 provided an opportunity for the government to undertake major macro-economic policy reforms of long-standing restrictive domestic investment and international trade policies. India gradually abandoned the use of quantitative controls in economic management in favour of market-based instruments. There was a decisive move away from inward orientation and toward greater integration with the global economy. Finally, the reforms signalled a shift away from an overstretched, overextended, rigid, and inefficient public sector and toward greater reliance on the private sector (Srinivasan and Tendulkar, 2003).

The pre-1991 trade and exchange rate regime protected domestic manufacturing industries through restrictive import policy. Prior to 1991, import tariffs in India were amongst the highest in the world. The government export-import policy plan (1992-97) ushered in radical changes to the trade regime by sharply reducing the role of the import and export control system. The share of products subject to QRs decreased from 87 percent in 1987-88 to 45 percent in 1994-95. The actual user condition on imports was discontinued. All 26 import-licensing lists were eliminated and a "negative" list was established (Hasan *et al*., 2003). Thus, apart from goods in the negative list, all goods could be freely imported – subject to import tariffs (Goldar, 2002). In addition to easing import and export restrictions, tariffs were drastically reduced. Average tariffs fell from more than 80 percent in 1990 to 37 percent in 1996, and the standard deviation of tariffs dropped by 50 percent during the same period.

The maximum tariff rate was lowered from a peak of 355 percent in 1990-91 to around 40 percent by the year 1999-2000. The rate for the manufacturing sector was reduced to 30 percent in 1999-2000 from a high of around 125 percent before the 1991 trade policy changes. The reductions in import duty rates were especially sharp for capital goods. The composite duty rate on "project imports" (imports of various capital goods needed to set up new projects) was lowered from 85 percent to around 25 percent. There is an even lower rate of 20 percent applicable for machinery for electricity generation, petroleum refining, coal mining and zero for machinery for fertiliser projects. A number of changes were also made to simplify the system-reduction in inter-product variations and rationalisation of the tariff structure. In addition, many end-use exemptions were removed. As a result of the tariff reforms, the collection rate of duty at the aggregate level fell from 47 percent in 1990-91 to 30 percent in 1999-2000.

Agricultural products, with the exception of cereals and oil seeds, faced an equally sharp drop in tariffs, though the NTBs of these products were lifted only in the late 1990s. There were some differences in the magnitude of tariff changes (and especially NTBs) according to industry use type, i.e. consumer durables, consumer non-durables, capital goods, intermediate and basic goods. The Indian authorities first liberalised capital goods, basic and intermediates, while consumer non-durables and agricultural products were slowly moved from the "negative" list to the list of freely importable goods only in the second half of the 1990s.

In 1991, the nominal exchange rate of the rupee was devalued by 22.8 percent relative to a trade-weighted basket of currencies. Temporary measures to deal with the BoP crisis (e.g., foreign exchange licensing, import compression, export linked imports, and a dual exchange rate system introduced to face the external payment crisis of 1991) were withdrawn soon thereafter. Market forces began to play a larger role in determining the exchange rate when partial convertibility of the rupee for current account transactions was introduced in 1993. Later on, full convertibility in the current account transaction was introduced.

All export subsidies and most of the QRs on intermediate and capital goods imports were withdrawn in 1991. The long list of imports subject to QRs and other restrictions was replaced in 1991 by a considerably narrower (though still long) list of monopoly consumer goods. The share of QR-protected goods in total tradable GDP had come down to 66 percent by May 1995, whereas that for manufacturing GDP dropped to 36 percent (most of it accounted for by QRs on consumer goods) by May 1996. Agriculture alone remained highly protected after the initial round of reforms; the mean protection rate in 1995 of 84 percent was only marginally lower than its pre-reform level of 94 percent. Quotas and stipulations of minimum export prices for agriculture exports persist.

Despite wide-ranging trade liberalisation in the 1990s and thereafter the, Indian tariff rates continued to be much higher than those in the rapidly growing countries of East and Southeast Asia (see Table 5.1). The post-Uruguay Round bound rate negotiated by India was invariably higher and for some products much higher than the average of the bound rates. The average applied tariff rate of 51.6 percent for India for all of the product categories combined was not only the highest but also nearly three times as high as the average of 19.2 percent for 28 developing countries (Srinivasan and Tendulkar, 2003).

Agriculture Trade Liberalisation

During the last five decades there have been highly interventionist trade policies practiced by India, which have discriminated against agriculture, particularly in the category of basic foods such as cereals. International trade in cereals by the private sector was practically banned during the period 1950-95, with the exception of *Basmati* rice exports and maize imports for the poultry sector. These restrictions on the external front were supplemented by substantial controls over pricing, procurement, stocking, marketing and transport of food grains at the domestic front.

When India embarked on to the process of comprehensive economic liberalisation in July 1991, the agriculture sector was not in the agenda items. It mainly touched upon the external sector, the industrial sector and fiscal reforms. The trade reforms undertaken as a part of larger external sector reforms included the devaluation of the rupee and gradual dismantling of import, export, and exchange controls. Although very little headway was made in the matter of liberalisation of agricultural trade, the devaluation of the rupee in 1991 made many Indian agricultural products competitive in the international market.

Table 5.1: International Comparisons of Tariff Barriers					
Country	Year	Simple Mean Tariff (Percent)	Standard Deviation	Import-weighted Mean Tariff (Percent)	Percentage Share of Tariff Lines with Tariffs Above 15 Percent
India	1990 1999	79.0 32.5	43.6 12.3	49.6 28.5	97.0 93.1
Bangladesh	1989 2000	106.6 21.3	79.3 13.6	88.4 21.0	98.2 51.8
China	1992 2000	41.0 16.3	30.6 10.7	33.2 14.7	77.6 4.2
Indonesia	1989 2000	21.9 8.4	19.7 10.8	13.0 5.2	50.3 11.2
South Korea	1988 1999	14.8 8.6	5.3 5.9	10.5 5.9	12.5 0.7
Malaysia	1988 1997	17.0 9.3	15.1 33.3	9.4 6.0	46.7 24.7
Nepal	1993 2000	21.9 17.9	17.8 20.9	15.9 17.7	58.9 18.7
Pakistan	1996 1998	50.9 46.6	21.5 21.2	46.4 41.7	91.4 86.3
Philippines	1989 2000	28.0 7.6	14.2 7.7	22.4 3.8	77.2 8.8
Sri Lanka	1990 2000	28.3 9.9	24.5 9.3	26.9 7.4	51.7 22.0
Thailand	1989	38.5	19.6	33.0	72.8

Source: Global Development Finance 2002, Analysis and Summary Tables, World Bank.

The exports of all merchandise including the exports of agricultural products from India recorded a significant increase in growth during the 1990s. Besides, gradual liberalisation of trade in India and dismantling the process of controls also contributed to a growth of agricultural exports. The total agricultural exports recorded an annual growth rate of 8.12 percent during the 1990s compared with a low growth of only 2 percent during the 1980 (Bhalla, 2004).

Agriculture Trade Liberalisation in the Post-WTO Era

The major impetus towards agricultural sector liberalisation in India came after the establishment of the WTO in 1995. India is a founder member of the WTO. In order to fulfill its obligations under the WTO AoA, India has undertaken several policy measures to reform its farm sector. India's obligations under the WTO AoA fall mainly under four broad areas namely: market access, export subsidies, domestic support, and Sanitary and Phyto-sanitary (SPS) measures.

India's Obligations under Market Access

According to the WTO AoA, all NTBs to agricultural trade were to be tariffied and converted into their tariff equivalents. Further, tariffs resulting from this "tariffication process" were to be reduced by a simple average of 36 percent over a period of six years in the case of developed and 24 percent over a period of 10 years in the case of developing countries. In addition to this, for countries which had tariffied, there was also an obligation to maintain current and minimum access opportunities and to establish a minimum access tariff quota of a minimum of three percent of domestic consumption in the base period 1986-88. This was to be gradually increased to five percent of base period consumption over the implementation period.

Along with many developing countries, India was permitted to offer ceiling bindings instead of tariffication. These bindings were not subject to the reduction commitments. India was also allowed to maintain QRs on account of BoP problems. But since India had not tariffied and was instead allowed to bind its tariffs, it did not have any market access commitment. But like many developing countries, which decided to bind their tariffs, India is also not entitled to use the Special Safeguard Measures (SSG) of the AoA, which can be used by only a few (36) developed countries, which had tariffied.

Since, AoA allowed members either to tariffy in all cases or to bind their tariffs, during the Uruguay Round, India chose to follow the latter route and bound its tariffs for 3375 tariff lines which constituted 65 percent of India's total tariff lines defined at 6-digit HS level. Out of these 3375 commodity groups, 683 commodity lines at 6-digits of HS classification belong to the agricultural sector. Simultaneously, India continued to have QRs, which it was permitted to impose because of BoP reasons. Like many other developing countries, except for a few commodities, India bound its tariffs at 100 percent for primary products, 150 percent for processed products and 300 percent for edible oils. But, for certain items (comprising about 119 tariff lines), which were historically bound at a lower level in the earlier negotiations, the binding levels were very low, in some cases, even zero. But these zero or low tariffs had no relevance because India was allowed to use QRs.

The US and some other countries in the Dispute Settlement Body (DSB) of the WTO challenged India's continuation of QRs on the plea of BoP position. In view of its improved position in the matter of foreign balances, India lost the plea for retention of QRs on account of BoP position –both at the DSB as well as at the Appellate Body. According to the understanding arrived at between the parties regarding the reasonable period of time latest by March 2001, India removed the QRs on 714 items including 142 commodities belonging to the category of agricultural commodities during 1999-2000. On the occasion of Export and Import Policy (EXIM) announcement on March 31, 2001, the Commerce Minister announced the removal of QRs on the remaining 715 items, thereby ending the much-maligned "Licence Permit Raj".

With the removal of 715 items from the list, which include 42 groups belonging to agriculture, quantitative restrictions on imports have been completely abolished and the obligation to replace QRs by tariffs has by and large been fulfilled (except for a few strategic commodities). After the decision to remove QRs, India was under GATT Article XXVIII, allowed to renegotiate the tariffs bindings on those commodities for which it had very low or zero tariff bindings. Consequently, in December 1999, India successfully negotiated and the bindings levels were suitably revised upward to provide adequate protection to the domestic producers. Out of these low bound tariff lines, bindings on 15 tariff lines, which included skimmed milk powder, spelt wheat, corn, paddy, rice, maize, millet, sorghum, rapeseed, colza and mustard oil, fresh grapes etc., were revised to a level ranging between 45 percent to 75 percent.

India's Commitments under Export Competition

Export subsidies were subject to reduction commitment, in the area of export competition, though several kinds of direct payments were exempted. The export subsidy commitment is either in the form of budgetary outlay reduction commitments or in the form of export quantity reduction commitments. Export subsidy outlays in budgets are to be reduced by 36 percent for developed countries and 24 percent for developing countries over a period of 6 and 10 years respectively. The volume of exports receiving subsidies is to be reduced by 21 percent per product or group of products for developed countries and by 14 percent for developing countries over the same time period. These reductions are to be made by taking 1986-90 as the base period. The LDCs are not subject to any reduction commitments. The commitments are defined over commodity aggregates rather than individual lines.

Export subsidies of the kind listed in the AoA, which attract reduction commitments, are not extended to India. Indian exporters of agricultural commodities do not get direct export subsidy. The only subsidies available to exporters of agricultural commodities are in the form of: (i) income tax exemptions on profits from export sales; and (ii) subsidies on costs of freight (export shipments) of certain products like fruits, vegetables and floricultural products.

Since these payments are exempt for developing countries from reduction commitments during the implementation period, they will not cause any adverse impact on agricultural exports from India, at least during this period. Therefore, India is making use of these subsidies in certain schemes of Agricultural & Processed Food Products Export Development Authority (APEDA), especially for facilitating the export of rice, wheat and horticulture products. But once the export supplies become self-sustaining during the adjustment period, these will have to be withdrawn.

India's Commitments under Domestic Support

The AoA distinguishes between three types of production support, grouped into "boxes", which are given the colours of traffic lights: green (permitted), amber (slow down – i.e. to be reduced), blue (subsidies that are tied to programmes that limit production). There are also exemptions for developing countries in the form of Special and Differential Treatment (S&DT).

Domestic support measures, according to the Agreement, are meant to identify acceptable measures of support to farmers and curtailing unacceptable trade distorting support to farmers. The trade distorting domestic support is measured in terms of what is called the "Total Aggregate Measurement of Support", which is expressed as a percentage of the total value of agricultural output and includes both product specific and non-product specific support.

According to the AoA, all non-exempt domestic support calculated as Aggregate Measure of Support (AMS), has to be reduced by 20 percent by developed countries in 6 years (1995-2000) and by 13.33 percent by the developing countries in 10 years (1995-2004), taking 1986-88 as the base period. However, domestic support given to the agricultural sector up to a *de-minimus* level of 10 percent of the total value of agricultural produce in developing countries and five percent in developed countries is allowed.

AMS is further classified into product-specific and non-product specific support. All the support/policies directed at producers of various agricultural products and provided on product-by-product basis constitute the product specific AMS. These support measures can be classified into three broad categories namely: Market Price Support; Non-exempt Direct Payments; and other Product Specific Support. The only measure that is relevant for the calculation of product specific support in India is the market price support since the other two – Non-exempt Direct Payments and other Product Specific Support – do not constitute a significant proportion of support in India. The market price support in the form of minimum support prices is announced by the government for different commodities, based on the recommendations of the Commission for Agricultural Costs and Prices (CACP). The non-product specific support is the measure of support given to agriculture by way of subsidised supply of inputs such as fertilisers, irrigation, electricity, credit and seeds, etc.

Gulati (2001) calculated that in the case of India, the product specific support in the year 1995-96 was negative to the extent of 38.5 percent. Bhalla (2004) has prepared a new set of estimates for both the product specific and non-product-specific support to agriculture. The results show that the product-specific support is negative both at fixed price based on TE 1986-88 or even if current price base is taken (see Table 5.2). However, the non-product support that is input subsidies is positive (see Table 5.3). But they do not exceed the *de minimus* level either individually or in the aggregate. Since India's total product support continues to be negative, it has proposed to the WTO that the negative support should be offset against positive non-product support while calculating the AMS. No final decision has yet been taken on this issue.

Table 5.2: Product Specific Support for Selected Commodities in 1999-00 as percent of Value of Output of Respective Commodity		
Item	**Product Specific Support**	
	Fixed Price Base	**Current Price Base**
Rice	-54.77	-52.52
Wheat	-97.25	-8.56
Cotton	-215.58	-192.79
Sugar	10.04	41.39
Source: State of the Indian Farmer, Vol.19, Ministry of Agriculture, Government of India, May 2004.		

Table 5.3: Non-product Specific support as percent of Value of Agricultural Output				
Items	**1995-96**	**1996-97**	**1998-99**	**1999-00**
Irrigation	1.58	1.59	1.52	1.44
Credit	0.07	0.07	0.04	0.07
Fertiliser	2.08	2.12	2.25	2.47
Power	3.97	3.90	4.09	4.58
Seed	0.00	0.00	-0.01	0.00
Total non-product support	7.70	7.67	7.90	8.57
Source: State of the Indian Farmer, Vol.19, Ministry of Agriculture, Government of India, May 2004.				

5.3 Trade Liberalisation – Economic Outcomes

It is almost 15 years that the economic reform process began in India. Since the beginning of the 1990s, the economy has been steadily moving towards integrating in the global economy. The first generation liberalisation has played a significant role with liberalisation cutting across trade, industry, financial and other sectors of the economy. As a result, India has become the world's 12th largest economy and the third largest in Asia behind Japan and China. The pace, content and degree of economic reforms have picked up pace with the subsequent years with the integration of Indian international trade policies to the world Trade Organisation's (WTO) trade liberalisation mandates.

The total GDP of the country is around US$570bn. The service sector, industrial sector and agriculture sector accounted for 50.7, 26.6 and 22.7 percent of the GDP respectively. Real GDP growth for the 2003-04 was estimated to be 8.4 percent and 7 percent in 2004-05. The service sector has been the principal driver of the GDP growth during the 1990s. The economy has withstood, without any major disruption, several shocks like the East Asian crisis, global depression, border tension, oil price fluctuation and major drought. There is macro-economic stability within the country. The inflation rate is also low. There is abundant liquidity at lower interest rate, exchange rate is reasonably stable and the rupee has remained almost stable, with some rise in value in terms of real effective exchange rate. Short-term external debt is also low within the country.

Imports and exports currently account for 23 percent of the GDP compared to 15 percent in 1990-91. The current account balance has also turned surplus in the last few years

Table 5.4: Average Annual Growth in GDP								
Indicator	**1981-82 to 1990-91**	**1992-93 to 2001-02**	**1991-92 to 2002-03**	**1997-98 to 2001-02**	**1997-98 to 2002-03**	**2003-04**	**2004-05**	**2005-06 (Est)**
GDP (%)	5.6	6.1	5.9	5.5	5.3	8.5	6.9	6.5-7.0
Agriculture	3.8	3.3	2.7	2.0	2.0	9.6	1.1	2.0
Industry	7.0	6.3	6.4	4.6	4.6	6.5	8.3	8.5-9.0
Services	6.7	7.8	7.8	8.1	8.1	8.9	8.6	8.5-9.0

Source: India Development Report, 2004-05.

from the deficit of 3.1 percent in 1990-91.With the abolishing of import-licensing, the quantitative restrictions that remained in most of the goods were completely dismantled. The weighted average tariff rate in agriculture and non-agriculture products has also come down. The custom duties the peak protective rates were brought down from 300 percent to even less than 85 percent.

Export growth also picked up pace significantly after the initiations of reform. Foreign portfolio and direct investment, which was virtually non-existent prior to the 1990s inflows, have risen significantly. They have contributed to the US$120bn in foreign exchange reserves at the end of June 2004. The Foreign investment promotion board was constituted for expediting approvals in other sectors and for investment approval above 51 percent. The Foreign Exchange Regulation Act (FERA) was amended and subsequently replaced by the Foreign Exchange Management Act (FEMA) to liberalise the operating environment of the firms with foreign equity and make it easier for firms with foreign equity. Participation of foreign institutional investors was promoted in the secondary market for Indian stocks. Portfolio foreign investment was also encouraged through the medium of Global Depository Receipts (GDRs) and American Depository Receipts (ADRs) floated abroad by Indian firms.

The industrial policy declared in 1991 substantially dispensed with the industrial licensing, announced measure facilitating foreign investment and technology transfers and threw open many sectors which were hitherto reserved for the public sectors. Private sectors were allowed to operate in all areas except those of strategic concerns such as defence, railway transport and atomic energy. The list of industries reserved for the public sector is reduced to six. The industrial sector is also going through a process of restructuring, consolidation, adaptation of cost-cutting measures foreign collaboration and technology upgradation. Some of the industries like pharmaceuticals and automobile have already become quite competitive in the world market. Although a huge restructuring took place in the industrial sector, on the whole the performance of the industrial sector during the post-reform period 1992-2002 was not as good as that in the pre-reform period 1982-90.

Agriculture Trade Liberalisation – Economic Outcomes

Impact on Production

From the above analysis, it appears that of the three commitments that India has given under the Uruguay Round Agreement (URA), at least two are unlikely to have any impact on Indian agriculture because: (i) India is not required to reduce its domestic subsidy levels, as its AMS are much below the cut-off point of 10 percent, being in fact negative in case of product specific; (ii) India has not subsidised its exports of agricultural commodities, and hence, it remains unaffected by the export subsidy reduction commitments. So the only commitment which can affect Indian agriculture, is that of market access or tariffication of quantitative restrictions (QRs) for Balance of Payment (BOP) reasons. However, the BOP justification for India's continued use of QRs, has come under increasing pressure because of the increase in foreign exchange reserves. In the Export-Import Policy announced on March 31, 2001, with the removal of QRs on 715 items the obligation to replace QRs by tariffs has by and large been fulfilled.

When the QRs were abolished in 2001, there was an apprehension that the Indian market would be flooded with cheap farm imports from the West. But that did not happen. India, along with the removal of QRs simultaneously, raised the tariff rates on many agricultural commodities in the late 1990s. The average agricultural tariff, excluding the special additional duty (SAD) rose from 33.8 percent in 1997-98 to 41.7 percent in 2001-02. The majority of agricultural product-related tariffs are in the 35 percent to 50 percent range. Hence, as international prices crashed in the late 1990s, imports did not increase significantly as import tariffs were adjusted upwards (World Bank 2004).

India's agricultural export policies were progressively liberalised beginning in 1994, subject to occasional reversals. Export policies pertaining to agricultural products changed frequently, often several times a year, and therefore did not follow a general trend. The policy reforms include reductions in products subject to state trading, relaxation of export quotas, abolition of minimum export prices, and increased credit availability for exports. India introduced export subsidies for cereals in early 2000. Government of India had to resort to export subsidies for rice and wheat as world cereal prices crashed to very low levels in the late 1990s. The decline in world prices coincided with an increase in the domestic support prices for wheat and rice, which encouraged increased production.

As a result of the upward revision of import tariffs and introduction of export subsidies on agricultural commodities, the level of trade protection increased for several major commodities in the late 1990s. Nominal protection coefficients (NPCs) represent the ratio of the domestic price to world price (the price of an exportable or importable commodity at the border). Estimates of NPCs (see Table 5.5) for rice and wheat indicate that trade protection for them increased rapidly in the late 1990s (Gulati et al 2003).

Table 5.5: Nominal Protection Rate for Selected Major Commodities (Exportable) in India

Year	Wheat	Rice	Sugar	Cotton
1991	1.17	0.86	1.10	0.67
1995	0.97	0.82	0.84	0.98
2002	1.37	1.35	1.77	0.56

Source: Gulati and others 2003.

Table 5.6 gives the trends of prices, production, exports and imports of the four major agricultural crops, which have been chosen for the study. Prices, the main economic indicator, which influences the production, exports and imports, have shown a more or less continuous rising trend between 1994-95 and 2003-04. The years have been selected to compare the situation between pre- and post-WTO period. While the rise in prices is steadier in the case of wheat and rice, there have been some ups and downs in the case of cotton and sugar. Nevertheless, there has not been any significant negative impact on prices as a result of agricultural trade liberalisation.

The production trend is also on the similar lines with some fluctuations in between but those are because of bad monsoons and not due to trade liberalisation. However, in case of cotton and sugar the fluctuation is more prominent but overall showing a positive trend. Again, the main reason is bad monsoons as cotton in particular is produced largely in those parts of India which have been facing droughts for the last few years.

In case of exports and imports, there is no consistent trend. We can clearly see the impact of our trade policy and the global situation. The imports of rice, wheat and sugar are very low in recent years because of high tariffs, which India is maintaining on the imports of these products. The only exception is cotton in which India has reduced its tariff considerably and the world cotton market is highly distorted because of the huge subsidies given by US and some EU countries to their farmers and exporters. As regards exports, rice has shown positive trend because India has niche market of *Basmati* rice in some regions/countries. The exports of wheat and sugar picked up pace in later years. Cotton exports have decreased in the post-WTO period.

Table 5.6: Trends in Prices, Production, Export and Import of Major Agriculture Crops

	Rice				Wheat				Cotton				Sugar			
Year	WPI	Prod.	Imp.	Exp.	WPI	Prod.	Imp.	Exp.	WPI	Prod.	Imp.	Exp.	WPI	Prod.	Imp.	Exp.
1994-95	111	81.81	3	384.0	109	65.77	0	0.08	154	11.89	161.0	45.0	119	275.5	727.0	20.0
1998-99	146	86.1	0	1492.57	152	71.3	266.0	0.32	167	12.3	22.0	49.17	154	288.7	127.0	5.81
1999-00	171	89.7	7.0	721	175	76.4	179.0	00.0	147	11.5	289.0	18	156	299.3	256.0	9.0
2000-01	168	85.0	4.0	644	177	69.7	1.8	97.0	157	9.5	259.0	49	153	296.0	7.0	112
2001-02	167	93.3	2	666	175	72.8	1.4	278.9	149	10.0	431.0	9.0	146	297.2	6.8	374
2002-03	166	72.7	NA	1205	176	65.1	NA	363.6	142	8.7	256.0	10.0	135	281.6	6.8	375
2003-04	169	86.4	NA	799.7	181	72.7	NA	453.2	181	13.5	NA	NA	139	244.8	9.2	258.3

Notes: 1. For the WPI (Wholesale Price Index) base year is 1993-94. 2. The value of production of rice and wheat is given in million tones. 3. In case of sugar the production value is of sugarcane in million tonnes and data of exports and imports is of sugar. 4. For cotton the production value in measured in million bales of 170 kg each. 5. The value of exports and imports is given in US$mn. 6. The data of the year 2003-04 is estimated (third advanced estimates).

Source: Economic Survey 2003-04, Ministry of Finance, Government of India; Ministry of Agriculture, Government of India; and other sources.

Table 5.7: Growth rates of GDP and Agriculture Production (Percent)			
Year	**GDP***	**GDP in Agriculture and Allied Sectors***	**Physical Production of Agriculture*****
1996-97	7.8	9.6	9.3
1997-98	4.8	-2.4	-5.9
1998-99	6.5	6.2	7.6
1999-00	6.1	0.3	-0.6
2000-01	4.4	-0.1	-6.3
2001-02	5.8	6.5	7.6
2002-03	4.0	-5.2	-15.6
2003-04**	8.1	9.1	19.3

*Notes: *at factor cost at 1993-94 prices; **advance estimates; ***as determined by index of agricultural production.*

Source: Economic Survey 2003-04, Government of India.

Impact on Real Income

The agricultural sector growth rate in India plays a crucial role in overall annual GDP growth. Even after more than 50 years of planned economic development and continued emphasis on rapid industrialisation, agriculture still accounts for over a quarter of the total GDP in India. Its significance is even more in terms of employment generation and livelihood. Three quarters of the population is rural and 70 percent of rural households depend on agriculture for their livelihoods. In view of these facts, it is necessary for the agricultural sector to contribute significantly to the total real income of India and simultaneously generate productive employment opportunities. For the agricultural sector to meet their high growth targets, it is equally important to have a continuous rise in capital formation, which has become almost stagnant over the last two decades. These three issues are discussed below.

Though India has become self-reliant in terms of meeting its food grains requirements, because of the heavy dependence of Indian agricultural sector on monsoons the farm sector growth rate does fluctuate a lot. This fluctuation in the growth rate of food grains productions in India has a direct bearing on the annual GDP growth. Table 5.7 shows the link between agricultural sector growth and the growth rate in the total GDP. The period from 1996-97 to 2003-04 also coincides with the implementation of the WTO AoA.

Gross Fixed Capital Formation (GFCF)

Capital formation is one of the most crucial factors for increasing production. This is particularly important for Indian agriculture where we are faced with the task of increasing production to keep pace with the ever rising population against the odds of the vagaries of monsoon. A strong capital base is required to make sustainable use of natural resources, for adoption of advanced techn,ology and the development of infrastructure for facilitating all agricultural activities. In other words, capital formation is necessary in

Table 5.8: GFCF in and for Agriculture at 1993-94 Prices (Rs. Crore)					
		GFCF		Percent Share in GDP of GFCF	
Year	GDP	in Agriculture	for Agriculture	in Agriculture	for Agriculture
1980-81	401128	13721	17279	3.4	4.3
1985-86	513990	13061	17656	2.5	3.4
1990-91	692871	15805	21560	2.3	3.1
1995-96	899563	16824	25283	1.9	2.8
2000-01	1198685	18364	27946	1.5	2.3
2001-02	1265429	19880	28830	1.6	2.3

Note: 1 crore = 10 million

Source: Report of the Committee on Capital Formation in Agriculture, Submitted in March 2003, Ministry of Agriculture, Government of India.

order to make agriculture a profitable commercial activity at par with other industries in the arena of global economy.

According to the Report of the Committee on Capital Formation in Agriculture (2003), set up by the government of India in 2001, agricultural development cannot be ensured by confining attention to the activities with in the boundaries of agricultural fields. It should encompass activities fully or partially meant for agriculture such as the production of fertilisers and pesticides, development of agriculture markets, rural roads and communications; augmentation of facilities for agricultural credit for small and marginal farmers, agricultural education, research and development of agricultural technology which are the main source of increasing production under the limited availability of natural resources. Therefore, for monitoring agricultural growth it is necessary to have a broader measure of agricultural capital formation that includes capital formation in all these activities, which can be called capital formation for agriculture in comparison with capital formation in agriculture.

According to the aforementioned report, there has been a continuous decline in the share of agriculture sector's capital formation in GDP. This is a great cause of concern for India. The broad trends in both GFCF in agriculture and for agriculture are similar during the period from 1980-81 to 2001-02. As percent to GDP, GFCF in agriculture has declined from 3.4 percent in 1980-81 to 1.6 percent in 2001-02. The corresponding share of GFCF for agriculture has also halved during this period. The deceleration has been more pronounced in the 1980s as compared to the 1990s (see Table 5.8).

It has also been found that the share of public sector GFCF in agriculture has declined in relation to GDP. The same is true of public sector GFCF for agriculture. Therefore has been, a long-term deceleration in the share of capital formation in agriculture in GDP at both aggregate and public sector level. In fact, the shares of GFCF in agriculture and for agriculture in GDP have declined much more sharply in the public sector (see Tables 8 & 9).

Table 5.9: GFCF in and for Agriculture at 1993-94 Prices in Public Sector (Rs. crore)					
		GFCF		Percent Share in GDP of GFCF	
Year	GDP	in Agriculture	for Agriculture	in Agriculture	for Agriculture
1980-81	401128	7358	9855	1.8	2.5
1985-86	513990	6005	9224	1.2	1.8
1990-91	692871	4871	8706	0.7	1.3
1995-96	899563	5318	9631	0.6	1.1
1999-00	1148442	4637	9902	0.4	0.9

Note: 1 crore = 10 million.

Source: Report of the Committee on Capital Formation in Agriculture, Submitted in March 2003, Ministry of Agriculture, Government of India.

GFCF in agriculture now accounts for less than 10 percent of total GFCF. The ratio seems to have declined very sharply during the 1980s. In the last few years there has been some improvement in the share of agriculture in total GFCF; however, in spite of this it is still well below what it was in the early 1980s. The same is true of GFCF for agriculture.

Currently, GFCF for agriculture at 1993-94 prices account for about 12 percent of aggregate capital formation. As against this, the share of agriculture in GDP is currently about 24 percent, which clearly shows that there is a strong case to increase the share of agriculture in total capital formation in the economy. Even in the case of Public Sector, the share of agriculture in total Public Sector capital formation has declined over the years.

As agriculture is getting diversified, there is a need to not only augment but also re-structure the pattern of investment in agriculture. Historically, the Public Sector has taken the lead in directing the growth and pattern of agriculture investment. Keeping in view the changed global scenario, the Committee recommends that

- Immediate steps should be taken to improve capital formation for agriculture in both Public and Private Sectors. Otherwise, it may be difficult to sustain the agriculture growth and rural purchasing power.
- Currently, irrigation accounts for the bulk of public investment in agriculture (above 90 percent). The new strategy of agriculture growth and diversification of agriculture from traditional crop cultivation to horticulture etc., would require more investments on cold storage, rural roads, communication, marketing network and facilities, warehouses etc.
- Simultaneously, efforts should be made to revitalise agriculture through introduction of biotechnology and other innovations. This would require substantial increase in investment on research & development for agriculture.

5.4 Trade Liberalisation – Impact on Poverty and Employment

Impact on Poverty

Economic liberalisation has an important role to play in elevating poverty and help the population at large to achieve a minimum standard of living within a reasonable period. This is expected to be achieved through higher growth – rising through the purchasing power of the poor with the endowment of land and non-land assets and generate wide scale employment opportunities in the economy.

The proportion of people living below the poverty line remained above 50 percent with no declining trend till the mid-1970s. It declined thereafter perceptively in the late 1970s and 1980s from 51 percent in 1977-8 to 39 percent in a 1987-8 (Planning Commission). The intensity of poverty also declined considerably – both in the rural and urban areas. During the 1990s slow down in the rural employment growth and slowdown in the growth momentum of rural non-agriculture activities seem to have affected the pace in decline in rural poverty and aggravated rural-urban disparities. Almost 260 million Indians (193 million in rural and 67 million in urban India) remained below the poverty line (BPL) in 1999-2000. The widening rural–urban poverty has coincided with widening inequality in the urban expenditure distribution. The widening inequality is also reflected in differential growth across the urban expenditures groups. The per capita expenditure of the top 30 percent increased at 3.31 percent per year, while that of the bottom 30 percent increased at 1.70 percent. On the other hand, rural inequality tended to decline in the 1990s. The rural bottom 30 percent experienced a decline in the annual growth rate of per capita expenditure during the 1990s. It dropped from 1.71 percent during 1970-89 to 1.19 percent during 1990-98.

The 1990s growth benefited urban areas the most and aggravated the rural-urban divide. Even with reduction in the poverty level, the absolute poverty level in India in income terms remained unacceptably large. Economic growth and improvement in real wages, particularly with growth with agriculture, which supports a considerable part of the population, has impacted upon the proportion of persons in poverty. There was also a major poverty elevation programme in India like self-employment, wage employment, public distribution system (PDS), nutrition and social security programmes along with income growth that has impacted in a major way in elevating poverty.

The composition of the poor has been changing and rural poverty is getting mostly concentrated in the agriculture labour and artisan households and urban poverty in the casual labour households.

Agriculture labour households, which accounted for 41 percent of rural poor in 1993-94, increased to 47 percent in 1999-2000. In contrast, the share of self-employed in agriculture among the rural poor dropped from 33 to 28 percent. The relative size of agriculture labour households among the poor has increased from 21 to 31 percent due to increased dependency of rural households on agriculture labour for livelihood as well as higher incidence of poverty among agriculture labour households – 40 percent in 1999-2000 in contrast to 26 percent in all rural households. Casual labour households constituted 32 percent of urban poor in 1999-2000 increasing from 25 percent in 1993-94.

Table 5.10: Incidence of Poverty Level – Social and Occupational Group								
	Incidence (percent)							
Category	**Very Poor**		**Poor**		**Very Poor**		**Poor**	
	Rural				**Urban**			
Caste								
ST	22.1	17.0	50.2	44.2	24.0	17.5	43.0	37.5
SC	21.7	11.5	48.3	35.3	26.1	16.4	50.9	39.1
OBC	NA	7.0	NA	25.5	-	10.7	-	30.2
Occupation								
Agriculture Labour	8.72	14.1	54.4	39.7	-	-	-	-
Non Agriculture Labour	15.2	8.7	42.2	27.2	-	-	-	-
Casual worker					36.6	26.0	64.5	53.0
Source: computed using NSS 50th and 55th Round data on Household Consumer Expenditure.								

The increase in its share was both due to the increased dependency of urban households on urban casual labour market from 25 percent in 1993-4 to 32 percent in 1999-2000 as well as higher incidence of poverty among the urban casual labour households. The growing dependence of rural and urban households on casual labour market exposes the poor to market risks and tends to increase transient poverty, whereby households move in and out of poverty due to fluctuations in the labour market. The Relatively higher share of rural poverty in India is disproportionately high among the Scheduled Castes (SCs) and Scheduled Tribes (STs). The share of STs in poverty has gone up during the 1990s and that of SCs remained more or less the same. The tribal communities as a group in India are poor and deprived.

The geographical landscape of rural poverty has been changing. The percentage share of backward states such as Bihar, Orissa, Madhya Pradesh, and Utter Pradesh in the rural poor increased from 53 percent in 1993-4 to 61 percent in 1999-2000. In contrast, there was reduction of incidence of poverty in agriculture prosperous states of Punjab, Haryana and Himachal Pradesh from 3.03 to 1.26 percent, and that of the southern states from 15.12 percent to 11.23 percent (SAPAP 2003). Some of the better off states such as Maharashtra, West Bengal and Gujarat have a relative higher share of rural poverty. These states accounted for one-fifth of the rural poor in 1999-2000. The urban poor got concentrated in Utter Pradesh, Maharashtra, West Bengal, Madhya Pradesh and Andhra Pradesh.

Their share in all India poverty rose from 56 percent in 1993-4 to 60 percent in 1999-2001. The percentage of the very poor in rural areas declined from 15 percent in 1993-94 to 8.7 percent in 1999-2000 and in urban areas from 15 percent to 9 percent. Inter-state variations in the incidence of the very poor were significant – the incidence of the very poor in rural areas varied between 0 to 21.7 percent in 1999-2000 and in urban areas between 0 and 21.6 percent.

The percentage of the stunted children among the poor varied between 32 and 63 in rural areas and between 31 and 64 percent in urban areas. The magnitude of multiple deprivations of the people in India is very high. Large-scale national wide survey by National Health Financing Scheme (NHFS) in 1998 revealed that 47 percent of the children are malnourished, 74 percent are anemic, 36 percent of the ever-married women aged 15-49 years have chronic energy deficiencies, 54 percent of the women aged 15-49 years in rural areas have no education, about 50 percent of the pregnant women suffer from iron deficiency, 71 percent of the rural households do not have any toilet facilities, 19 percent of the villages do not have any health facility and 51 percent of the villages do not have any drainage facilities – either underground or open.

The New Delhi based National Council for Applied Economic Research (NCAER) survey of human development in India has also revealed that 50 percent of the population suffers from capability poverty; 43percent of the population have domestic lighting, only 23 percent have access to tap water and a mere 33 percent utilise the public distribution facilities.

Evidence is also available of the gender discrimination against women in the labour market, particularly in rural and unorganised sectors. While all members in a poor household may suffer, it is possible that women and girls in the family suffer disproportionately more, and it is possible that while a household may not be counted among those suffering from poverty, the female member in it may display all the characteristics of poverty and deprivation. Another aspect of the discrimination against women is revealed by the difference in the male female wage rates for identical works.

Although in some sectors some improvements are visible, but generally wage rate of female continued to be less than those of the male workers. NSS data has shown that the female wage as a percentage of male wages has remained more or less locked at 70 for casual workers in agriculture though they have improved from 58 to 63 percent for casual workers in agriculture. Female-headed households registered higher poverty rates than the general population for most states.

Impact on Employment Generation

Productive employment generation is the common objective of any economic growth model. When India embarked upon a new economic development strategy in 1991, employment generation was one of the major objectives. This is also one of the major indicators of poverty alleviation. It has been almost one-and-a-half decade since we ushered into a new economic regime of export-led growth, the result on employment generation front is nor very heartening. This is evident from government's own document, published by Planning Commission. An excerpt from its introductory chapter is cited below.

"The need to ensure adequate growth in employment opportunities to provide productive employment for the continuing increase in the labour force is widely regarded as one of the most important problems facing the country. There is widespread concern that the acceleration in GDP growth in the post reforms period has not been accompanied by a commensurate expansion in employment. Public sector employment is expected to fall as the public sector withdraws from many areas. There are fears that the process of internal liberalisation and globalisation, inevitable though they may be, are creating an environment, which is not conducive to expanding employment in the organised private sector. Existing industrial units are shedding excess labour in order to remain competitive and new technology, which is essential to ensure competitiveness, is typically more automated and therefore not job creating. The net result of these forces, it is feared, could be a very slow expansion in employment opportunities in the organized sector, with a rise in unemployment rates and growing frustration among the youth. The problem is perceived to be especially severe for educated youth, who have high expectations about the quality of employment opportunities that should come their way".[3]

The rate of unemployment, as measured by the NSS surveys appears to have increased in the 1990s with unemployment on the basis of current daily status increasing from 6.03 percent in 1993-94 to 7.32 percent in 1999-2000. Other measures of unemployment also show an increase. The NSS data show that the growth of employment has dropped sharply from about two percent per year in the period 1983 to 1993-94 to less than one percent in the period 1993-94 to 1999-2000. The deceleration in employment growth has attracted a great deal of attention.

The relationship between growth of GDP and growth of employment is usually characterised by a summary parameter such as the elasticity of employment with respect to GDP, which can be calculated either for employment in the economy as a whole or for employment in individual sectors. The elasticity of employment indicates the percentage growth in total employment (or sectoral employment) to be expected from a one percent growth in GDP (or GDP in individual sectors).

Table 5.11 shows that the elasticity of total employment has been declining consistently in each sub-period. This obviously reflects acceleration in the growth of productivity per person employed, which is a desirable outcome, especially if it is taking place in sectors where productivity per person employed is very low. We also note that employment elasticities may be very low in sectors where there is a great deal of under-employment, which means there is considerable room for output to expand without an expansion in measured employment.

A remarkable feature of Table 5.11 is that although the employment elasticity declined in the earlier period, the decline was especially sharp in the 1990s. The employment elasticity for the economy as a whole was 0.53 percent during the period 1977-78 to 1983 and this declined to 0.41 percent during 1983 to 1993-94. It then declined very sharply to 0.15 percent during 1993-94 to 1999-2000, which is less than half the elasticity of 0.38 percent, which was assumed when making employment projections for the Ninth Plan.

The low employment elasticity in the 1990s reflects the fact that employment growth decelerated in this period while GDP growth accelerated. The total employment growth decelerated from 2.04 percent during the period 1983-94) to 0.98 percent per year during 1994-2000. Much of the slowdown in total employment growth was due to developments

Table 5.11: Elasticity of Employment to GDP					
Sector	Estimated Elasticities			Projected	
	1977-78 to 1983	1983 to 1993-94**	1993-94 to 1999-00	As used in 9th Plan	Projected for the Future Projections
Agriculture*	0.45	0.50	0.00	0.50	0.10
Mining & Quarrying	0.80	0.69	0.00	0.60	0.00
Manufacturing	0.67	0.33	0.26	0.25	0.22
Electricity	0.73	0.52	0.00	0.50	0.00
Construction	1.00	1.00	1.00	0.60	0.60
Wholesale & Retail Trade	0.78	0.63	0.55	0.55	0.50
Transport, Storage & Construction	1.00	0.49	0.69	0.55	0.40
Finance, Real Estate, Insurance & Business Services	1.00	0.92	0.73	0.53	0.50
Community, Social & Personal Services	0.83	0.50	0.07	0.50	0.30
All Sectors	0.53	0.41	0.15	0.38	0.22***

*Note: Manufacturing includes workers engaged in repair services, except for the year 1977-78. *Estimated elasticities for agriculture have been calculated on the basis of 3-year moving average of GDP at 1980-81 prices for the period 1977-78 to 1983 and 1983 to 1993-94. For the period 1993-94 to 1999-00 we have used the GDP series with base 1993-94 but a three-year average is not used since data are not available for 1992-93 or 2000-01. **This period combines two distinct periods for which data are separately available i.e. 1983 to 1987-88 and 1987-88 to 1993-94. However, 1987-88 was a drought year when employment was abnormally low and this distorts elasticities in both periods. The combined period 1983 to 1993-94 has been used to avoid this distortion.* ********* *Implicit elasticity based on a 6.5 percent GDP growth.*

Source: Planning Commission, India.

in two important sectors, viz. agriculture (including forestry and fishing) and community social and personal services. These sectors, accounting for almost 70 percent of total employment, experienced no growth in employment in the period 1993-94 to 1999-2000.

5.5 Farm Trade Liberalisation – Impact on Poverty & Employment Generation

The true benefits of trade liberalisation in agriculture cannot be realised unless it leaves a positive mark on social sectors. In the Indian case, it is more important as a majority of the poor are dependent on agriculture for their subsistence. Therefore, it is very crucial to see the impact of agriculture sector liberalisation on social indicators such as poverty, health and education, and equity.

Poverty

Ever since the Uruguay Round AoA kickstarted trade liberalisation in agriculture in 1995, there has been a considerable concern in India about its implications for more than 600 million people who are dependent on farming for their livelihood. This is particularly true for products like rice, wheat, cotton and sugar, which are the lifeline of not only majority of rural people but also products like cotton and sugar provide employment to a significant proportion of the urban population as well.

Table 5.12: Estimates of Incidence of Poverty in India						
Year	Poverty ratio (percent)			No. of poor (million)		
	Rural	Urban	Combined	Rural	Urban	Combined
1977-78	53.1	45.2	51.3	264.3	64.6	328.9
1983	45.7	40.8	44.5	252.0	70.9	322.9
1987-88	39.1	38.2	38.9	231.9	75.2	307.1
1993-94	37.3	32.4	36.0	244.0	76.3	320.3
1999-00	27.1	23.6	26.1	193.2	67.1	260.3
2007*	21.1	15.1	19.3	170.5	49.6	220.1

*Note:*Poverty projection for 2007.*

Source: Tenth Five-Year Plan, Planning Commission, Government of India.

As of 1999-2000, India's poverty continues to be predominantly rural although rural poverty declined faster than urban poverty over the last 25 years. Moreover, the decline in national poverty seems to have been driven mostly by the decline in rural poverty – not surprising given that 74 percent of India's population lives in rural areas. The decline in poverty is remarkable during the period 1993-94 and 1999-2000 when the rural poverty went down by almost 10 percentage points in comparison to the seven percent fall in combined (rural and urban) poverty ratio (see Table 5.12).

This period 1993-94 to 1999-2000 roughly coincides with the early years of implementation of WTO AoA. But how much this fall in poverty ratio in this period can be attributed to trade liberalisation undertaken by India to fulfill its obligations under AoA is a matter of debate and further research. As far as India's commitments under AoA are concerned, it did not have to bring any major change in its existing policies except the removal of QRs on imports. In the previous section we have seen that out of three pillars of AoA, India is not required to undertake any cut in its domestic support and export subsidies. While the exiting domestic support level is well below the permissible limit, export subsidies are not provide in India.

Employment

Agriculture accounts for around 60 percent of total employment and as a result growth and development in this sector have significant impact on the overall employment situation in the economy. However, at the same time it must be recognised that agriculture is not a sector where Indian policy-makers are looking for a large increase in total employment generation. On the contrary, agriculture has traditionally served as a residual employer, and is therefore characterised by considerable underemployment, disguised unemployment, seasonal variation in employment and relatively low real wages. The longer-term employment strategy should therefore aim at absorbing as much of the expansion in the labour force as possible in the non-agricultural sector, thus reducing the pressure of labour on land and thereby tightening the labour market, so that incomes per head in farming and real wages of agricultural labour rise significantly.

The relationship between growth of GDP and growth of employment is usually characterised by a summary parameter such as the elasticity of employment with respect to GDP, which can be calculated either for employment in the economy as a whole or for employment in individual sectors. Table 5.12 presents Planning Commission of India's estimates of employment elasticities for the agricultural sector, and also for the economy as a whole, based on data on employment growth and GDP growth for three different periods spanning the past two decades.

From the data given in Table 5.13, it is evident that during the period 1993-94 to 1999-2000, the initial years of implementation of WTO AoA, employment elasticity in agriculture sector reduced to zero. It means increase in agricultural output during this period did not result in any increase in employment. The data given in Table 5.14 confirms this result. We see that during the period 1993-94 to 1999-2000, employment in agricultural sector has actually gone down in absolute numbers, showing a negative growth of –0.34 percent.

Table 5.13: Elasticity of Employment to GDP in Agricultural Sector and All Sectors

Period	Estimated Elasticities in Agriculture*	All Sectors
1977-78 to 1983	0.45	0.53
1983 to 1993-94**	0.50	0.41
1993-94 to 1999-00	0.00	0.15
Projected		
As used in 9th Plan projections	0.50	0.38
Projected for the future	0.10	0.22***

*Notes: *Estimated elasticities for agriculture have been calculated on the basis of three year moving average of GDP at 1980-81 prices for the period 1977-78 to 1983 and 1983 to 1993-94. For the period 1993-94 to 1999-2000 the GDP series with base 1993-94 have been used but a three-year average is not used since data are not available for 1992-93 or 2000-01. **This period combines two distinct periods for which data are separately available i.e. 1983 to 1987-88 and 1987-88 to 1993-94. However, 1987-88 was a drought year when employment was abnormally low and this distorts elasticities in both periods. The combined period 1983 to 1993-94 has been used to avoid this distortion. ***Implicit elasticity based on 6.5 percent GDP growth.*
Source: Report of the task force on employment opportunities, 2001, Planning Commission, Government of India.

Table 5.14: Growth of Employment in Agriculture and Total Employment

	Employed workers (million)			Annual growth rate (%)	
Sectors	1983	1993-94	1999-00	1983-94	1994-00
Agriculture	207.23	242.46	237.56	1.51	-0.34
Total Employment	302.76	374.45	397.00	2.04	0.98

Source: Report of the task force on employment opportunities, 2001, Planning Commission, Government of India.

5.6 Conclusions: The Road Ahead

India's achievements in the post-reform periods as far as economic performance is concerned are wide-ranging and clearly impressive. The recovery from the 1991 crisis was exceptionally swift and the post-stabilisation period saw a significant acceleration in growth compared to the growth rate before the reforms. It also brought the stabilisation in the foreign exchange situation and restructuring of the economy so that the country could move to a higher growth path. There was a major change in the trade, financial and external sector policies in the country to streamline the economy with the world economy. The country now has the potential to achieve impressive rapid economic growth. India is now evenly poised to match or exceed China's growth performance.

India is gaining comparative advantages in trade mostly in services through effective deployment of skilled labour and using the aptitude in new technologies along with policy initiatives. This will position India in the emerging paradigm of globalisation. India has achieved a low real interest rate, a competitive and predictable real exchange rate, a low and stable inflation rate, a stable fiscal policy with low fiscal deficits and a viable current account ratio of GDP in the balance of payments.

However, experience of the reform process in India has shown that it has not achieved its objective to an extent in reducing poverty in the country. In the post-reform period (as compared between 45th and 46th rounds, just before the economic reform compared with the rounds 52 and 53, the most recent post-reform situation) there is almost no change in the pre- and post-poverty measures. Effective measures still need to be taken in the economy to trickle down the benefits of growth and development in the different sectors of the economy to the poorest of the poor in the country. India still needs a lot to emphasise on continuing commitment to traditional programmes for poverty elevation, which exists even before reforms. These include direct support of consumption of the poor by subsidised sales of food grains through the PDS, employment programmes providing wage employment in public and private works especially in rural areas and a variety of self-employment programmes involving provisions of a combination of capital subsidy, credits and technical assistance to set up micro enterprises in both rural and urban areas.

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Endnotes

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2 Prof. Raj Krishna popularised the phrase "Hindu Rate of Growth" in the 1970s, during the period of increasing controls and slowing growth rate.
3 Excerpt from the introductory chapter of Planning Commission's Report of the Task Force on Employment Opportunities, July 2001.

6 CHAPTER

Nepal: *Trade, Development and Poverty Reduction*

– Yuba Raj Khatiwada[1]

6.1 Introduction

Poverty reduction has become a central challenge in today's world marked with grave inequality. From the perspective of human development, welfare of the marginalised section of the society is important. As a result, focus on poverty alleviation has gathered momentum. According to Amartya Sen (1999), the development policies should be directed towards maximising people's capabilities – their ability to live a life they value. However, the poor people are the most disadvantaged ones; they deserve an urgent attention to raise their living standards. This seems to be in concurrence with one of the aims of the Millennium Development Goals (MDGs), i.e. to halve the proportion of people living in absolute poverty by 2015.[2]

Amidst the wave of globalisation, trade has undoubtedly taken the centre stage for reducing poverty. However, the inter-linkages of trade, development and poverty reduction remain ambiguous at best. The impact of trade on human development may work through the channel of economic growth if it raises the income and government revenue which in turn results in increased investment in social and productive sectors (UNDP, 2003).

The eventual failure of inward-oriented trade regime such as Import Substitution Industrialisation (ISI) is indicative of the fact that restricting trade may tantamount to stifling development. Extensive literature suggests that there are direct and indirect, static and dynamic gains from trade and its liberalisation. According to the Stolper-Samuelson theory of factor price equalisation, opening up markets would put an upward pressure on the labour prices. This will ultimately benefit the poor people of the developing and least developed countries (LDCs). In addition to gains from the inter-sectoral shift, trade liberalisation spells more efficiency in terms of enhanced competition, facilitation of intra-trade industry, transfer of technology and attraction of export-oriented Foreign Direct Investment (FDI). All these elements play a role in accelerating the economic growth which is very crucial for poverty reduction. The contention thus is not about the centrality of the trade for development, but about striking an intricate balance to use trade for reducing poverty and fostering human development. It has been pointed out that efforts should be directed towards "development driven approach to trade rather than trade-driven approach to development" (UNCTAD, 2004). Thus, trade should be viewed as a means to an end rather than an end in itself. Such an insight provides much-needed room for other "non-trade" factors like macro-economic policies, foreign assistance in the form of aids, technology transfer and so on which are instrumental for an integrated development.

6.2 Nepalese Scenario

The State of the Economy of Nepal

Nestled in South Asia between two emerging economic powers – India and China – Nepal displays a rather fragile economy. As a least developed country (LDC), with a mere per capita income of US$230 or US$1,370 in PPP terms (UNDP, 2004) Nepal's Human Development Index (HDI) performance is abysmal. With an HDI (2002) value of 0.504, Nepal was ranked 140 among 177 countries (Human Development Report, 2004). Against the backdrop of the ongoing armed Maoist insurgency and the political turmoil, HDI of Nepal may not improve markedly in the near future. In terms of human poverty in developing countries, Nepal ranked 69th out of 95 countries with HPI -1 (Human Poverty Index) value of 41.2 percent. Absolute poverty level is around 37.7 percent of which 87.7 percent live in the rural and inaccessible areas. In fact, poverty remains rampant with almost half of the populace living under international poverty line. Amidst such persistent poverty, income inequality has risen so much that the richest 20 percent account for 45 percent of the GDP while the poorest 20 percent has only six percent.

Thus it comes as no surprise that "poverty alleviation" is the overarching objective of the Nepalese Government. This is reflected in various periodic economic plans such as the Eighth, Ninth, and 10th Plan, which have been set the goals of reducing poverty. To achieve the desired goals, the 10th Plan emphasises the role of broad-based high and sustainable growth, social-sector development with focus on human development, targeted programmes ensuring social inclusion and good governance.

Notwithstanding the low level of economic development, Nepal is one of the most liberalised and trade dependent economies in the South Asian region. This is evident from its trade to GDP ratio of about 50 percent, an average tariff rate of 14 percent and virtually no quantitative restrictions (World Bank 2003). The much touted benefits of deregulation and trade liberalisation however remain evasive for a majority of the Nepalese populace. Entrenched in "mass poverty", agriculture remains a major source of livelihood for 78 percent of the population in Nepal. The importance of agriculture in the Nepalese economy is evident from its major contribution of 39.2 percent to the GDP. Among others, industrial sector contributes 20.2 percent to GDP while service sector amounts to 41 percent.

Table 6.1: Trade and Finance in Nepal

Description	1999	2002	2003
Trade in goods as a share of GDP (%)	40.2	35.7	41.3
FDI, net inflows in reporting country (current US$)	0.0	-5.9 million	14.8 million
Aid per capita (current US$)	15.6	15.1	18.9
Present value of debt (current US$)	.	1.7 billion	2.1 billion
Total debt service (% of exports of goods and services)	7.6	6.2	6.0
Short term debt outstanding (current US$)	42.5 million	40.0 million	66.0milllion

Source: World Bank World Development Indicators database, April 2005.

6.3 Reforms and Liberalisation Efforts

The initial steps of Nepal towards the multilateral trading regime can be traced back to 1985, when it became one of the first recipients of Structural Programme (SP) in South Asia, which was followed by Structural Adjustment Programme (SAP). To achieve the desired goal of poverty reduction, liberalisation measures were kickstarted in the early 1990s.

Agriculture

In the spirit of liberalisation, various deregulation policies were adopted to facilitate participation of private sectors. The burden of government expenditure has been greatly reduced with the withdrawal of agricultural subsidies in seeds, fertilisers, irrigation, pesticides and other inputs. Moreover, trade-related to agro-sector was deregulated with minimum effective trade barriers and elimination of non tariff barriers (NTBs). The average tariff rates on import of primary products ranges from 0 to 15 percent with an average of less than 10 percent. None of the agricultural imports (barring few sensitive produces) are subjected to licences or quotas.

Financial Sector

The various financial reforms included but are not limited to removal of entry barrier, enactment of Finance Companies Act, 1985 and its amendment in 1992, abolition of pre-emption of bank resources in the form of statutory liquidity requirement, establishment of prudential norms of Basle Accord, enactment of Nepal Rastra Bank Act, 2002 which granted autonomy to the central bank and so on (Kanel and Kharel, 2005). In terms of monetary policies, Nepal adopted various measures: removal of credit ceilings, differential interest rates, margin requisites and deregulation of interest rates. Moreover, indirect monetary policies such as bank rate, variable cash reserve requirement and open market operations are also implemented.

Exchange Rate

In the process of liberalisation of the exchange rate, the Nepalese currency was devalued by around 50 percent against all international currencies followed by full convertibility in the current account. Various other reforms undertaken in the foreign exchange regime include: 100 percent retention of export income in convertible accounts in the domestic banks, permission to open foreign currency deposit account in local banks, facility of payment in dollar of imports of specified products, permission for banks to lend money in foreign currency to the borrowers involved in foreign exchanges, etc.

Nepal today has a dual exchange rate policy: market-driven in the case of hard currency and pegged in case of India, which has been a major trading partner of Nepal. The pegged exchange rate with India is not considered favourable for Nepal as it prevents the depreciation of the Nepalese currency. This in turn results in import surges due to decreased competitiveness of Nepalese products compared to Indian goods. Against the backdrop of the expiry of Multi-Fibre Arrangement (MFA) in textile and clothing (T&C) exports, the prevalent exchange regime of Nepal caused further deterioration in international competitiveness of exports.

Taxation Policy

With the objective of restructuring public expenditure and managing fiscal imbalances, Nepal has tried to reform and broaden its tax base. Three major initiatives were undertaken in this regard: (1) introduction of the value added tax (VAT); (2) expansion of income tax net to include insurance benefits, retirement benefits, inheritance of property; and (3) restructuring of tax administration.

Foreign Direct Invetsment

The government introduced various legislations, some of which are: the Industrial Enterprises Act, the Foreign Investment and Technology Act, the Industrial Policy, the Trade Policy and the Foreign Investment and the One Window Policy. All these legislations are focused on to attract FDI.

6.4 Impacts of the Reform Measures

The aforementioned liberalisation polices were adopted to reduce poverty by accelerating economic growth. One of the obvious consequences of liberalisation has been the increase in the volume of trade. In 1990, the total exports from Nepal stood at US$381mn, which increased to US$1,190mn in 2005. However, contrary to diversification over export markets, dominance on India is on the rise. Thus the prospect of market access has remained elusive for Nepalese exporters confined to limited export destinations. Speaking of trade with other countries, high export concentration, mainly around ready-made garments, *pashmina* and carpets has made Nepal's trade more vulnerable to international shocks. The situation was further worsened by supply-side constraints and increased competition from the neighbouring countries.

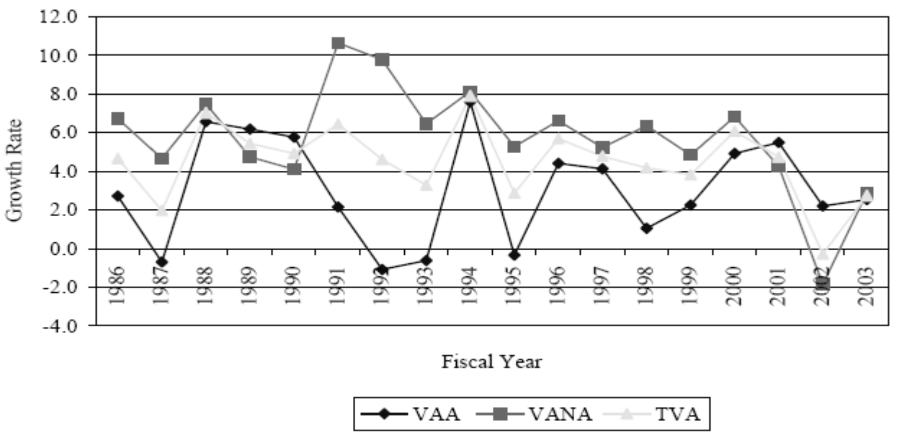
Table 6.2: Average Annual Growth Rates of GDP by ISIC Division

Description	1995-96	1996-97	1997-98	1998-99	1999-00	2000-01	2001-02	2002-03	2003-04 (revised)
Agriculture Fisheries & Forestry	3.81	4.36	0.85	2.84	4.89	5.48	2.23	2.50	3.86
Manufacturing	9.04	7.05	3.42	5.29	7.20	3.76	-9.97	1.98	1.73
Construction	7.10	6.63	2.20	6.80	9.60	0.87	1.12	1.69	0.23
Finance & Real estate	7.61	4.71	5.87	5.00	5.08	1.72	3.31	3.28	2.87
Trade, Hotel & Restaurants	4.51	4.07	5.76	3.89	6.76	1.52	-10.09	3.31	6.38
Total Agriculture	*3.81*	*4.36*	*0.85*	*2.84*	*4.89*	*5.48*	*2.23*	*2.50*	*3.86*
Non-agriculture	*6.99*	*5.43*	*4.98*	*5.63*	*6.83*	*4.48*	*-1.94*	*3.23*	*3.05*
GDP at factor cost	*5.56*	*5.10*	*3.21*	*4.48*	*6.00*	*4.76*	*-0.45*	*2.87*	*3.33*

Source: Central Bureau of Statistics.

The economic reforms failed to spur sustainable growth of the productive sectors (see Table 6.2 and Figure 6.1). Similar to the experience of other Asian nations, agriculture liberalisation has failed to generate positive growth in Nepal over long run. The agricultural growth has been highly erratic and unsatisfactory with hardly any evidence of diversification of commodity production for markets.[3] Moreover, the encouraging trend of increase in yield rates is attributed mainly to favourable weather conditions, thus

Figure 6.1: Trend of Value Added Growth



Notes: VAA= Value Added in Agriculture; VANA= Value Added in Non Agriculture; TVA= Total Value Added
Source: Macroeconomic policies, shocks and poverty reduction in Nepal (data collected from Ministry of Finance)

making the Nepalese agriculture more vulnerable to weather-led internal shocks. The role of irrigation is still limited to paddy production. Thus this facility is yet to be successfully implemented for enhancing agricultural productivity.

The removal of agricultural subsidies has proved detrimental to the interests of the small and poor farmers who are witnessing increase in input prices, while subsequent decline in output prices. The hike in prices resulted in input being unaffordable to the average poor farmers with negative implications for nutrients level. The productivity has further deteriorated with lack of monitoring in the regulation of quality for the fertilisers. Some analysts opine that the government deregulation led to the creation of private monopolies. The situation of the farming sector was worsened as the markets were overtaken by cheap imports from India.

The manufacturing sector too did not fare well in the face of limited domestic demand, stiff competition from Indian producers, inadequate infrastructure, lack of skilled labour, and capital. The service sector, on the other hand, registered a vibrant growth. However, this growth was mainly because of remittances sent by the Nepalese nationals working abroad. The proportion of households receiving remittances in 1995-96 was 23 percent, which increased to 32 percent in 2004-05.

The importance of the financial sector in the Nepalese economy is becoming more prominent. The ratio of financial assets to GDP climbed to 76 percent in July, 2000 from a mere 32 percent in 1990. Nevertheless, the financial reforms have not been able to reduce/eliminate the share of non-performing assets in government-owned commercial banks, and Agriculture Development Banks which still ranges at 29 to 40 percent (Nepal Rastra Bank, 2004). This has severely affected the efficacy and competitiveness of the economy as a whole. Moreover, the formal credit markets cater to the needs of the urban households, leaving the bottom 20 percent in utter despair (ibid). Such an exclusion of the poorer segment has augmented the poverty problems.

Tax reforms have helped increase the share of revenue in GDP to 12.4 percent in 2003. Contractionary fiscal polices supplemented by similar monetary polices have stabilised prices to keep inflation under control (inflation rate ranges around 3-5 percent). However, Nepal has been maintaining fiscal balances by curtailing development expenditure which does not bore a good omen for the poverty stricken nation. Most of the government budget in the recent years is directed towards security and defence in the face of ongoing armed Maoist insurgency. Thus with the waning of the development budget, the productive sectors such as agriculture are hard- hit which could prove fatal for the Nepalese economy. Given the poor resources of Nepal, financial aid in the form of grants and loans has been vital for maintaining fiscal balances (see Table 6.3).

Table 6.3: Foreign Aid Commitment (by Sector) (NRs. in million)

Source	1998-99	1999-00	2000-01	2001-02	2002-03	2003-02	2004-05*
Agriculture, irrigation & forestry	3804.0	685.8	3290.3	748.3	3976.1	2083.1	745.0
Transport & Communication	1380.9	5628.8	924.6	5361.2	4410.2	44.3	1415.0
Power	318.0	4174.4	1158.7	758.5	6282.1	1866.4	0.0
Industry & Mining	1372.7	876.6	0.0	0.0	25.7	0.0	0.0
Rural Development	848.4	1474.0	3399.1	2148.9	2318.4	484.6	2920.0
Water Supply & Sewerage	440.0	528.7	15418.4	6205.8	3201.2	3007.2	1888.4
Education	1083.2	4034.5	540.2	2007.4	9208.0	899.8	10945.9
Health	1246.4	-	9.6	4895.6	610.7	176.6	12437.3
Others	4858.9	3055.2	6546.0	11102.2	13138.2	15176.0	4680.0
TOTAL	18352.5	20448.0	31286.9	33227.8	43202.7	23728.0	35031.6

*Note: *First eight months.*

Source: Ministry of Finance.

However, foreign aid is alleged to be responsible for distorting the national priorities on poverty alleviation. Many people argue that aid has forced the state to execute the wrong development prescription, such as the purchase of inappropriate goods from donor countries, including execution of capital-intensive projects and has even fostered corruption (Sharma, 2003).

Nepal's performance in terms of attracting FDI has been dismal even when compared to the LDCs. This failure has been attributed to the poor social and physical infrastructure. Because of limited financial inflow, it did not generate much employment. For example, 36 percent of FDI originated from India, 17 percent from the US and 11 percent from China. In terms of distribution sector-wise, 43 percent went to the manufacturing, 21 percent to tourism and services and 14 percent to energy (Kotilainen and Kaitila, 2002).

Sharma (2003) analyses that major portion of FDI was used in the production of low technology consumer goods and in the service enterprises with hardly any export potential. Nepal has yet to attract FDI that brings in technical expertise, which would enhance the competitiveness of Nepal.

6.5 Trends in Poverty Incidence

Poverty analysis reveals a trend of decline in poverty incidence both in urban and rural areas (see Table 6.4). It is estimated that the average per capita consumption expenditure in the year 2004-05 rose to Nepalese Rupee 15,224 (US$243 from.7,235 (US$115)) in 1995-96.[4] However, the disparity between the rich and the poor has been widening as can be seen from the Gini coefficient. The Gini coefficient which was 0.34 in 1995-96 increased to 0.41 in 2003-04. Moreover, the decrease in poverty incidence is a ramification of remittances from Nepalese workers abroad rather than robust economic growth in the country.

Table 6.4: Comparative Analysis of Poverty Management

	Poverty Incidence (in percent)			Poverty Gap (PI)			Squared Poverty Gap (P2)		
	1995-96	2003-04	Change (%)	1995-96	2003-04	Change (%)	1995-96	2003-04	Change (%)
Nepal	41.76	30.85	-26	11.75	7.55	-36	4.67	2.7	-42
Urban Area	21.55	9.55	-56	6.54	2.18	-67	2.65	0.71	-73
Rural Area	43.27	34.62	-20	12.14	8.50	-30	4.83	3.05	-37

Source: Central Bureau of Statistics.

The trend of globalisation in Nepal seems to have benefited a small specified lot only. This signals that trade liberalisation has not succeeded completely in helping the country move away from the vicious trap of economic stagnation and persistent poverty.

6.6 WTO Membership

In 1989, Nepal applied for a membership in the General Agreement to Trade and Tariff (GATT) - the multilateral trading regime of the day. With the establishment of the WTO in 1995, Nepal was given an observer's status. Finally, in the Cancun Ministerial Conference on September 11, 2003, Nepal became a full-fledged member of the WTO – the only other LDC to accede besides Cambodia.

Opportunities

The entry into the WTO spells vast opportunities for Nepal to boost its economy, which can have poverty-reducing implications. Premised on principles of non-discrimination, particularly Most Favoured Nation (MFN) and National Treatment, Nepalese goods and services can foray into international markets besides the traditional ones (namely India, Germany and the US) without being subjected to discrimination. Furthermore, membership in the WTO is to protect smaller countries like Nepal from unfair and discriminatory trade deals involving much powerful and stronger trading partners.

However, accession to the WTO has come at a high cost. Nepal had to undertake liberalisation commitments in 11 broad sectors and 70 sub-sectors, which is much higher than the average criterion set for the LDC group. The fact that WTO members do not get 'what they deserve, but what they negotiate' (Bhattacharya and Rahman, 1999) subtly points that a weaker nation may not obtain a fair deal. The experience of Nepal's accession shows that rather than being integrated to the multilateral trading system on favourable terms, weaker nations are subjected to provisions that are at best equal to those of other developing countries and at worst less favourable than those of more developed nations (UNCTAD, 2004). Nepal has succeeded the rigorous accession procedure marked with strenuous negotiations. Now the challenge facing Nepal is to be able to act internationally with an eye on the national development goals.

Challenges and Recommendations

The WTO membership comes with various strings attached, which may hinder the economy of an LDC like Nepal. Some of the challenges facing the country are discussed below along with some recommended solutions.

Constrained Policy Space

Firstly, WTO membership is feared to severely curtail the 'policy space' previously enjoyed by the national government. The current approach of the WTO is 'one size fits all' and is more suited to the demands of the rich industrialised nations. Thus, the objective of the WTO may not necessarily reflect those promoting human development and MDGs. With the WTO membership, the government will have reduced capacity to function as the regulator and agent for distributing within the state. This could stall the development of the poorer countries like Nepal in the absence of policy flexibility no longer required by the developed countries.

Ineffective S&DT

Given the low level of development, Special and Different Treatment (S&DT) provision can help facilitate Nepalese economy to integrate globally. However, in reality, the S&DT provision is too limited in scope to be of much help to Nepal. Of the five provisions, only two (i.e. related to transitional periods, and reduced level of commitment) are of binding nature and hence enforceable. The remaining three provisions (i.e. prioritising the interests of the developing countries, providing preferential market access to the developing countries and providing technical assistance to the developing countries and LDCs) are just "best endeavour" clauses, which the developed countries are not obliged to implement. It would be redundant to speak of their importance for a resource poor country. Thus, with a lack of assistance, WTO membership could make the marginalised section of the Nepali society more vulnerable to the negative forces of globalisation.

Dislocation of Various Sectors

As a member of the multilateral trade regime, Nepal is bound to face stiffer competition, which may have implications for various sectors of the economy. The garment industry, the main source of foreign exchange, will no longer be able to enjoy the quota allowances under MFA, which is being phased out in 2005. However, the EU's offer of Everything But Arms (EBA) could be used as a cushioning effect by Nepal at least temporarily. According to this initiative, there are no quotas and duties on all products besides arms from 49 LDCs of the world.

Moreover, agricultural sector, which is still reeling under the adverse effects of the deregulation of the government, has to brace itself more challenges. In the context of Nepal, impact of trade on the agriculture has significant implications for the purpose of poverty reduction. This is especially true in the light of the role agriculture plays in terms of "promoting food security, livelihoods and rural development of developing countries" (Regmi, 2004).

The loopholes in the Agreement on Agriculture (AoA) are evident from massive export subsidies given by the EU, the US and Japan to their farmers which has created a dis-equilibrium in the international market. The irony is that instead of market access, the developing countries have to deal with the cheaper subsidised agricultural goods from the developed world. This could deepen poverty crisis in Nepal with the erosion of the only livelihood option for the vast majority of the population.

Small & Medium Enterprises (SMEs) – the largest employer in Nepal after agriculture – also will be significantly challenged. SMEs in Nepal are closely linked to agriculture in the light the that vast majority of them are agro-based. Though they can be compared to the backbone of the national economy, they are limited in terms of productivity, capital assets and marketing capacities. Their existence is vital not only from the perspective of economic development but also for the maintenance of peace and tranquillity in the country.

Market Access

The opportunity to gain a foothold in the international markets remains highly intangible owing to distortions in international rules and domestic economy. Behind its rules-based façade, the WTO in reality remains very much power-based catering to the demands of the stronger nations. This is justified by the unfair agricultural subsidies by the developed countries. Although the tariff levels are decreasing, various other NTBs are finding its ways especially under the pretext of quality regulations. For example, standards related agreements like Sanitary and Phyto-Sanitary (SPS) and Technical Barriers to Trade (TBT) often put unnecessary requirements that can strain the trade potential of LDCs like Nepal. Thus, Nepal with other developing nations should make a concerted effort to get better deals in the future negotiations, among which one could be more realistic standard requirements.

Supply-side Constraints

It is noted that the export performance of South Asia has been driven by a relative improvement in supply capacities. Thus, while developing trade policies, it would be short-sightedness of Nepal just to focus on market access without proper attention to capacity building for the sake of enhanced competitiveness. It is imperative that the rural and marginalised section of the society is not excluded. Efforts should be taken to identify the sectors where Nepal has comparative advantage to assist product specialisation. Besides, cautious diversification of the export base is essential to ensure sustainability and reduce volatility of trading regime.

Given the infant level of development that Nepal is at, some degree of government intervention may be required. This is pertinent against the backdrop of a country that is lacking in adequate skills, resources and technology. Lastly, the importance of good governance and adequate infrastructure need not be emphasised much. Good governance is considered by UNCTAD (2004) to be critical for civil peace, which is sorely missing from the Nepalese scenario. The ongoing Maoist insurgency has resulted in the destruction of the physical infrastructure of the nation with disruption in transportation and electrical supplies. The situation is exacerbated by the migration of the rural people into nearby cities and India. Thus the conflict has severely impaired skill building capacities and accumulation of human capital. This has had a negative impact on the trade-poverty relationship in the context of Nepal, which could entrap the country into the vicious cycle of poverty.

6.7 Conclusion

In today's globalised world, trade is considered to be the facilitator of pro-poor human development goals. However, the relationship between trade, development and poverty reduction is ambiguous. It should be realised that trade facilitates development not in isolation but when supported by other non-trade factors like stable macro-economic policies and so on.

Speaking of Nepal, the impact of trade liberalisation that was initiated in the early 1990s has been rather lukewarm. In the light of underdeveloped infrastructure, various sectors were dislocated due to increased foreign competition. The poorer section of the rural society was the hardest hit. Furthermore, the link between trade and finance was not positive in the case of Nepal as is evident from the limited FDI inflows. In a nutshell, trade related measures have failed to fit well with the overall poverty reduction strategy. Nevertheless, Poverty Reduction Perspective Strategy (PRPS) of the 10th Plan recommends increasing the contribution of trade in the economy through various mechanisms such as making trade policies more compatible with regional and multilateral trading agreements, enhancing competitiveness and enhancing private sector participation.

Regardless of the dismal performance, Nepal has taken a bold step towards integrating into the global economy by entering the WTO. Though fraught with various challenges, the membership spells vast opportunities as well. It might help Nepal become economically independent with diversification in terms of export profile and export destination. The need of the hour is to strengthen the supply capabilities to enhance domestic competition and international market access. Lastly, it would benefit Nepal to be involved in the international forum to negotiate terms that are favourable for developing countries as well. Thus, rural-oriented development policies that facilitate internal and external trade and macro-economic stability will be pivotal in preventing Nepal from low equilibrium growth trap and widespread poverty.

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Endnotes

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2 However, achieving this goal could be a tall order despite the latest World Bank (2002) estimate that the absolute poverty in the developing world has declined from 32 to 25 percent. "The number of people below the international poverty line declined by a mere one percent per year between 1990 and 1999, decreasing from 1.3 billion to 1.1 billion. When excluding East Asia, the average proportion of income-poor in developing countries declined less dramatically – to 33 percent in 1998, down from 35 percent in 1990. At this pace, poverty will not be halved by 2015; it will only be one-quarter below its level in 1990." (Vandemoortele, 2002)

3 Price-induced policies' impacts on Asian agriculture can be found in Vyaas (2002).

4 The exchange rate as of July 12, 2005 being one US dollar = Nepalese Rupees 70

7

CHAPTER

Linkages between Trade, Development and Poverty Reduction: *The Case of Pakistan*

– Akhtar Mahmood[1]

7.1 Introduction

Pakistan pursed protectionist trade policies during the years between early 1950s and late 1970s. The major objective of these policies was to protect the nascent industries against imports. The import regime was characterised by both tariff and non-tariff barriers (NTBs). Along with high tariffs on imports the non-tariff barriers included licensing, bans and quota restrictions. In line with the experiences in many developing countries with respect to import substituting trade regime, these policies led to s distortion in the resource allocation and slow economic growth. The move towards a more liberalised trade regime was initiated in 1981, when measures were taken with a view to reducing quantitative restrictions and rationalising the tariff structure. During the 1980s and 1990s the economy became more liberalised, and export-oriented industrialisation strategy received much prominence.

Theoretically, in a country like Pakistan where labour is abundant, a liberalised trade regime would mean increased returns to labour. Because of liberalisation the producers are likely to be gained from reduced prices of raw materials and capital goods, whereas the consumers are also likely to be benefited from reduced prices of consumer goods. Tariff reduction, therefore, is expected to help in an improvement in aggregate welfare and reduction in poverty. The empirical evidence on the relationship among trade liberalisation, growth and poverty in Pakistan, however, is not clear, as the country has experienced improved economic growth *vis-à-vis* increased poverty incidence following the implementation of reforms. The purpose of this paper is to shed some light on some of the associated issues.

7.2 Poverty in Pakistan

As the definition and measurement of poverty is fraught with considerable difficulty, like many other countries, Pakistan established its own official poverty line in 2000-01. Since the United Nations Millennium Declaration, the international community led by the World Bank, has also agreed on a poverty line to monitor progress in the achievement of Millennium Development Goals (MDGs). These national and international definitions have, however, not put an end to legitimate controversies about the meaning of poverty. Policy makers and scholars are well aware that poverty is not just low income and/or low consumption; it also includes lack of human development, vulnerabilities such as food insecurity, insufficient availability of remunerative employment, and lack of access to social services. It is also now widely recognised that, whether or not a poverty line incorporates human development and social indicators, monitoring of these indicators must form an essential part of any review of poverty in a country.

Table 7.1: Percentage of Population Below the Official Poverty Line								
	1986-87	**1987-88**	**1990-91**	**1992-93**	**1993-94**	**1996-97**	**1998-99**	**2000-01**
Pakistan	29.1	29.2	26.1	26.8	28.7	29.8	30.6[a]	32.1[b]
Urban	29.8	30.3	26.6	28.3	26.9	22.6	20.9	..
Rural	28.2	29.3	25.2	24.6	25.4	33.1	34.7	..
Poverty Gap				4.2	5.1	4.1	6.4	6.8

Notes: [a] The head count index based on Rs. 673.54 per adult equivalent per month at the prices of 1988-99 PIHS Survey; [b]The index is based on Rs. 748.56 per adult equivalent per month at the prices of 2000-01.

Source: PIHS Survey, Planning Commission, Government of Pakistan.

The definition being used by the Planning Commission for the determination of Pakistan's poverty line is based on a calorific requirements approach. The Planning Commission agreed in 2000-01 on a "national poverty line on the basis of 2,350 calories per adult equivalent per day at Pakistani Rs 748.57 (US$12) per capita per month at the prices of 2000-01 and minimum non-food requirements. Based on this criterion, the percentage of the population estimated to be falling below the poverty line is reported in Table 7.1.

It can be seen from Table 7.1 that the head-count ratio of poverty fell during 1987-88 and 1990-91 from 29.2 percent to 26.1 percent, and then rose continuously in the decade of the 1990s until it reached a high level of 32.1 percent in 2001-02. The behavior of 'poverty' since then has yet to be estimated, but it seems that, despite a relatively high inflation rate in 2004-05, a strong gross domestic product (GDP) growth rate might break the momentum of rising poverty and perhaps even reverse it.

Table 7.2 shows that after the stagnation of the 1990s, Pakistan began to recover its traditional moderately high growth rates in 2002-03, and that it did so without raising any inflationary expectations. The exceptionally high inflation of 2004-05 is at least partly due to the abnormal behaviour of oil prices. Government is, however, determined to bring down this rate as soon as possible, and has already announced important changes in its monetary policy to restrain demand. It is therefore not overly optimistic to hold the view that recent relatively high GDP growth rates are likely to stop the rise in poverty in the country.

Table 7.2: Real GDP Growth Rates and Inflation Rates			
	2002-03	**2003-04**	**2004-05**
GDP Growth Rates	5.1	6.4	8.4
Per Capita Growth Rates	3.9	3.3	6.0
Inflation Rates	3.1	4.6	9.3

Source: Economic Survey 2004-05, Government of Pakistan.

Table 7.3: Poverty and Social Indicators: 1997-03			
	Pakistan	**South Asia**	**Low Income**
Urban population (% of total population)	34	28	30
Life expectancy at birth (Years)	64	63	58
Infant mortality (per 1000 live births)	76	68	82
Child malnutrition (%of children under 5)	-	48	44
Access to improved water sources (% of population)	90	84	75
Illiteracy (%of population age 15+)	54	41	35
Gross primary enrollment (% of school age population)	73	95	92
Male	84	103	99
Female	62	88	85
Source: Pakistan at a Glance, World Bank, 2005.			

There is not much of an argument these days that a calorie-based definition of the poverty line is a narrow and an incomplete criterion. This measure has therefore to be seen together with human and social indicators of an economy in order to capture better the 'wide domain of poverty'. The social indicators of Pakistan reported by the World Bank (see Table 7.3) portrays a depressing picture not only for Pakistan but also for the South Asia as a whole.

Recognising that the poor are not a simple, homogenous mass, and that a uniform, undifferentiated policy might therefore not work to reduce poverty, the Planning Commission of Pakistan recently carried out another survey to deconstruct the poor into categories such as chronically poor, transitory poor and transitory vulnerable. This survey has brought out that as much as 63 percent of the poor population in fact falls between the poverty line and a level of consumption that is equivalent to 75 percent of the poverty line.[2] In other words, poverty in Pakistan is characterised by large amounts of clustering around the poverty line and a high proportion of the vulnerable population tends to move in and move out of poverty. A poverty reduction strategy must therefore take account of the range of poor around the poverty line rather than focus only on the fixed head count number.

7.3 Institutional Arrangements

Planning has been the cornerstone of Pakistan's development policy virtually since its creation, and food security has always been one of the pillars of Pakistan's poverty reduction programmes. Looking back, it is fairly clear that Pakistan has never failed to ensure availability of food (cereals and sugar) at affordable prices though a temporary scarcity of sugar did once trigger a massive protest movement. The wheat procurement and distribution system that Pakistan has operated over several years has never been a very efficient system, but it has provided adequate quantities of wheat to all parts of the country at all times at uniform and subsidised prices.

Ensuring food security, even in this very limited sense, has been no ordinary achievement. Pakistan has never fallen a prey to famine or even near famine even in its most difficult times. But it also has to be acknowledged that in the past, successive governments have failed to commit adequate volumes of resources and administrative attention to the social sectors (education, health, safe drinking water etc); this failure is simply too brazen to be laboured here. This mixed record (relatively strong on food security and weak on social sectors) should not, however, obscure the fact that the decade of the 1980s did see a distinct decline in the incidence of income and consumption poverty, while the 1990s experienced a more or less continuous increase in head-count ratio of poverty stagnation in its GDP growth rates, and a very slow increase in its exports.

Following the depressing experience of the 1990s, the government articulated an Interim Poverty Reduction Strategy Paper (IPRSP) in 2000 that provided an integrated focus on a diverse set of factors that impact on poverty and other development outcomes. The core elements of the IPRSP were to engender growth, improve human development and governance and reduce the vulnerability of the poor to shocks.[3] The full Poverty Reduction Strategy Paper (PRSP) was issued in December 2003. This strategy is part of the Poverty Reduction and Growth Facility agreed by the International Monetary Fund (IMF) and the World Bank with the government.

The 2003 strategy paper encompasses a large array of actions that have to be elaborated and implemented by virtually the entire government, but the Ministry of Finance, being responsible for the conduct of Pakistan's relations with the IMF and the World Bank, plays the lead role. In turn, the Ministry of Finance has set up a PRSP Secretariat that prepares the paper in consultation with concerned ministries and monitors progress in implementation of the Strategy Paper. This Secretariat is being assisted by a research centre called the Center for Research on Poverty Reduction and Income Distribution. The Planning Commission of Pakistan is providing full support to the Ministry of Finance in the preparation of the Strategy Paper.

Finally, it may be noted that Pakistan has completed the arrangements under its 2001 IMF Poverty Reduction and Growth Facility, and that no new Facility is now in force in Pakistan. In fact, Pakistan is now pursuing its poverty reduction strategy on its own.

7.4 Trade Liberalisation and Poverty

From the 1950s to the 1980s, Pakistan pursued heavily protectionist trade policies through a combination of tariff and non-tariff barriers (NTBs). However, these protectionist policies led to a distortion in resource allocation, generating inefficiencies in resource use (Siddiqui and Kemal, 2002). Pakistan progressively liberalised from 1987 onwards. This policy change stemmed from the realisation that theoretically, trade liberalisation promotes economic growth and this in turn reduces poverty. The break up of the linkage is that trade liberalisation will affect international capital and labour flows, bring about technological change, and the outcome would be economic growth. To reduce poverty, this economic growth must be complemented by sound domestic policies, good governance, and effective institutions delivering public services. Although short term structural changes may lead to transitional negative effects, the long term effect would be a decline in poverty. However, it is important to realise that the beneficial effects may not be spread evenly across the different sectors of the economy, and that they may accrue unevenly amongst the urban and rural population (Husain, 2001).

Empirically, Siddiqui and Kemal (2002) explore the links between trade liberalisation and poverty. Their study concludes that liberalisation should result in increased welfare and falling poverty. However, the welfare gains and poverty reduction are greater for urban households. On the other hand, they also stress that that remittances play an important role for generating economic growth and reducing poverty. They prove that trade liberalisation in the presence of decline in remittances reduces welfare of urban households and the incidence of poverty. This is due to the double impact of a reduction in trade deficit financing as well as reduced household consumption. However, rural households still experience slight welfare gains. This is mainly because they are not recipients of remittances in the first case. It is nevertheless important to note this welfare gain to rural households is less than the welfare gain in the presence of trade liberalisation and no reduction in remittances. As far as detailed sector by sector analysis of linkages between trade liberalisation, development and poverty reduction are concerned, there is a dire need for in-depth up to date research.

7.5 Macroeconomic Policies and Trade Liberalisation

Poverty in Pakistan increased in the decade of the nineties as the country experienced severe exogenous shocks such as economic sanctions and drought. In this decade, Pakistan's GDP grew at just about 4 percent compared with 6.5 percent in the 1980s: agriculture registered a bare 3.1 percent compared with a 5.4 percent in the 1980s. The share of investment stagnated, and the share of interest payments in the GDP rose from 3.8 percent to 6.8 percent, while the share of development expenditure fell from 7.3 percent in the eighties to 4.7 percent of GDP in the nineties. Inequality (Gini Coefficient) did not change but the absolute number of the poor did rise.

Table 7.4: Tariff Reform in Pakistan

Year	Slabs	Maximum
1987-88	17	125
1994-95	13	65
1997-98	05	45
1998-99	05	35
2000-01	04	30
2001-02	04	25
2002-03	04	25
2003-04	04	25

Source: National Tariff Commission, Government of Pakistan.

As Table 7.4 shows, Pakistan began its liberalisation of trade in 1987-88, and since then it has eliminated virtually all its non-tariff barriers (NTBs) such as licensing procedures, quantitative restrictions (QRs), and its system of foreign exchange quotas; at the same time it has reduced its tariffs substantially. The average of the applied tariffs of Pakistan is now about 17 percent, and its maximum tariffs (except its tariffs relating to the automotive sector) have come down from 125 percent in 1987-88 to 25 percent in 2002-03. The dispersion of its tariffs has also been reduced drastically. Pakistan currently has only four tariff slabs: 5, 10, 15, and 25 percent.

This reform did not, however, stem the slowdown of growth in the value of exports and imports in the 1990s: exports grew merely at the rate of 5.6 percent compared with 8.5 percent in the 1980s, while imports increased only at the rate of 3.2 percent as against 4.5 percent. Employment, a major channel through which international trade affects poverty, did not improve either. In 1999, the Labour Force Survey of Pakistan reported that the unemployment rate was already 5.89 percent, which then rose to 7.82 percent in 2000; rural unemployment rose to 6.94 percent and urban unemployment to 9.92 percent. These high unemployment rates were unprecedented in the history of Pakistan.

The economy now seems to be turning the corner. During the last four years, the GDP of Pakistan has grown from 1.8 percent in 2000-01 to more than 6 percent in 2004-2005.[4] In 2004-05, agriculture, which has the strongest immediate impact on rural poverty, grew by 7.6 percent, manufacturing by 12.5 percent, and services by 7.9 percent. International trade, another important determinant of poverty, has also risen strongly over the first five years (except in 2001-02) of this decade. In 2004-2005, exports rose by more than 15 percent. It need not be reiterated here that trade affects poverty directly through its impact on the cost of living, jobs, and wages, as well as government revenue, and indirectly through its effect on the development and utilisation of productive capacity of a society. Higher capacity utilisation is therefore an important indicator of the benign effects of expanding international trade. In Pakistan, the highest increase in capacity utilisation has been observed in electronics and automobiles. Other industries that have done well are fertiliser, paper and paper board, tractors, industrial chemicals, and steel.[5] These industries either exceeded 100 percent capacity utilisation or very nearly 100 percent capacity utilisation. It is therefore reasonable to expect that poverty is no longer increasing, and is perhaps decreasing.

7.6 Complementary Policies

Sound macroeconomic policies, high growth and liberal trade policies are indeed necessary but not sufficient for a substantial reduction of poverty. It is now widely acknowledged that macro-economic policies have to be supplemented by social sector and targeted poverty related expenditures to help the poor move out of their dire predicament. There is no doubt that in the past authorities did neglect the social sectors, but since 2001 the Ministry of Finance is making a systematic effort to redress this. The enormous problems of poverty, however, still remain. The government will, therefore, not only have to ensure that there is no backsliding in any sector; it will also have to make every effort to reinforce its reform strategy. Table 7.5 displays the new directions in the social sector policies of Pakistan, which shows a fairly dramatic increase in social sector allocations at least in the first two years of the Interim Poverty Reduction Strategy Paper (I-PRSP) regime, but more than that, it brings out how wide is the range of measures that must be taken to cope with poverty.

Table 7.5: Social Sector and Poverty Related Expenditures (Rs billion)				
	2001-02 Actual	2000-03 Actual	2003-04 Actual	2004-05 Budget
I. Community Services	**10.98**	**16.57**	**20.63**	**21.46**
Roads, highways,& buildings	6.34	13.15	16.45	16.58
Water supply and Sanitation	4.64	3.42	4.18	4.88
II. Human Development	**90.67**	**105.81**	**134.13**	**147.73**
Education	66.29	78.61	97.96	102.38
Health	19.21	22.37	26.58	36.08
Population Planning	1.33	3.12	4.91	4.88
Social security and welfare	3.66	1.30	4.14	3.90
Natural calamities	0.19	0.41	0.54	0.49
III. Rural Development	**24.30**	**34.18**	**45.30**	**43.04**
Irrigation	10.13	15.54	22.94	32.37
Land Reclamation	1.84	1.76	2.00	2.44
Rural Development	12.33	16.88	18.38	7.23
Rural Electrification			1.98	1.00
IV. Safety Nets	**8.33**	**13.75**	**11.46**	**19.03**
Food subsidies	5.51	10.86	7.84	14.63
Food Support Program	2.02	2.24	2.80	3.90
Tawwana Pakistan	0.80	0.59	0.40	0.50
Low cost housing		0.06	0.42	0.00
V. Governance	**32.98**	**38.54**	**42.44**	**46.80**
Administration of justice	1.98	2.25	2.44	3.41
Law and Order	31.00	36.29	40.39	43.39
TOTAL	**167.25**	**208.84**	**253.96**	**278.06**
Percentage Increase		***24.9***	***21.6***	***9.5***
Source: Economic Survey 2004-05, Ministry of Finance.				

7.7 Current Poverty Reduction Strategy

The strategy that the Government of Pakistan, in consultation with the IMF and the World Bank, announced in 2003 to reduce poverty and meet the MDs rests on four pillars: (i) achieving high and broad-based economic growth while maintaining macroeconomic stability; (ii) improving governance; (iii) investing in human capital; and (iv) targeting the poor and vulnerable. Built on these pillars, government is already implementing a comprehensive programme of reform of its macroeconomic policies, and its financial and foreign trade sectors. The country's overall fiscal deficit has already come down from 8.8 percent of the GDP in 1990-91 to 3 percent in 2003-04, and the

Table 7.6: Tariff Liberalisation in Pakistan	
Year	**Effective Rate of Customs Duty (Percent)**
1994-95	34.0
1997-98	22.9
1998-99	18.0
2000-01	17.0
2001-02	15.1
2002-03	15.6
2003-04	14.7
2004-05	14.2

Note: It excludes the tariffs in the automobile sector.

Source: Central Board of Revenue.

government intends to keep it around 3.5 percent until FY 2008. The aim of monetary policy is to stimulate private activity and to stabilise the foreign exchange rate around its current market-determined rate. The exchange rate does not any more discriminate against agriculture as it used to do in the 1980s and 1990s.

Trade liberalisation and export promotion is one of the major areas of reform. It has already been reported that the maximum tariffs in Pakistan now do not exceed 25 percent, and that the number of slabs have been reduced to just four. It can also be seen from Table 7.6 that in FY 2005 effective customs duty rates on dutiable imports were a mere 14.2 percent. Some of the major tariff peaks (e.g. automotives) have also been reduced, and value-added tax has been introduced to reform distorted and discriminatory tariff structures. Pakistan gave up its QRs and other bureaucratic NTBs quite some time ago.

Exports have been progressively liberalised. For example, in FY 2005, export duties on many agricultural products such as raw cotton, rice (husked and unhusked), raw hides, fish, molasses and birds (falcons, other) have been eliminated. It has also been decided to enlarge the export finance scheme, among other things, to provide adequate resources for small and medium enterprises (SMEs). According to official sources, two special export zones are being established, and an Upgradation Fund will be set up and managed by both the public and private sectors.

The Government of Pakistan has further decided to review the costs and benefits of its remaining protectionist policies, and carry out a rationalisation of its tariff structure to eliminate its anti-export bias. In its 2004-05 Annual Import Policy, Pakistan also substantially reduced its list of prohibited products. At present, this list contains items such as anti-Islamic, obscene, or subversive literature, alcoholic beverages and spirits, and edible products not fit for human consumption. Products importable under health and safety requirements include wheat, fish and fishery products, sugarcane seeds, banana seeds, vegetable seeds, insecticides, fungicides etc. Import of edible products is also subject to some restrictions related to food safety. Moreover, Pakistan has adequate legal and institutional arrangements in place to protect its productive system from the harmful effects of dumping, sudden import surges, and foreign subsidies. Pakistan's import policy is now amongst the least restrictive of the developing countries.

Targeting the Poor and Vulnerable

Targeting the poor and vulnerable is now an integral part of Pakistan's poverty reduction policy. The country has already established two micro-credit banks and several institutions responsible for making direct transfers to the poor. Some of these are mentioned below:

Khushali Bank: It is an important part of the comprehensive financial system for the poor. Khushali Bank was established in 1999, and today it has a network of 130 service outlets across 64 districts of the country. It now plans to extend its work to another 11 districts in the current year. The disbursements of this bank, mainly in the rural areas of the country, amount to nearly Pakistan Rs. 3 billion (US&48mn).

SME Bank: *It is working as a pioneering bank for the promotion of SMEs in the country. Gross advances extended by the bank have already exceeded Pakistan Rs. 1 billion (16mmn). Total disbursement of credit to 642 customers in 2004 stood at Pakistan Rs. 388 million (US$6.2mn).*

Pakistan Poverty Alleviation Fund (PPAF): It is a public-private enterprise with three windows: (i) line of credit for expansion of poverty-targeted micro-credit programmes through the Credit and Enterprise Development Unit; (ii) grants and loans for community physical infrastructure on a cost-sharing basis, mostly for clean drinking water identified by communities, locally run through the Community and Physical Infrastructure Unit; and (iii) grants to strengthen and build the institutional capacity of organisations and communities through the Human and Institutional Unit. The beneficiaries of the Fund add up to 329.9 million people spread over 87 districts of the country. The fund has already completed 3,000 schemes.

In addition to the above institutions, the State Bank is managing two endowment funds, namely the *Micro Finance Development Sector Fund and the Community Investment Fund*. The former is devoted to the capacity-building and skill-development needs of poor communities, particularly women, while the latter provides funds for community-level development schemes.[6]

Social Safety Nets: It includes the Worker Welfare Fund, Food Support Programme, Social Security, Employees Old Age Benefit, Pakistan *Bait-ul-Mal,* and *Zakat Fund*. *Zakat* is the single largest mechanism for cash transfers to the poor. This Fund provides financial assistance for day-to-day livelihood, education stipends, health care, social welfare, and marriage assistance. Zakat already assists two million people and another 1.5 million are being added to the programme. This programme does not simply help in the fulfillment of basic needs, it also helps to rehabilitate the poor permanently.

Food Support Programme: It is designed to compensate for the effect of increases in retail wheat prices brought about by increases in producer prices. Cash support of Pakistan Rs. 2.5 billion (US$40mn) was allocated in 2004 for disbursement on a bi-annual basis.

Pakistan Center for Philanthropy: It was established in August 2001 to raise social understanding of philanthropy and to assist in the creation of a social, regulatory, and fiscal environment for the promotion of philanthropy. It has been estimated that the people of Pakistan give about Pakistan Rs 70.5 billion (US$1.13) in private charity. Finally, non-governmental organisations (NGOs) are also making their contribution to greater awareness of poverty and its eradication.

7.8 An Assessment of the Current Strategy

There is no doubt that the Poverty Reduction Strategy being practiced in Pakistan since 2001 represents a significant advance over the partial and uncoordinated policies of the past. This advance is being made both in terms of concepts and practice. The strategy recognises clearly that the concept of poverty goes well beyond income and consumption deprivation, and that a wide range of actions at several levels of the society and the economy is required to reduce and finally to eliminate it. However, it is not possible at this stage to make even a reasonably fair assessment of the impact of the current strategy on poverty. The Household Income Expenditure Survey, called the Living Standards Measurement Survey, which is designed to provide the necessary information, is still only partly complete. Its incomplete, ill-digested and premature results cannot therefore be used with any confidence, as some official agencies have done, to make a judgment about how the strategy has worked in real life. However, it is clear from Table 7.4 that expenditures on poverty-related activities have increased significantly and that the operations of the safety nets have been enlarged. These policies cannot but have made a notable, positive impression on poverty.

Notwithstanding this optimistic picture, it seems that the current strategy needs to pay greater attention to rural development. This is important because the bulk of the population of Pakistan still lives in rural areas. There are three areas in particular which need to be highlighted in the future. First of all, rural markets for major agricultural commodities need to be reformed radically. At present, Pakistan's rural areas are ill-equipped to take advantage of the liberalisation of trade policies of the US and the EU that are likely to come about as a result of the Doha Round of Negotiations on Agriculture. Current stabilisation policies should not be allowed to distort unduly farm-gate prices in relation to the international prices. It is important that the rise in international prices of major agricultural commodities that are to result from reduction of agricultural subsidies by the industrialised countries reach the farmers. This will not only increase the income of the farmers but also increase employment in the rural areas.

Secondly, processing of agricultural products needs to be improved drastically in the rural areas to reduce waste, and improve quality and efficiency. Quality has now become an essential pre-requisite for export promotion. Concurrently, farm-to-market roads need to be increased substantially to integrate better rural markets with national markets, and electrification needs to be accelerated to modernise rural processing industries. There is also a need for better definition of public policy instruments for livestock development. Government needs to develop a better regulatory role and a more WTO-compliant phyto-sanitary and public health framework. Investment on livestock is one of the most effective poverty reducing measures. And, thirdly, operation of safety nets needs constant attention. Safety nets, apart from being expensive, can be abused extensively.

It is therefore essential that the targeting and delivery mechanisms of these programmes be made transparent and efficient.

Above all, justice, equality before law, respect for the property rights of the poor (however, meagre their assets may be), and the rights of women to their inheritance, to work outside the home, and to the security of their person need to be enforced in the rural areas. Progressive politicisation of the institutions responsible for administration of land rights, irrigation, justice etc., has only led to their absorption in the ancient *biraderi*, caste, and tribal structures of economic and political power. Regrettably, those institutions no longer have much capacity left in them to act even in a relatively impartial and objective manner. Restoration of the rule of law is a prime prerequisite for the reduction of poverty, and laws need to be made in a transparent, democratic manner.

Risks to Poverty Reduction Strategy

It is important to recognise that the unquestionable progress government has made in liberalising its trade regime and in implementing its poverty reduction strategy is not yet secure; in fact, it is still open to several risks. These risks need to be understood clearly and policies need to be designed to minimise them. Some of the most obvious risks are listed below:

- A high rate of inflation, particularly inflation in food prices, is a constant danger to the well-being of the poor. There is no doubt that the present high rate of inflation (9.5 percent), if not checked effectively, will undo most of the effects of the pro-poor policies of the last four years. A continuous rise in the price of food, which constitutes the bulk of the consumption of the poor, is particularly lethal. Government must therefore pay immediate attention to this issue.
- An adverse exogenous economic or political shock might weaken the resolve of the government to continue with its trade reform and poverty reduction policies.
- A shift in the domestic balance of power could not only stop further liberalisation but even reverse the progress already made. It is therefore important for a liberalising government to estimate carefully the protectionist power of a coalition which comprises: a traditional bureaucracy reluctant to lose its power to intervene in economic activities as a result of deregulation and liberalisation, the interests clustered round import-substitution industries (e.g. automobiles), and trade unions. Coalitions of this kind have sufficient power by themselves to block liberalisation but, when combined with ideologically motivated militants, they can become a serious threat to the forces that seek greater integration with the world economy. Government must therefore be ready to exercise leadership, initiate educational and capacity-building programmes, and where necessary, introduce adjustment assistance measures to reduce the pain of change.

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CHAPTER

Linkages between Trade, Development and Poverty: *Sri Lanka*

– Dushni Weerakoon[1] and Jayanthi Thennakoon[2]

8.1 Introduction

The linkages between trade, growth and poverty have begun to receive increased attention in recent years. It is partly a reflection of the recognition that the structural adjustment programmes (SAPs) of the 1980s, while making some headway in reducing absolute poverty levels, were not entirely successful in addressing widening income inequality, be it within particular nations or between nations. Only a handful of developing countries – primarily in East Asia – have been able to indicate substantial progress, although a second-tier of developing countries particularly China and India are increasingly providing evidence of some success.

While there is little contention that economic growth is a necessary condition to alleviate poverty, empirical evidence that broadly suggest causal impacts has to be interpreted with some care. The linkage to establish the interrelationship between trade, growth and poverty generally concerns the relationship between trade and growth and the relationship between growth and poverty. While many studies have concluded that there is a positive association between trade and growth, most are unable to conclude anything about causality. Does openness lead to growth or does growth lead to openness? For instance, the richer a country gets the more inclined it might be to open up to the outside world. An alternative explanation might also be that both are caused by a third factor such as the quality of institutions in a country that impacts positively on both the prospects for enhanced growth as well as the effectiveness of trade policy.

The problem is made more difficult because of the fact that trade openness still remains very ill defined and there is no suitable proxy that can adequately capture all the important dimensions. Even if causality from trade to growth is accepted, one has to be careful in distinguishing between trade impacts (the flow of exports and imports) and trade policy measures *per se* (relating to tariff and non-tariff barriers). While a link between *de facto* trade openness and growth may exist, it is more difficult to establish a nexus between trade liberalisation and growth. The problem is made even more complex by the fact that countries that undergo trade reforms typically tend to do so as part of an overall growth enhancing policy package that includes many structural reforms implemented sequentially or in tandem.

The outcome in most instances is a general acceptance that trade liberalisation is supposedly good for growth but there is less clarity on who wins and who loses, or how freer trade affects poverty. Whether a particular trade reform policy is pro- or anti-poor depends not only on which tariffs are being reduced, and how much of a price change is passed through to the poor, but also on how the poor earn and spend their incomes. More important than price changes may be whether markets exists at all given that trade reforms can both create and destroy markets. Extreme adverse poverty shocks are often associated with the disappearance of a market, while strong poverty alleviation can arise when markets are introduced for previously un-traded or unavailable goods.

Trade reform is also likely to have a major effect on the prices of factors of production – where wages of the unskilled are the most important from a poverty perspective. If reform boosts the demand for labour-intensive products, then there is a likelihood of an increase in wages and employment. However, whether this 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 from unskilled families, while trade reforms boost demand for semi-skilled labour, poverty will be unaffected – or it could even worsen as wages of unskilled workers would fall.

Trade reform can also affect government revenue, but it is not inevitable that the poor suffer. It is ultimately a political decision whether new taxes are introduced to make up for the shortfall, or whether government expenditures are cut instead. The impact on poverty depends on whether the new taxes or cuts in expenditure fall disproportionately on the poor.

In establishing empirical linkages of the impact of trade policy on poverty, one of the main stumbling blocks is the lack of an effective means of linking changes in trade policy to changes within individual households. Tools such as the computable general equilibrium (CGE) models have been employed to gauge the effects of macroeconomic shocks – trade liberalisation or tax reforms for instance – on the economy as a whole. But the analysis of macroeconomic shocks and the analysis of income distribution and poverty use very different techniques and sources of data. The former are based on national accounting data while the latter are generally analysed on the basis of household or individual data. Thus, CGE models have to be refined to distinguish between the poor and non-poor within categories of households to make the link between trade policy changes and poverty. In the final analysis, however, it is important to keep in mind that any model is only as good as the data available and the assumptions on which it is based; economic models, however refined, also do not replicate the exact functioning of any economy.

Economic theory suggests that international trade will lead to an increase in relative returns to the abundant factor – that is unskilled labour in the case of developing countries. Thus, unskilled labour that comprises a large proportion of the poor ought to be the major beneficiaries of trade liberalisation. But in reality, this may not always be the case if there is segmentation in the labour market, where reserves of surplus labour is de-linked from those sectors likely to benefit from trade liberalisation, the poverty and income-distribution consequences of trade liberalisation become even more complex.

For instance, there is increasing evidence to suggest that the ‘export push’ that comes from trade liberalisation does not benefit the agricultural sectors as much as the industrial sectors. Agricultural sectors are less export-oriented, while industrial sectors also benefit from cheaper imported inputs that can offset a drop in domestic prices as a result of increased competition. Governments, therefore, need to pay close attention to how workers, especially agricultural ones and their families adjust to changes brought on by freer trade.

It also raises questions of what the appropriate policy response should be to address such concerns: does it mean greater centralisation of investment policies and/or direct targeting of grants from the centre or offering greater economic autonomy to regions? It is a juggling act that is made more difficult by shrinking government revenues as income from tariffs drop. It can leave policymakers with two choices: cut spending or find other sources of revenue, typically through taxes but these solutions in turn will have poverty and welfare effects on any economy.

The policy implication to governments then is that trade liberalisation needs to be accompanied by complementary domestic policies and institutions to ensure more equitable growth from it. Some of these relate to macroeconomic stability, labour market flexibility, adequate physical and social infrastructure, good governance and market supporting institutions. To attain some degree of balanced regional growth, for example, government policy may have to target developing infrastructure along with other policies to encourage inflows of manufacturing into underdeveloped regions. Much of trade theory assumes perfect markets and free mobility of factors, i.e. conditions that do not exist in reality, particularly in developing countries. Microeconomic constraints are particularly binding in the case of small entrepreneurs, constraining the economic position of the poor even further.

Therefore, any research undertaken to establish linkages between trade, development and poverty has to look at the underlying micro-and-meso mechanisms that are fundamental to understanding the poverty problem. It means how and through which mechanisms the poor small farmers, landless labourers, factory workers or small entrepreneurs are affected by trade liberalisation.

Opening up to trade means that sometimes industries in developing countries have to make adjustments to deal with greater international competition. More open economies invariably also tend to be more vulnerable to external shocks. Thus, the risks of households at the margin falling into poverty may also increase. Governments need to devise policies – through the provision of social safety nets and continuous skill retraining for example – to mitigate the downside risks. In short, where freer trade displaces workers, governments may need to devise appropriate mechanisms to help them adjust.

Sri Lanka initiated an economic liberalisation programme in 1977 that laid the foundation for far reaching reforms in almost all spheres of economic activity.[3] It marked a radical departure from an inward-looking, controlled-economy approach to a liberalised, export-oriented strategy. The policy programme included many of the standards reforms of a SAP, including liberalisation of trade and payments, rationalisation of public expenditure, de-control of prices and interest rates, promotion of private sector development, foreign investment promotion and financial sector reforms. Although during the following decade, the reforms transformed the Sri Lankan economy – moving it away from a predominantly agriculture base to an increasingly industrialised one – a second phase of reforms were felt to be necessary in the 1990s to rejuvenate a flagging economy battered by an on-going civil conflict in the north and east (aggravated from 1983 onwards) of the country and an insurgency in the south (1987-89).

While Sri Lanka has made measured progress in GDP growth in the last two decades of reforms posting an annual average GDP growth of nearly five percent in the last two decades and per capita growth of over three percent in the same period, there has been limited headway in poverty reduction. The national poverty headcount is still at 22.7 percent and relatively high for a country with a per capita income of over US$1,000. In more recent years, there is also increasing evidence to suggest that income inequality in the country has also been on the increase. Improved trade performance and GDP growth in Sri Lanka has, therefore, by no means been a sufficient condition for poverty reduction.

This paper will examine in some details the Sri Lankan experience with trade reforms and its impact on the broader development objectives of the country.

8.2 The Key Elements of the Reform Process

Sri Lanka continued with the fairly 'liberal' open economic policy regime it inherited at the time of independence, driven by a strong foreign exchange position dependent on primary export commodities (tea, rubber and coconut). Deteriorating international terms of trade from the mid-1950s, however, prompted a gradual shift towards inward-looking policies in the 1960s and 1970s as in the case of many contemporary developing countries at the time.

However, unlike many other developing countries, Sri Lanka had historically placed greater emphasis on equity and welfare. It has often been cited as an interesting case of a developing country whose level of social progress has been relatively high than most other developing countries with a similar level of per capita income (Isenman, 1980; Sen 1981). Even during the late 1970s, Sri Lanka was spending on average 9.5 percent of its GDP on welfare expenditure compared with 6.4 percent by Thailand, 3.9 percent by South Korea and 3.1 percent by the Philippines.[4] Successive governments committed themselves to a large number of social programmes; free education, health services and a wide range of consumer subsidies that have proven to be the most costly programmes entered the government budget.

Table 8.1: Standards of Living in some Asian Countries in the 1960s

	Per Capita Income (US$)	Adult Literacy Rate (%)	Life Expectancy at Birth (years)	Infant Mortality (per 1,000 births)
Sri Lanka	152	75	62	63
Thailand	95	68	51	-
Malaysia	280	53	57	75
Korea	153	71	54	62
India	73	28	43	-
Philippines	254	72	51	98

Source: Lal and Rajapathirana (1989).

Welfare achievements, however, have not been without any economic costs to the country. Budgetary costs remained high, while an overwhelming dependence on primary commodity exports exposed the country to deteriorating international terms of trade effects. GDP growth averaged only 2.9 percent per annum over the period 1970-77, while per capita income growth averaged only 1.6 percent per annum over the same period. Unemployment was at a record high of 24 percent of the labour force in 1975. Stringent import controls were imposed to keep the external payments situation under control, particularly in the face of the 1973 oil price shock.

By the mid-1970s, the Sri Lankan trade regime was characterised by a system of stringent exchange and import controls and the existence of a dual exchange rate. Quantitative restrictions (QRs) on trade were more prevalent than at any previous time of its economic history with an estimated 6000 consumer items under price control measures by 1977.[5] The balance of payment (BOP) position was however untenable in the longer term. Industry was starved of much needed intermediate and capital goods imports. The external payments situation was also not helped by the lack of international assistance.

A change of government in 1977 saw a re-orientation in economic strategy with a significant shift in policy to open up the Sri Lankan economy to external trade and investment. While the government gave immediate priority to trade liberalisation, the policy programme included many other standards reforms of a SAP, including liberalisation of external payments, rationalisation of public expenditure, de-control of prices and interest rates, promotion of private sector development, foreign investment promotion and financial sector reforms.

Tariff Reforms

The trade reforms introduced in 1977 included specific measures aimed at promoting manufactured exports. The tariff reforms were intended to replace the existing licensing system which had been the main instrument used to restrict imports under the previous regime. Nearly all the non-tariff barriers (NTBs) on imports which had existed since the early 1960s were also abolished. With the government opting to rely on tariffs as the principle restraint on imports, the new policy regime removed most of the QRs, substituting higher tariffs for them, ranging from zero percent on the price of essential goods to a prohibitive rate of 500 percent on goods considered to be 'luxury' consumer items (See Box 8.1 for details of tariff adjustments in Sri Lanka). The virtual dismantling of QRs and the introduction of a multi-band tariff structure constituted a substantial shift from the pre-1977 period. While the tariff rates introduced were generally quite high, the removal of the scarcity premia attached to QRs (and the potential for rent-seeking) in it self was expected to hold beneficial effects in reducing the levels of nominal protection. Deficiencies in the new system – one of the most significant being the wide disparity that existed in the tariff rates, ranging as it did from 0 to 500 percent – were addressed thereafter with progressive liberalisation of the tariff structure in the following years.

Box 8.1: Key Tariff Reforms in Sri Lanka	
1977	The tariff structure was revised and simplified into a six-band duty system for classification as follows: (i) zero percent on the price of essential goods; (ii) five percent on most raw materials, spare parts and machinery; (iii) 12.5-25 percent on most intermediate goods; (iv) a common revenue rate of 50 percent on goods that are neither "essential" nor "luxury"; (v) a common protective rate of 100 percent on goods being produced domestically and; (vi) a prohibitive rate of 500 percent on 'luxury' consumer goods.
1985	Although the tariff regime remained a six-band structure, there were in effect 17 bands in operation as follows: (i) zero percent on essential goods; (ii) 5 percent on raw materials; (iii) 10-15 percent (9 rates) intermediate band; (iv) a 60 percent revenue band; (v) 75-150 percent (4 rates) protective band and; (vi) 250 percent prohibitive rate.
1991	A further revision of the tariff structure was implemented with the adoption of a four-band tariff system. The rates were: (i) 10 percent on raw materials and capital goods; (ii) 20 percent on intermediate inputs including semi-finished item; (iii) 35 percent on chemicals required as inputs to industry and; (iv) 50 percent on finished goods.
1995	Introduction of further tariff cuts under a three-band duty structure of 10, 20 and 35 percent.
1998	Three band system of 5, 10 and 30 percent (agriculture under 35 percent)
2000	Two band structure of 10 and 25 percent (a few agricultural products under 35 percent).

With the introduction of the new regulations, a large number of consumer goods were exempted from import controls, while import restrictions on a wide range of intermediate and capital goods were withdrawn. The rationale for the liberalisation of consumer goods imports was that it was intended to alleviate shortages of basic consumer goods – most of which were distributed under a strict rationing system during the earlier regime. With the exception of food, grain and petroleum products, the public sector import and distribution monopolies were also effectively terminated. Although most QRs were removed, a limited list of items continued to remain under import licensing. Some 281 items remained under the licence scheme although the numbers were gradually reduced. Licensing continued to be employed for the purpose of monitoring and for the most part was issued to all applicants for any quantity sought, particularly for the import of essential consumer items such as flour and sugar.

In terms of export duties, while attempts were made to relieve the tax burden on non-traditional exports, duties on the traditional exports were however raised to take into account the higher rupee value following the devaluation of the currency. Such export taxes were, however, progressively phased out over the following years.

Payments Reforms

Other structural reforms that were adopted simultaneously also had significant implications on the trade regime. One of the most important was the reform to the payments system. Prior to the 1977 liberalisation, Sri Lanka had been operating a dual payments regime under the Foreign Exchange Entitlement Certificate (FEEC) scheme.[6] As part of the reform process, the FEEC scheme was abolished, the exchange rate unified and subject to a nominal depreciation of over 45 percent against the US dollar and the exchange rate was officially referred to as being determined in a floating system with the US dollar used as the intervention currency. In practice, the exchange rate policy resembled a 'managed' float rather than a 'free' float left entirely to the whims of market forces.

Essentially, the reforms established a new foreign exchange market under which the Central Bank adjusted the exchange rate on a daily basis to stabilise erratic fluctuations in the rate. The reform of the exchange rate system had a number of implications for the external sector. The FEEC system had tended to discriminate against the traditional export sector while at the same time providing a premium to non-traditional exports. The new system of a unified rate of exchange to a large extent held beneficial implications for the traditional export sector. At the same time the nominal devaluation that accompanied the unification also tended to reduce the bias against the export sector as a whole.[7]

Institutional Reforms

In order to encourage the export sector and diversify the export structure of the economy, institutional reforms included the establishment of Free Trade Zones (FTZs) to create a climate conducive to attracting foreign direct investment (FDI). In fact, FDI was seen as a key element in promoting export growth, supplementing scarce domestic capital, technology, and managerial skills, as well as a means of penetrating foreign export markets. The institutional framework associated with the strategy included the establishment of a Greater Colombo Economic Commission (GCEC) in 1978, which was formally changed to the Board of Investment (BOI) in 1992.

The GCEC was charged with the task of attracting and supporting export-oriented foreign investment in the country through the means of an attractive incentive package to foreign investment.[8] The FTZs offered rapid processing of applications, infrastructural and support facilities, tax holidays and exemptions and other benefits, including the absence of import duty on imports of equipment, construction material and raw materials, etc. In return, these enterprises were expected to export their total output. Tax concessions for the enterprises essentially depended on such criteria as foreign exchange earned on export sales, the extent of employment creation, magnitude of capital investment, and the introduction of new technology into the industry.

To oversee the export development drive, an Export Development Board (EDB) was set up in 1979, which was assigned the task of assisting export ventures in product development and marketing, and providing exporters with necessary supporting export services. Given the high degree of concentration of Sri Lanka's export structure and the strong bias towards import substitution in its industrial sector, broad macroeconomic policies such as the reform of the exchange rate and the removal of import restrictions alone were considered insufficient to generate the desired export drive. With that in mind, the EDB introduced several specific export development measures and promotional schemes.

The major incentive/support schemes introduced included tax incentives, concessionary financing and export credit insurance. It has long being argued that the specific export development and promotional schemes under the FTZs and the EDB gave an advantage to export-oriented producers over those producing for the domestic market. Many of the schemes had the effect of reducing production costs below comparable costs to those producers manufacturing for the domestic market.

Macro Policy Adjustments

The reforms in the trade and exchange regimes also aimed at bringing to an end the public sector monopolies handling a large range of items, and encouraging private sector participation in trading. It was also intended as a means of promoting consumer welfare by encouraging the availability of a wider choice of goods and services to consumers at lower prices through increased competition in the market. In this context, the liberalisation measures included the abolition of price controls on most goods and the phasing out of subsidies with the intent of allowing the market mechanism to function smoothly, and thereby facilitate an efficient allocation of resources for productive purposes.

The relaxation of price and import controls meant that much greater use had to be made of monetary policy instruments. Monetary policy under the post-1977 economic reforms focused on interest rates instead of resorting to credit rationing and administrative controls by adopting a policy of high interest rates. There were several arguments for such a policy stance: firstly, it was in line with the government's commitment to the free play of market forces where interest rates were to reflect the true cost of capital; and secondly, it was hoped that higher rates would also have the effect of discouraging demand for credit, particularly for 'non-essential' purposes. Primarily however, the policy was aimed at encouraging domestic savings. The interest rate was also used as a policy instrument to provide priority sectors with finance at concessionary rates under several refinance schemes.

These schemes covered primarily exports and export-oriented projects. In addition, the government also actively encouraged the entry of foreign banks into Sri Lanka. It was considered necessary and desirable to allow foreign banks to open branches in the country to achieve the objective of attracting foreign investment, particularly in view of the government's decision to establish FTZs.

On the fiscal front, reforms were aimed at reducing government expenditure on welfare programmes, for example, through the introduction of open market prices for essential commodities (as against the earlier policy of price subsidies) and the introduction of a food stamps scheme for low-income households.

The emphasis in government expenditure shifted to the development of infrastructural facilities for the economy, regarded as necessary if the economy was to raise private sector participation in economic activity, and equally important if Sri Lanka was to attract much needed foreign investment. An ambitious public investment programme therefore was undertaken, based primarily on capital intensive, capacity-expanding projects. These included a massive irrigation project (the Accelerated Mahaweli Development Scheme) which aimed at bringing large extents of irrigated land under cultivation, while at the same time substantially increasing the hydro-electric generating capacity for the economy. Other noteworthy public expenditure programmes were an ambitious programme of housing intended to provide a million housing units and a programme of urban development.[9]

The Second Wave of Reforms: 1989/90

A 'second phase' of reforms was announced in 1989 – geared to further relaxing remaining restrictions and constraints in the economy – as the country saw an end to the social and political unrest that had overwhelmed the Southern and Western Provinces of the country in the period 1987-89 (although the civil war in the North and East of the country continued to be waged). The reforms introduced in 1989 revolved around further incentives to foreign investment, relaxation of restrictions on foreign exchange, additional foreign currency banking facilities and further easing of licensing requirements with respect to trade and industry.

Further rationalisation of the tariff structure in 1989 led to an overall 30 percent reduction in nominal rates, and the removal of all non-tariff controls except those on a limited range of strategic items. In the sphere of trade and industry, most industrial licensing requirements were removed in 1989. The remaining controls on imports of plant and machinery were removed, as well as a substantial number of controls on imports of industrial raw materials, leaving only 12 categories of such items still under license for security and health reasons.

In the area of foreign investment, further reforms were carried out to rationalise and simplify investment procedures. In addition, automatic investment approval was accorded in most economic sectors with up to 100 percent foreign equity participation. The government also renewed efforts to rejuvenate its flagging programme of privatisation of public enterprises. The focus of the privatisation programme has revolved around the promotion of a wider share ownership to foster capital market development.

8.3 Post Reform Growth Performance

The singular most striking feature of the immediate post-liberalisation economic performance was an impressive acceleration in Sri Lanka's rate of economic growth (see Table 8.2). To a large extent, the acceleration in GDP growth was driven by a massive public investment programme (particularly, the Accelerated Mahaweli Development Programme which was largely donor funded). Gross domestic capital formation, which had been no more than 15-16 percent of GDP prior to liberalisation, rose sharply in the post-1977 period to peak at 34 percent of GDP in 1980. Concurrently, public investment as a proportion of GDP had nearly doubled to 15 percent by the early 1980s.

However, the economy was running into difficulties as early as 1980. The public investment programme not only ate into scarce resources, but also contributed to a build up of significant inflationary pressure. The removal of universal food subsidies and the introduction of a food stamp scheme in 1979 helped to reduce government expenditure.[10] This improvement in the fiscal position, however, was counter balanced by the massive increase in capital expenditure as a result of the public investment programme. The resulting macroeconomic imbalance in the economy was particularly severe because the increase in public investment went unmatched by an increase in public savings. Thus, the scene was set for emerging budget deficits and soaring inflation.

As these problems became evident in the early 1980s – with budget and current account deficits running at approximately 25 percent and 17 percent of GDP and, inflation recording a rate of 26 percent in 1980 – the government at the behest of the IMF was forced to adopt a more prudent macroeconomic strategy. While some improvement in macroeconomic management was achieved on the domestic and external front by 1984, with the budget deficit down to just over 10 percent of GDP and the current account deficit down to 6.6 percent of GDP, the government was faced with new and escalating problems on the socio-political front. The economic problems facing the government were exacerbated by escalating civil unrest, which besides the structural damage inflicted on the economy as a result, served not only to undermined investor confidence in the country but also added to the budgetary burden via higher defence expenditure.

From 1985, Sri Lanka began to experience a rapid downturn in its growth performance. A resurgent Marxist political force, i.e. People's Liberation Front (JVP), whose main aim was the destabilisation and overthrow of the government, caused widespread disruptions to commercial life with the enforcement of illegal strikes. From 1986 to 1989, social and political unrest that was widespread in all parts of the country and as both direct and indirect repercussions of the civil disturbances percolated through the economy, economic growth slowed considerably. A five year rolling investment and development plan for 1986-90 which envisaged a growth rate of 4.5 percent per annum for the economy proved far too optimistic in reality. Economic performance in 1987 was the poorest in the decade with a growth rate of only 1.5 percent.

With the end of the Marxist uprising in the South in 1989, the government undertook a second phase of reforms in 1989-90 to revive Sri Lanka's growth prospects with the assistance of an IMF ESAF programme. As a part of the reform process – and partly in response to the 1987-89 uprising – the government also adopted an ambitious rural poverty alleviation programme (*janasaviya*). Economic growth rebounded sharply in the early 1990s to grow at an annual average of 5.6 percent per annum during the period 1990-94.

The growth momentum continued into the second half of the 1990s, where despite a change of government a commitment to open economic policies continued marking a departure from the past where the absence of economic policy continuity has been variously blamed for the county's poor performance in the previous decades (Kelegama, 1998).

Nevertheless, economic growth proved to be sluggish and volatile during the second half of the 1990s and into the new decade, battered by both domestic and external shocks. 2001 marked the worst year of economic performance in post-independent Sri Lanka with GDP growth contracting by 1.5 percent in the face of rising international oil prices and a worsening civil conflict in the country. Despite a gradual recovery during 2002-04, Sri Lanka has continued to be burdened by high fiscal deficits, rising public debt and heightened political instability that has continued to dampen growth prospects during this period.

8.4 Post-reform Trade Performance

On the external front, export performance improved dramatically with the liberalisation of the economy (exports as a percentage of GDP rising to an average of 25 percent in the 1980s from an average of 15 percent prior to liberalisation). The mainstay of export earnings in the post-reform period was been an impressive acceleration of industrial production while Sri Lanka's traditional export crops – tea, rubber, and coconut products – experienced indifferent growth for much of the post-reform period. The most striking feature of export performance was the rapid growth registered by the garments export sector which overtook tea as the highest gross export earner from 1986.

Reflecting the differing growth rates, the commodity composition of exports also underwent a transformation. The most significant change was the decline in the share of traditional tree crops in the country's total export earnings and the increasingly significant role played by industrial exports. The share of exports of the industrial sector, which accounted for just 15 percent of total export earnings in 1978, had come to account for more than 75 percent of total exports by the mid 1990s. Garments exports alone had come to account for more than a half of Sri Lanka's export earnings by the mid 1990s (having accounted for a negligible share of under four percent at the beginning of the liberalisation episode).

Table 8.2: Selected Macroeconomic Indicators: 1978-2004

	1970-77	1978-83	1984-89	1990-94	1995-01	2002-04
GDP growth (%)	2.9	6.0	3.5	5.5	4.2	5.1
Agriculture (as % of GDP)	29.2	27.8	27.0	25.5	21.3	19.1
Industry (as % of GDP)	25.9	27.7	26.6	25.8	26.9	26.5
Services (as % of GDP)	44.9	44.5	46.4	48.7	51.8	54.4
Investment (as % of GDP)	16.9	27.8	23.5	24.4	25.3	22.7
Domestic savings (as % of GDP)	13.3	13.1	13.6	14.7	17.1	15.4
Budget deficit (as % of GDP)	-6.8	-16.2	-11.8	-9.8	-9.3	-8.3
Inflation (%)	5.7	15.3	9.9	13.1	9.7	7.8
Exports(as % of GDP)	16.1	25.6	21.7	25.4	30.5	28.4
Imports (as % of GDP)	17.3	41.9	31.5	36.6	39.5	37.8
Consumer's goods (as % of imports)	48.0	29.0	23.1	22.3	18.6	19.2
Intermediate goods (as % of imports)	35.1	46.1	54.5	52.2	54.4	59.6
Capital goods (as % of imports)	15.3	24.5	19.1	24.9	22.8	19.9
FDI (as % of GDP)	0.0	0.9	0.5	1.1	0.7	1.0

Source: Central Bank of Sri Lanka, Annual Report, various issues.

Table 8.3: Growth and Composition of Exports						
	Growth (%)		Composition (%)			
	1978-1990	1990-2004	1978	1990	2000	2004
Agricultural exports	*2.2*	*4.2*	*76.1*	*36.3*	*18.2*	*18.5*
Tea	4.5	5.7	48.4	24.9	12.6	12.8
Rubber	-0.8	-0.1	15.3	3.9	0.5	0.9
Coconut	10.4	4.9	7.4	3.5	2.1	1.9
Other Agriculture	5.7	6.8	5.0	4.0	2.8	2.9
Industrial exports	*21.3*	*13.1*	*14.3*	*52.2*	*77.5*	*78.2*
Garment	19.6	13.0	-	31.6	54.0	48.8
Gems	10.1	6.1	4.0	3.7	1.6	1.9
Other	49.4	13.4	5.5	7.1	2.5	1.1
Total Exports	*8.2*	*9.6*	*100.0*	*100.0*	*100.0*	*100.0*

Source: Estimated from data available from the Central Bank of Sri Lanka, Annual Report, various issues.

Export performance was helped by a significant increase in inflows of FDI following the setting up of FTZs. Inflows of FDI increased steadily from 1978 to 1983, but declined sharply thereafter with the outbreak of the civil conflict. FDI inflows recovered sharply in the early part of the 1990s with the implementation of the privatisation programme, but continued to stagnate around one percent of GDP. Initially, FDI inflows were overwhelmingly concentrated in the garments sector accounting for more than a quarter of total FDI by the mid-1980s. FDI played a significant role in manufactured sector export performance with many studies indicating that FDI was more efficient in raising manufactured export growth (Athukorala, 1986, 1995; Kelegama, 1992). For example, in terms of the share of total manufactured exports, exports by foreign firms with FDI is estimated to have increased from 24 percent in 1977 to 46 percent in 1982 (Athukorala, 1986). This is hardly surprising given the rapid expansion of East Asian garments exporters with already established foreign markets operating from Sri Lanka.

Despite impressive growth rates in the manufacturing sector in the post-1977 period, there were several weaknesses in the growth pattern.[11] The greater part of the growth in exports can be attributed to garments and petroleum re-exports; the total output of garments and chemical industries continued to expand because of their multilateral ownership which is not only better equipped to competition but was also capable of taking advantage of import liberalisation of raw materials and capital equipment. The adjustment process was made more complex as the country suffered the 'Dutch Disease' effect arising from a significant increase in foreign capital inflows. As a result, the country experienced a real exchange rate appreciation and resultant international loss of competitiveness in exports (Lal, 1985; White and Wignaraja, 1992). While the country's manufacturing base expanded with the rapid growth of the garment industry, non-garment industrial growth remained extremely weak.

The absence of a suitable industrial strategy – in the belief that price incentives generated from trade policies would be sufficient – is argued to be a root cause of weak manufacturing sector performance (Kelegama, 1992). But perhaps most importantly, political instability in the country that saw a sharp deceleration in FDI inflows also contributed to slowing down industrial diversification.

Thus, despite the improvement in export performance, Sri Lanka continued to experience high trade deficits as export growth failed to keep pace up with import growth (as import tariffs were liberalised) to narrow the deficit significantly. The country's primary manufacturing export earners – garments – remained highly import dependent with an estimated import content of 60 percent of inputs. Sri Lanka has nevertheless been able to maintain a reasonable deficit on the current account, due mainly to a surplus in transfers from remittances of nationals working abroad.

Agriculture

While the initial trade policy reforms focused primarily on manufacturing, the agriculture sector has also undergone broad-based tariff adjustments. Nevertheless, the agriculture sector has been protected from imports through relatively higher levels of tariffs and some quantitative restrictions. There are concerns that liberalisation of agriculture by way of lower tariff barriers could generate serious impacts on the Sri Lankan economy such that costs could offset its benefits (Thenuwara, 2003). The argument put forward is essentially that liberalisation of agriculture may not result in productive gains in the sector, but that it may incur serious losses arising from political economy dimensions. First, some sub-sectors in agriculture such as tea, rubber, and coconut have difficulties in facing price competition resulting from liberalisation since they are operating in a rigid labour market. Second, agriculture policies in Sri Lanka have been designed around voter consent due to the dependence of large rural masses on agriculture. Third, the WTO treats agriculture as a sector where protection is justified to a certain degree.

As in most developing countries, agriculture assumes an important place in Sri Lanka both in terms of contribution to GDP as well as employment. Liberalisation of the agricultural sector, therefore, has wide ranging consequences for Sri Lanka's poverty and income distribution. Some have argued that the impact of trade liberalisation on domestic agriculture has been quite severe on particular products such as rice, onions, chili, potatoes, green gram, meneri, and sweet potatoes, where production has been dropping continuously (Fernando, 2003).[12]

In looking at broader structural adjustment policies on Sri Lanka's agriculture sector, there is evidence to suggest that the export agricultural sector indicated positive growth while the increase in imports held negative consequences for domestic food production, particularly after second wave of policy reforms introduced in 1989 (Yamuguchi and Sanker, 2004). In addition, the larger scale farmers are seen to have benefited by the policy reforms while small scale farmers have been adversely affected. The adverse impact on domestic agriculture has not derived primarily from tariff policy *per se*, but rather as a result of other factors such as the removal of various agriculture subsidy schemes (in particular the removal of fertiliser subsidies). Nevertheless, Yamaguchi and Sanker (2004) conclude that the structural adjustment policies have been favourable for overall agricultural development in the long run even though their impact on the domestic food sector has been negative (with negative impacts offset by increased revenue from the export earnings).

Industry

Tariff reforms led to considerable restructuring of the industrial sector. The textile and wearing apparel sector shows the most remarkable growth performance among the given sectors and the share of this sector in total manufacturing output increased from 7 percent to 15 percent during the period 1977-82. The chemical, petroleum, rubber and plastic product sectors occupied the next position in the rank of growth performance (Athukorala, 1986). These firms have benefited from free availability of imported inputs and from significant protection provided by new tariff structure. A survey of manufacturing firms (a total of 3,018 firms) carried out in 1980 to ascertain the impact of import liberalisation found some adverse consequences with the average business failure rate to be around 20 percent.[13]

However, the relative impact of liberalisation on registered and unregistered manufacturing units at the aggregate level between 1977 and 1979 differs (see Table 8.4). The categories of 'closed down' and 'adversely affected' included 78 and 80 percent of small scale units, respectively (Athukorala, 1986). On the other hand, the 'closed down' category contained no large scale units. Moreover, estimates of average business failure rates for domestic industrial units for the post-1977 period show relatively lower failure rates for domestic industries of food products, non-metallic mineral products, ferrous and non-ferrous metal products and chemical products and higher failure rates for machinery and equipment, electrical goods and other light-manufacturing sector. The textile and wearing apparel sector, in particular the spinning and weaving sub-sector, was among the most affected (Athukorala, 1986). The study concludes that the nature of the impact on a given producer is not necessarily corelated with the degree of protection provided by the trade regime. Instead, the nature of ownership, the scale of operation, the pattern of local demand, the protection gained through the nature of the commodity involved have determined the impact on its performance level. In particular, the impact of trade liberalisation has been more adverse to small scale producers irrespective of the type of products they produce.

Small scale industries were the most negatively affected, bearing the brunt of import liberalisation: (i) larger firms benefited from liberalised imports of raw materials and

Table 8.4: The Impact of Trade Liberalisation on Manufacturing Units

Nature of Impact	Approved Industries	Unapproved Industries	All Industries
Closed down	8.6	3.1	4.3
Adversely affected	15.8	26.9	24.6
Benefited	37.6	18.5	22.5
Unaffected	38.0	22.5	48.7
Total	100.0	100.0	100.0

Source: Athukorala (1986).

capital equipment; (ii) small scale units could not compete with low prices of liberalised imports of finished goods; (iii) small scale firms could take advantage of incentives to export promotion through middlemen of large scale firms; and (iv) small scale firms could not benefit from increased financial resource mobilisation (Osmani, 1987). The worst affected in the rural informal sector from liberalisation was the handloom sector. Other industries which were also affected consisted of agro-based industries such as treacle, juggery making and pottery (Osmani, 1987). However, liberalisation was associated with gains to some industries such as certain handicrafts, coir products and *beedi* making. While Osmani (1987) concludes that despite some limited progress in a few industries, the rural-informal sector had not benefited and suffered a net adverse effect.

All available information suggests that the domestic textile sector was the most adversely affected by import liberalisation. The handloom industry in particular, operating for the most part in the unorganised sector, was a weak force in terms of its ability to lobby the government and many firms went out of business. According to the Central Bank Industrial Survey of 1978, a year after the liberalisation of imports, out of 1,300 firms in this sector on its mailing list, 200 firms informed the closing down of business (Athukorala, 1986). Similarly, estimates prepared by the Ministry of Textiles on the unorganised handloom textile sector suggests that out of about 110,000 handlooms which existed in the country, about 30,000 had ceased to function by 1980 (Athukorala, 1986). The number of looms in the country had declined to 15,000 by 1987 (Osmani, 1987). The Ministry of Handloom and Textiles puts the figure of handlooms operational in the 1990s at 20,000 (Ministry of Handloom and Textiles, 1991).

Even though the government appeared to be looking to the handloom sector to generate employment and to support rural development with increasing export earnings, these objectives could not be realistically achieved in the context of liberalisation. Furthermore, since the largest concentrations of workers employed in the handloom industry were found in rural areas in Sri Lanka, micro impacts of trade policy was negative and therefore had a negative impact on living standards of lower income segments of the population on the whole (Gunathilake, 1997).

8.5 Trade Reforms and Employment

The key channel through which trade liberalisation affects both absolute and relative poverty is through its impacts on employment level. Most of the literature concentrates on employment as a source of change – change in welfare, change in quality of life and ultimately change in poverty. However, the effect can be either positive or negative. Positive impacts of trade liberalisation include an expansion of employment opportunities created by trade reforms along with export promotion and FDI as the main source of employment generation in the manufacturing sector. The negative consequences of employment are associated with contraction of employment and sources of income as trade reforms directly contribute to the removal of state support in marketing, raw material, subsidies in inputs and preferential access to public resources for infant industries, rationalisation of the public sector and structural changes in the economy on the whole.

Economic growth in the post-reform period was accompanied by a consistent decline in the rate of unemployment in the country. While data on comparable rates of unemployment over time have to be interpreted with some caution, available estimates suggest

Table 8.5: Key Employment Statistics						
	Unemployment	Sectoral Profile of Employment				
	(%)	Agriculture	Manufacturing	Mining	Construction	Services
1978/79	14.8	52.0	12.5	1.2	5.0	29.3
1981/82	11.2	50.5	12.3	1.7	5.1	30.4
1986/87	15.5	47.7	13.4	1.9	5.7	31.3
1990	15.9	46.8	13.3	1.6	3.9	34.5
1995	12.3	36.7	14.7	1.6	5.3	41.6
2000	7.6	36.0	16.6	1.1	5.5	40.3
2003	8.4	34.7	16.1	0.0	5.4	43.8
2004	8.5	34.1	16.7	0.0	4.7	44.5

Sources: Central Bank of Sri Lanka, Annual Report, various issues.

that the rate of total unemployment fell from 24 percent in 1973 to 14.8 percent in 1979.[14] By 1982, the rate had fallen further to 11.2. From the mid-1980s, however, Sri Lanka began to experience rising unemployment as the growth momentum slowed down considerably so that by 1990, the unemployment rate was estimated at 15.9 percent. With the resumption of economic growth in the 1990s, unemployment fell consistently to 7.6 percent by 2000. While the severe economic contraction experienced in 2001 saw unemployment increase marginally, it has remained around 8.5 percent in more recent years.

Taking the available statistics into account, the attempt to reduce unemployment may be deemed to have been successful in the initial aftermath of the reform programme. Thus, contrary to the expectations of an increase in unemployment following a significant liberalisation of the economy, Sri Lanka in fact was able to claim a reduction in unemployment. However, there are many reasons – both endogenous and exogenous – to account for this decline, which had little to do with the reform programme *per se*.

In the post-reform period, there was a surge in out-migration of workers from Sri Lankan seeking employment, particularly to the Middle East. Whilst employment opportunities in the Middle East had opened up from the mid-1970s, the out-migration from Sri Lanka was constrained by stringent exchange control regulations and other restrictions. The second oil price shock of 1979 gave momentum to this trend as the demand for labour in the Middle East expanded considerably. It is estimated that approximately 350,000-400,000 Sri Lankans found employment in the Middle East over the period 1977-84 (Ministry of Plan Implementation, 1985).

A second impetus for the decline in unemployment figures came from the repatriation of Indian nationals, mostly from the estate plantation sector from Sri Lanka agreed under the Sirimavo-Shastri Agreement of 1964. An estimated 337,000 people were repatriated during the period 1977-82. A third inducement for increased employment came from the government's massive public investment programme, particularly the Accelerated Mahaweli Development Programme (AMDP). Following the escalation of the civil conflict from the mid-1980s, recruitment to the armed forces and ancillary services was also another avenue of employment generation in the country. What clearly emerges from the above analysis is that the initial spurt in the reduction in the rate of unemployment was largely on account of factors that had little to do with the liberalisation programme.

Despite the general decline in the rate of unemployment, the 1977 reform package adversely affected many small scale and rural industries in the country. According to the Population Census of 1981, about nine percent of the labour force was employed in the rural industrial sector. The industries, which provided most of the employment, were handloom, carpentry, pottery, bricks, tiles, coir products and tobacco products (Osmani, 1987). Employment in these industries was severely affected by trade policy reforms with the domestic textile sector being the most adversely affected by import liberalisation. The corresponding employment losses in this sector were quite significant. It has been estimated that handlooms employed some 150,000 people in the 1970s but that by the 1990s, total employment in this sector had fallen to less than 25,000 (Ministry of Handloom and Textiles, 1991). In fact, the loss of employment in this sector during 1977-80 is estimated at 40,000 (Waidyanatha, 1980).

It can justifiably be argued that a certain amount of re-employment of displaced labour took place in the post-reform period, particularly in the rapidly expanding export oriented garments industry. According to estimates (see Table 8.6) during the period 1980-85, there was an increase of 80,000 jobs in the manufacturing sector. However, it has been argued that the manufacturing sector, targeted as the key determinant of employment creation in post-reform Sri Lanka had largely failed to generate a satisfactory level of labour absorption in the period 1977-85 (Kelegama and Wignaraja, 1992). Total employment in manufacturing as reported in different surveys indicate that in contrast to the first half of the 1980s, the manufacturing sector generated almost 200,000 jobs in the next five years.

Table 8.6: Employment Patterns in the Organised Sector Industries

Industry - ISIC	1977 Level	Increment 1977-80	Increment 1977-85
31 Food, beverages & tobacco	28,429	3,936	35,453
32 Textiles, wearing apparel & leather products	33,180	15,793	41,658
33 Wood & wood products	6,476	2,252	3,385
34 Paper & paper products	7650	612	66
35 Petro-chemicals & others	14,446	2,750	7,803
36 Non-metallic mineral products	9,963	9,960	7,951
37 Basic metal products	1,790	453	222
38 Fabricated metal products, machinery & transport equipment	15,513	437	3937
39 Other manufactures	1,129	668	870

Source: Kelegama and Tiruchelvam (1995).

In the manufacturing sector, as would be expected in keeping with the overall developments in output growth, the textile and garments sector contributed to the largest share of employment growth. Nearly 45 percent of employment growth in manufacturing in the period 1977-85 originated in this sector (see Table 8.6). This phenomenon is inextricably linked to the fact that one of the major contributing factors to employment generation in manufacturing was the export promotion and foreign investment promotion strategy of the government. The contribution of new industries with foreign capital participation (set up in the post-reform period) to overall increase in industrial employment is estimated at 59.5 percent in 1980 and 65.2 percent by 1985 (Kelegama, 1995). In 1983, employment generated by the Greater Colombo Economic Commission (handling FDI in all designated FTZ enterprises) was estimated at 9.2 percent of total manufacturing employment (Wanigatunga, 1987).

However, employment in FDI related enterprises was largely confined to raising the level of female labour force participation in the manufacturing sector. In FTZs, female labour accounted for approximately 70-80 percent of the total, of whom semi-skilled female labour dominated the total employment generated. This is again a reflection of the dominance of garments sector related foreign investment that characterised post-reform FDI inflows to Sri Lanka.[15] Thus, the generation of employment after 1977 has been biased towards women, primarily in the low paid, low skilled strata (Rodrigo, 1994). Females benefited from new opportunities created by export industries to move out of traditional economic activities. However, these are concentrated in the trade zones, which are mostly in the urban sector along with a bias towards low skilled female workers. Another sector, which has benefited from liberalised trade, is the retail and wholesale trade sector and the number of females employed in the commercial, mercantile and service sector has also been on the increase (Rodrigo, 1994). The employment opportunities generated in these sectors have the greatest impact on low income groups.

8.6 Trade Reforms, Growth and Poverty Reduction

While the economy did indicate an improved outcome in terms of GDP growth, most data suggest that poverty may not have changed much over the period (World Bank, 2002). In fact, perceptions of inequity in access to the benefits of market driven policies is argued to have been a contributory factor in heightening social and political tensions

Table 8.7: Poverty Headcounts for Sri Lanka

	1990-91	1995-96	2002	Gini Coefficient of Per Capita Expenditure	
				1990-91	2002
National	26.1	28.8	22.7	0.34	0.42
Urban	16.3	14.0	7.9	0.37	0.44
Rural	29.4	30.9	24.7	0.30	0.39
Estate	20.5	38.4*	30.0	0.24	0.33

*Notes: * Comparability for estate headcount for 1995-96 with that for other years may be affected by the fact that the 1995-96 survey was sampled differently for the estate sector.*

Source: World Bank (2004), Sri Lanka Development Policy Review.

in the country in the latter part of the 1980s (Dunham and Jayasuriya, 2001). In response, the government adopted a considerably more populist and expansionary policy stance in what has been termed the 'second wave' of liberalisation that included an ambitious poverty alleviation programme (the Janasaviya programme).

Sri Lanka suffers from a lack of comparative statistics to assess the change in poverty status accurately over time. Nevertheless, there is evidence to suggest that the incidence of poverty reduced by about two percentage points over the period 1985 to 1995 (IPS, 2002). However, population growth meant that the absolute number of poor did not decrease over time. More recent data indicate that the national poverty headcount ratio showed a modest decline from 26.1 percent in 1990-91 to 22.7 percent in 2002 (see Table 8.7).[16] However, there are significant inequities in poverty reduction across sectors and provinces of the country. During the decade 1990-91 to 2002, the poverty gap between the urban sector and the rest of the country widened, while there was also a significant increase in poverty in the estate sector (primarily the tea plantation crop export sector).[17] The decline in rural poverty from the mid-1990s was a result of the recovery of the agriculture sector from a severe drought in 1996 (which may also have affected the survey results of 1995-96) and the gradual positive trend in per capita agricultural production thereafter.

Sri Lanka is also characterised by significant regional differences in poverty, with the Western Province, which accounts for nearly 50 percent of GDP in the economy registering by far the lowest rates of poverty. There is evidence to suggest that over the past decade, Sri Lanka has witnessed an increasing tendency towards wider regional disparity in the incidence of poverty (WB, 2004). Although numerous qualitative studies have been undertaken in the conflict-affected areas, there is no official estimate of the extent of poverty in the North and Eastern Provinces as they have been excluded from national consumptions surveys in the past two decades.

Increasing inequality over the decade is also reflected by the Gini coefficients (see Table 8.7). The increased by almost 24 percent for the country as a whole between 1990-91 and 2002, including an increase of 19 percent for the urban sector and 30 percent for the rural sector. Analysis of the links between poverty reduction, growth and inequality suggest that had inequality not increased during the decade, Sri Lanka would have experienced a significantly greater reduction in poverty (WB, 2004).

Empirical studies that have attempted to establish linkages between trade policy reforms and poverty in Sri Lanka remain fairly limited and inconclusive in terms of broad conclusions. A study by Weerahewa (2002), for example, which focuses primarily on the link between globalisation and poverty attempts to assess the relative importance of technology, trade and government transfers in explaining the changes in poverty in Sri Lanka.[18] The analysis based on poverty measures shows that from 1977 to 1994, relative poverty has increased and absolute poverty has decreased. More than 46 percent of the increase in relative poverty is argued to be due to the trade phenomena, while neither the absolute changes in poverty nor wage rates can be explained by it. The analysis further indicates that trade shocks have decreased the domestic price of agricultural goods and marginally increased the prices of goods in the rest of the economy from 1977 to 1994 and has, therefore, increased the well being of capital owners and decreased that of labour owners.

However, the study argues that trade is not the most important determinant of changes in poverty in Sri Lanka in the period examined. Trade plays the second most important factor while technological change primarily explains changes in relative and absolute poverty in Sri Lanka from 1977 to 1994 and relative poverty from 1994 to 2000. Therefore, the influences of trade based liberalisation and of trade in general on poverty are argued to be quite small. In addition, the results of the study shows that trade liberalisation from 1977 to 1994 is pro-poor while that from 1994 to 2000 is anti-poor.

Weerahewa (2004) provides an analysis of the impacts of trade liberalisation and market reforms on the paddy/rice sector in Sri Lanka. The study reveals that trade liberalisation results in a drop in prices of food items and, therefore, an increase in calorie intake of the consumers. Gains are argued to accrue to all income groups with the biggest beneficiaries being the very poor consumers. However, it points out that producers may not reap the gains from rice trade liberalisation since decreases in prices would reduce the income of the farmers and therefore the purchasing power of the farming community. This would offset some of the gains of rice liberalisation. In addition, a fall in prices can lead to inefficient high cost producers leaving the industry. In Sri Lanka, this inefficient sector consists of smallholdings and such an exit has serious impacts on absolute poverty – at least in the short run. Therefore, the biggest losers are the farmers in rural areas. Overall, the results appear to support policies of rice trade liberalisation – with the proviso that complementary policies to minimise oligopoly powers of middle men and to improve the bargaining power of farmers – is instituted.

Jayanetti and Tillekeratne (2005) arrive at similar conclusions in analysing the impact of trade liberalisation on poverty and household welfare with a special focus on rice and potato sectors in Sri Lanka. While the study concedes that rice producing households are adversely affected by tariff reduction, the results appear to indicate that tariff reduction for rice will improve overall welfare in the country, with the extent of gains being higher for the poor compared to the rich. It is argued that since there are more net consumers of rice than net producers, trade liberalisation would contribute to poverty alleviation in the country. The study also highlights the necessity of compensatory and complimentary policies to reduce the adverse effects of trade liberalisation on the poor.

8.7 Conclusion

Attempts to assess direct linkages between trade reforms, development and poverty in Sri Lanka remain fairly complex given that trade reforms were implemented as part of a broader package of structural adjustment policies. For example, fiscal consolidation efforts – such as removal of universal subsidies – had a direct impact on households; the government's massive public investment programme created employment opportunities but in turn led to spiraling inflation and loss of competitiveness of the export sector through an appreciation of the exchange rate, etc. Exogenous factors such as political instability further undermined economic performance and the country's growth prospects.

Direct impacts of trade reforms are clearly evident in certain manufacturing sectors. One of the biggest losers of tariff policy changes was the country's textile and handloom industry as import tariffs on inputs for the country's rapidly expanding export-oriented garments sector was liberalised. While the textile and handloom industry saw significant losses in employment, the garments industry in turn created additional employment, supported by an inflow of FDI into the sector.

Nevertheless, there is clear evidence to suggest that while Sri Lanka experienced rapid industrial and export diversification and an improved rate of economic growth in the post-reform period in general, it was less successful in translating this to address broader conditions of poverty and inequity in the country. The reduction in the rate of unemployment in the immediate post-reform period was also due largely to factors unrelated to the trade reform programme. The poverty headcount ratio has remained fairly high although some progress has been made in reducing overall absolute poverty levels in the country. Nevertheless, sectoral and regional inequities have widened for the most part over the years.

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3 These policy reforms have been well documented. See Lal and Rajapatirana (1989), Cuthbertson and Athukorala (1991), Athukorala and Jayasuriya (1994).
4 World Bank, *World Development Report*, 1981.
5 Weerakoon and White (1995).
6 Introduced in 1968, the basic objectives that underlined the introduction of this scheme were (a) to promote non-traditional exports; (b) to restrain non-essential imports and; (c) to divert black market foreign exchange transactions into official channels. Under the FEEC system a premium exchange rate was offered for non-traditional exports. The major effect of the scheme was to provide a favourable rate of exchange for non-traditional exports and to impose additional rupee costs on imports, particularly on raw materials and capital goods.
7 In 1994, Sri Lanka attained Article VIII Status of the IMF guaranteeing full convertibility of the current account of the balance of payments (BOP).
8 The law that set up the GCEC rescinded the operation of certain statutes within its area of authority to make the economic climate more attractive to foreign investors, including some labour laws.
9 Despite the expansionary consequences of vastly increased levels of government expenditure, such capital investment projects were seen as essential to revitalise a flagging agricultural sector, boost industrial activity through the private sector, and provide much needed employment opportunities.
10 During 1970-77 food subsidies accounted for 4.6 percent of GDP per annum, but during 1978-83 this figure was down to just 1.1 percent.
11 These are, for example, decelerating growth momentum, lop-sided growth and inadequate export orientation.
12 Another sector which was seriously affected by trade liberalisation was milk. Prior to liberalisation, the National Milk Board provided not only fresh milk at affordable cost, but also an incentive to the small dairy farmers. However, the country's supply of milk powder is at present dependent on imported milk. As a result, it has been argued that higher prices of these products have created a situation where 2.1 million families in Sri Lanka cannot afford daily standard milk consumption for their children (Fernando, 2003).
13 Ministry of Industries and Scientific Affairs (1980), Survey to Ascertain the Impact of Liberalisation of Imports on Domestic Industry, Colombo (mimeo). The survey covered all the manufacturing units serviced by the Ministry of Industries and Scientific Affairs, totalling 3016 companies in both the public and private sectors.
14 Central Bank of Sri Lanka, *Consumer Finance Survey*, various issues.
15 Thus, the private sector too has played an important role in generating employment in the post-reform period. The share of private sector paid employment increased from 1.4 million in 1981 to 2 million by 1991(Rodrigo, 1994).
16 Poverty incidence estimates are based on the official poverty lines (Rs. 1423, Rs. 833 and Rs. 475 for 2002, 1995-96 and 1990-91), respectively.
17 A decrease in income earners per estate household during the period is likely to explain part of the increase in poverty in this sector.
18 The paper has used a general equilibrium model incorporating two sectors (agriculture and rest of the economy), two factors (labour and capital) and two income groups (the rich and the poor), while three data sets have been used to reflect the elements of Sri Lankan economy in 1977, 1994 and 2000. The impact of trade on poverty has been incorporated into the model in terms of changes in import tariff, export tax and relative export prices.

9 CHAPTER Trade, Development and Poverty Reduction: *The Case of Vietnam*

– Nguyen Thi Minh Huong[1] & Doan Hong Quang[2]

9.1 Introduction

Intensified integration into the world economy and pro-poor nature are the two salient features of Vietnam's success in the last two decades. On average, the real GDP per capita of Vietnam grew by 5.9 percent per annum between 1993 and 2002 and only five countries in the world have experienced a faster increase in GDP per capita over the last decade. International trade also displayed a much faster rate of growth. Over the same period, the value of exports and imports grew on average by 17.5 percent annually. Strong economic performance goes hand in hand with significant reduction of poverty. As the size of the economy roughly doubled between 1993 and 2002, the fraction of the population living in poverty declined by half, from 58 percent to 29 percent. Vietnam's achievements in terms of poverty reduction are one of the greatest success stories in economic development.

It is widely held that positive impact of trade liberalisation can only be realised if trade reform is associated with relevant domestic reform. The success story of Vietnam in terms of growth and reduction of poverty in the last 15 years provides a good example of how liberalisation of trade regime associated with other reforms can speed up growth and at the same time benefit the poor. Property rights reform in agriculture and a pro-poor effectively functioning safety net and policies supporting redundant workers of the state sector are important accommodating reforms that assist the poor to benefit from trade-induced opportunities and growth and at the same time contribute to the mitigation of the potential negative impact of increased exposure to international trade.

This paper analyses the relationship between trade, growth and poverty reduction in Vietnam in the reforming years. The paper discusses the main policy changes and accommodating trade reform in order to promote sustainable growth and accelerate poverty reduction in Vietnam and at the same time highlights the key issues facing Vietnam in the lead up to the World Trade Organisation (WTO) accession and deeper integration into regional and world economy.

9.2 A Brief Chronicle of Trade Reform in Vietnam

Trade reform has been one of the most important components of the on-going economic reform programme since 1986. Since the introduction of *Doi moi* in 1986, progress to reform the trade regime has been impressive (see Table 9.1). Together with institutional reform in agriculture and macroeconomic stabilisation, liberalisation of foreign trade and investment are the most important pillars of the first wave of the reform programme.

Table 9.1: A Summary of Trade Reform Measures in Vietnam	
Years	**Imports reforms/events**
1989	Customs tariff introduced for the first time.
1990	Special sales tax introduced; export-import companies required to register; export of certain commodities limited to relevant exporters associations.
1991	Imported inputs used to produce exports exempted from duty; export processing zones regulation introduced; export duty on rice reduced from 10 to one percent; private companies allowed to engage in international trade.
1992	H system introduced; trade agreement with the EU signed.
1993	Export shipment licensing relaxed; duty rebate system improved; customs declaration form improved.
1994	Import permits eliminated for all but 15 products; GATT observer status received; licensing steps reduced; export shipments relaxed.
1995	Joined ASEAN; import permits system relaxed; import quota goods reduced to seven; export quotas reduced to one (rice); export taxes raised on 11 products.
1996	Maximum tariff reduced considerably; AFTA list promulgated; managed import goods reduced to six.
1997	WTO Accession process started; rice quotas allocated by provincial government; import of sugar Prohibited; temporary prohibitions imposed on consumer goods.
1998	Management of quota goods shifted to tariffs; highest tariffs reduced substantially; private sector exports allowed; foreign invested enterprises allowed to export goods not in licence; CEPT road map released; 3-schedule tariff introduced; partial surrender requirements imposed; special sales tax extended.
1999	liberalising right to import and export issued; new tariff with smaller range and rates released; surrender requirements reduced from 80 percent to 50 percent; list of conditional imports.
2000	The US-Vietnam bilateral trade agreement signed; Import permits system relaxed (from 20 to 12); QR on 8 out of 19 remaining groups removed; trade promotion centre established; control on foreign exchange relaxed
2001	All legal entities permitted to export most goods without having obtain a special licence; quantitative restrictions multilaterally on all tariff lines of 8 groups of products removed; foreign exchange surrender requirements reduced from 50 percent to 40 percent; 713 tariff lines moved from TEL to IL.
2002	Foreign exchange surrender requirements reduced from 40 percent to 30 percent; list of goods and tax rates for implementing CEPT detailed; Implementing decision for the Bilateral Trading Agreements with the US issued; WTO negotiation team started working session in Geneva.
2003	Foreign exchange surrender requirements abolished; sixth and seventh WTO working parties conducted; tariff rates for implementing CEPT officially announced.
2007	Vietnam becomes a WTO Member.

Source: CIE 1999, and updates from other sources.

Significant changes in trade and foreign exchange policy, along with liberalisation aimed at controlling foreign investment had been introduced right in the beginning of the reform. The law on Foreign Direct Investment (FDI) was introduced in 1987 that ushered the era of the "open-door" policy. The law was substantially revised in 1990, 1992, 1996, and 2000 mainly to simplify and impose deadlines on the approval procedures, reduce biases against 100 percent foreign owned investment, and target incentives to specific classes of activity. The revisions also allowed private enterprises to enter into joint ventures with foreign investors.

Table 9.2: Nominal Tariff Rates and Dispersion in Selected East Asian Countries, 2000

	Tariff measure	All products	Primary products	Manufacturing
China	Mean	15	14	15
	CV	71	102	59
	Weighted mean	20	19	16
	Maximum	121		
Indonesia	Mean	8	7	16
	CV	128	159	119
	Weighted mean	11	5	26
	Maximum	170		
Malaysia	Mean	10	5	15
	CV	200	181	172
	Weighted mean	13	12	16
	Maximum	300		
Philippines	Mean	8	6	8
	CV	94	57	19
	Weighted mean	7	5	9
	Maximum	60		
Thailand	Mean	18	16	19
	CV	84	48	55
	Weighted mean	17	14	18
	Maximum	80		
Vietnam (2002)	Mean	16	19	14
	CV	113	124	102
	Weighted mean	15	17	13
	Maximum	120.0	120.0	50.0

Source: World Bank (2003b), pp.17.

Liberalisation of Vietnam's trade and exchange system has covered almost all aspects of the trading regime. The controls on entry into foreign trading activities were relaxed, resulting into a rapid increase in the number of enterprises allowed to engage in trade. The restrictions used to manage exports and imports were also relaxed and new trade policy instruments such as quantitative restrictions (QRs) and tariff were introduced. The process has been continued at a steady pace in recent years with progressive elimination of almost all QRs, and substantial reduction of tariffs.

Customs tariff was introduced for the first time in Vietnam in 1989 and have been reduced several times since. The average import tariff was about 16 percent in 2002, displaying a considerable decline in both the nominal rate of protection and in the dispersion as measured by the coefficient of variation. Over the period 1997-2002, the maximum applicable tariff rate was reduced from 200 percent to 120 percent and only one percent of the total tariff lines have rates above 50 percent (World Bank, 2003). In terms of protection with tariff, Vietnam has a similar level of protection as compared with its Asian neighbouring countries.

Another important change in the trading regime is the gradual reduction of state monopoly in foreign trade and private sector has enjoyed increased access to foreign trade rights and licences. Producers have been allowed to sell their exports to any licenced foreign trade company since 1989. In 1991, private companies were allowed to engage directly in international trade. Quotas were removed on all but 10 exports and 14 imports, and tariffs were introduced in the beginning of 1990s. The number of foreign trade permits increased rapidly over a relatively short period of time, from about 30 in 1988 to 300 in 1991 and private firms held about 15 percent of foreign trade permits by mid-1993 (World Bank, 1993). A turning point in the participation of private sector in international trade took place with the issuance of Decree 57/1998/ND-CP in 1998. Since then enterprises have been now allowed to trade the goods as per their business registration. There are also no longer minimum requirements for any enterprise engaging in international trade such as minimum chartered capital, experience in foreign trade and business licence.

Official engagement in bilateral and multilateral agreements commenced with the conclusion of a preferential trade agreement (PTA) with the European Economic Community (now the EU) in 1992. In 1995, Vietnam joined Association of Southeast Asian Nations (ASEAN) and became a member of ASEAN Free Trade Area (AFTA). In 1998, Vietnam became a full member of Asia-Pacific Economic Cooperation (APEC) and submitted an Individual Action Plan (IAP) for meeting the liberalisation objectives associated with membership. The Vietnam-US Bilateral Trade Agreement (BTA) came into force on December 10, 2001. Since the mid-1990s, Vietnam had launched her negotiations for WTO accession. Finally, it acceded to the WTO on January 11, 2007.

9.3 Impact of Trade Reform

There are several potential impact of trade reform on economic growth and poverty of a country. The reduction of barriers to international trade could result in an increase in the effectiveness of resource allocation and hence lead to an improvement of the performance of the economy. Import of modern capital and equipments obviously has positive impact on productivity and business performance. The induced growth effect of trade reform would bring about changes in poverty through the increase in the average income per capita and also through increased resources available for poverty reduction programmes.

Trade reform can also affect poverty directly through changes in the distribution of opportunities and income. An immediate impact is the substitution and income effects associated with the changes in the relative prices. Another impact closely related to the reallocation of resources is the redistribution of employment opportunities and hence the subsequent redistribution of income. Mainstream international trade theory predicts that labour abundant developing countries like Vietnam have comparative advantages in labor-intensive industries that do not require skilled workers. Trade liberalisation leads to an expansion of these labour-intensive industries, and therefore an increase in demand for low skilled workers. However, increased openness can also be associated with increased exposure to fluctuations of international prices and capital flows and increased risk implies rising vulnerability for the poor as they do not have adequate assets and means to cope with shocks.

Impact on Economic Growth

Radical trade reform has arguably made vital contribution to the outstanding performance of the economy in the last two decades or so. On average, real GDP grew at around 7-8 percent per annum during the 1990s. The shares of export and international trade in GDP have increased rapidly and in 2002, the value of exports and imports was already higher than GDP. Judged by these commonly used measures of a country's openness, Vietnam has become a relatively open economy within a short period of time.

Table 9.3: GDP Growth and Official Merchandise Trade, 1991-2004

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
GDP growth (%)	5.8	8.7	8.1	8.8	9.5	9.3	8.1	5.8	4.8	6.7	6.8	7.0	7.2	7.7
Inflation (%)	67.6	17.5	5.2	14.5	12.7	4.6	3.6	9.2	0.1	-0.6	0.8	4.0	3.0	9.5
FDI (US$ bill.) Commitments	1,32	2,17	2,90	3,77	6,53	8,5	4,65	3,9	1,46	2,01	2,43	1,333	2.3	4.2
Export (US$ bill)	2.09	2.58	2.99	4.05	5.45	7.26	9.19	9.36	11.54	14.48	15.03	16.71	20.15	26.50
Growth of Exports (%)		23.7	15.7	35.8	34.4	33.2	26.6	1.9	23.3	25.5	3.8	11.2	20.6	31.5
Exports as % of GDP	*24.0*	*26.2*	*22.7*	*24.9*	*26.2*	*29.4*	*32.6*	*31.6*	*39.8*	*45.6*	*45.9*	*47.9*	*59.3*	*65.9*
Import (US$ bill)	2.34	2.54	3.92	5.83	8.16	11.14	11.59	11.50	11.74	15.64	16.22	19.75	25.26	31.95
Growth of imports (%)		8.7	54.4	48.5	40.0	36.6	4.0	-0.8	2.1	33.2	3.7	21.8	27.9	26.5
Imports as % of GDP	*26.9*	*25.7*	*29.8*	*35.7*	*39.2*	*45.1*	*41.1*	*38.9*	*40.1*	*48.4*	*49.4*	*56.6*	*67.7*	*73.5*
Total Trade/ GDP (%)	52.9	51.9	52.4	60.6	65.4	74.6	73.7	70.5	79.9	94.0	95.0	104.6	126.9	139.5

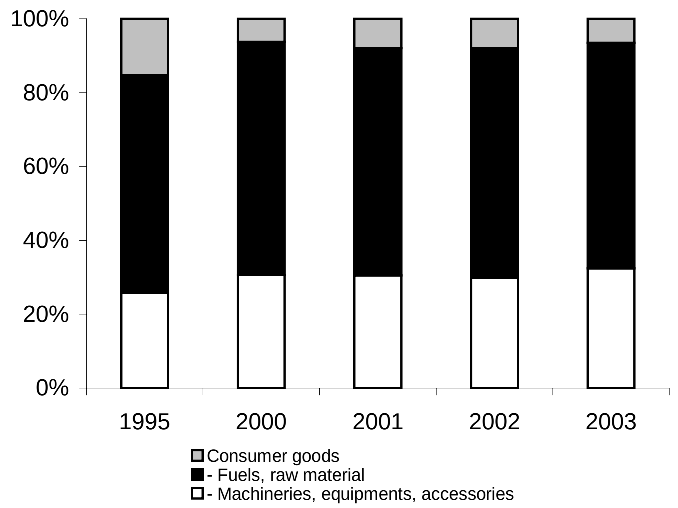
Source: General Statistical Office (GSO).

By 2004, the value of exports was nine times higher than the level in the beginning of the 1990s. The share of overall exports in GDP increased from 24 percent in 1991 to 65.9 percent in 2004. At the same time, there was a significant structural change in Vietnam's export. Initially exports were heavily reliant on Vietnam's agricultural and mineral products, with oil, rice, coffee and seafood playing a very important role. By the late 1990s, Vietnam had developed an increasingly dynamic manufacturing export base, especially in the textile and garments industries and increasingly in footwear industry, which provides potential opportunities for non-agricultural employment to overcome poverty.

Recently, textile and garment has become the largest export item for manufactured products (the second largest after crude oil in 2002 and 2004, but in 2003 it was the largest). In 1991, it took roundly 7.6 percent of total (merchandise) export value, in 2000, 2002, 2003 and 2004 this figure were 12.7 percent, 16.4 percent, 18.3 percent, and 16.5 percent, respectively. At present, Vietnam's textile and garment products have been exported to over 170 countries and territories, of which the largest foreign markets are US (37.9 percent in 2002, and 56.4 percent in 2004), Japan and Germany.

Footwear industry is another industry with outstanding export performance. The share of this industry in total exports rose from less than 0.5 percent in 1991 to 9.8 percent in 1998 and to 12.2, 11.2, and 10.2 percent in 2002, 2003 and 2004 respectively. In 2004, combined export value of textile, garment and footwear industry has surpassed that of four key agricultural export products (marine products, rice, coffee, and rubber). Footwear of Vietnam has been exported to 160 countries and territories, and the biggest markets are the EU (70 percent in 2002 and 65.5 percent in 2004), the US (10.5 percent in 2002 and 15.4 percent in 2004) and Japan (3 percent in 2002 and 2.6 percent in 2004). Rapid growth of footwear and textile and garment exports clearly contributes significantly to the rapid growth of the manufacturing and overall economy.

Figure 9.1: Composition of Vietnam's Import (1995-2003)



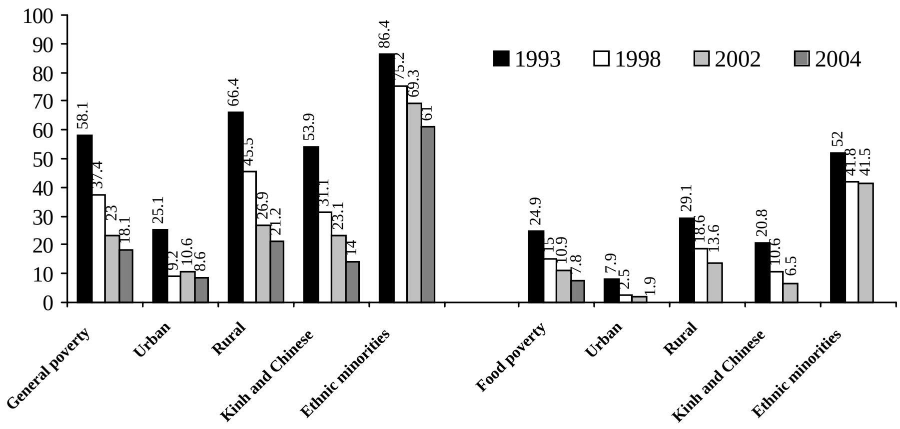
The structure of Vietnam's imports reveals interesting information about how Vietnam's international trade could be a useful catalyst to economic growth. Vast majority of Vietnam's imports have been inputs to production. Capital and intermediate goods constitute a significant and increasing part of total imports (from 84.8 percent in 1995 to 93.9 percent in 2003) and rose by 3.4 times (from US$6.9bn in 1995 to US$23.6bn in 2003). By contrast, the share of consumer goods fell to 6.4 percent in 2003 instead, and the value went up only 1.3 times. In the former, the largest items are fuels and raw material which accounted for around 60 percent of total imports during the whole period of 1991-2003 (except for 1994 when this share went down to 53.7 percent). During that period, the share of the second largest item, i.e. machinery and equipments, rose from 25.7 percent to 32.4 percent. As imported machinery and equipment has been commonly viewed as a potential source of economic growth, such a biased import structure is certainly conducive to rapid long-term economic growth.

Impact on Poverty reduction

Significant reduction in poverty in the reforming years is arguably one of the most important achievements in development of Vietnam. A spectacular characteristic of Vietnam's growth pattern is its strong pro-poor nature. Between 1993 and 2004, the poverty incidence as measured by the headcount ratio has fallen by 40 percentage points from 58.1 percent to 18.1 percent. The "elasticity" of poverty reduction to growth is found to be amongst the highest in the world. Almost a third of the population, the equivalent of more than 20 million people, was lifted out of poverty in less than 10 years.

Figure 9.2 shows the trend of poverty reduction of various population groups. In general, urban and rural areas experienced very similar rates of poverty reduction over the period 1993-2004. However, ethnic minorities seem not to benefit as much from economic growth as the main ethnic group, *Kinh,* and people with Chinese background. The poverty

Figure 9.2: Poverty Incidence in Vietnam (1993-2004)



Note: Poverty rates are measured as a percentage of the population. Poverty gaps reflect the average distance between the expenditures of the poor and the poverty line, in percentage of the latter.

Source: GSO

incidence of ethnic minority, especially food poverty incidence has decreased only by a small extent over the period 1998-2004.

Trade reform has been a decisive factor behind the escape from poverty of hundreds thousand of rural households. Some studies found that increased production of the principal agricultural exports raised a household's chances of escaping from poverty.[3] In the case of rice producers/farmers, those for which 75 percent of the production value is from rice, initial higher yield made considerable contribution to lifting them out of poverty. For coffee, the effects of trade liberalisation were more highly visible. Being a net coffee producer increased the probability of a household moving out of poverty by over 800 percent.[4] However, coffee prices experienced considerable volatility that has caused farmers numerous hardships. Globalisation can therefore bring about increased vulnerability, not just the benefits.[5]

Employment Effects of Trade Liberalization

It is expected that trade liberalisation for a country like Vietnam would generate a big jump in demand for low skilled labor due to the expansion of labour-intensive industries following the reduction of barriers to international trade. However, the current low level of employment generation presents a paradox to policy makers and economists. The actual rates of employment growth have been far below that of international trade and GDP.

Low employment growth implies low growth elasticity of employment, and the elasticity is particularly low in manufacturing for Vietnam. The output elasticity of employment in Vietnam manufacturing remained 0.2-0.23 during the 1990s, while the figure for China is 0.53 (1987-1996) and Thailand displayed an elasticity of 0.77 over the 1986-1994 period (Jenkins, 2002). Vietnam's outstanding GDP growth and poverty reduction at a low elasticity of employment provides an evidence for the importance of quality of employment for poverty reduction.

There are, however, some big winners in terms of employment from the reduction of trade barriers. Textile and garment (T&G) manufacturing as well as footwear have become a major source of non-farm employment, particularly women migrating from rural areas. T&G grew at an annual average rate of 10 percent during the 1990s, much higher than the national GDP growth and the share of T&G in manufacturing output was around 10.5 percent in 2000 (GSO, 2001). From 2002, T&G has become the second most important export after crude oil. In terms of employment generation, T&G industries account for 23 percent of manufacturing jobs in 2002 (GSO, 2003).

Table 9.4: Growth of GDP, Employment, Export, and Import (in percent)

	Employment growth	GDP growth	Export growth	Import growth
1990-1995	2.3	8.2	16.4	21.7
1995-2000	1.5	6.9	19.3	12.5
2001-2004	3.2	6.7	76.3	97.0

Source: Mekong Economics (2002) and GSO (2001-2004).

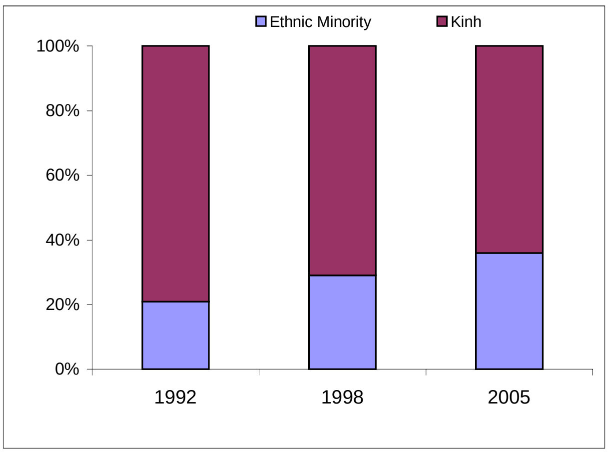
Trade liberalisation at the same time can lead to the contraction of comparative disadvantaged industries and in Vietnam, at least three groups of losers can be identified. First, liberalisation of trade could lead to job losses in the highly protected sectors such as the heavy industries and also affect the livelihood of suppliers to those sectors. Second, the state-owned enterprises (SOEs) restructuring expected to lead to considerable labour retrenchment. Third, the volatility of international prices for agricultural products can make poor farmers becoming increasingly exposed to risk and uncertainty caused by fluctuation in the world markets. Without valuable assets to cope with, the majority of them also will no longer be able to rely on contracts with the SOEs trading in agricultural commodities. Those contracts currently have a strong insurance component embedded, as they stabilise prices in "bad" times. The restructuring of these SOEs, as a consequence of trade reform, could worsen the situation of poor farmers in the "bad" time.

Trade Liberalisation, Inequality and Vulnerability

As trade liberalisation implies changes in relative prices of goods and services and redistribution of income and opportunities, the integration into the world economy will obviously affect inequality. As a matter of fact, Vietnam has experienced increasing inequality albeit at a modest rate during the period 1993-2004. The Gini index for expenditure reached 0.37 in both 2002 and 2004, slightly up from 0.34 in 1993. The share of the poorest population quintile in the total expenditure also decreased from 8.4 percent to 7.8 percent over the period of 1993 -2002.

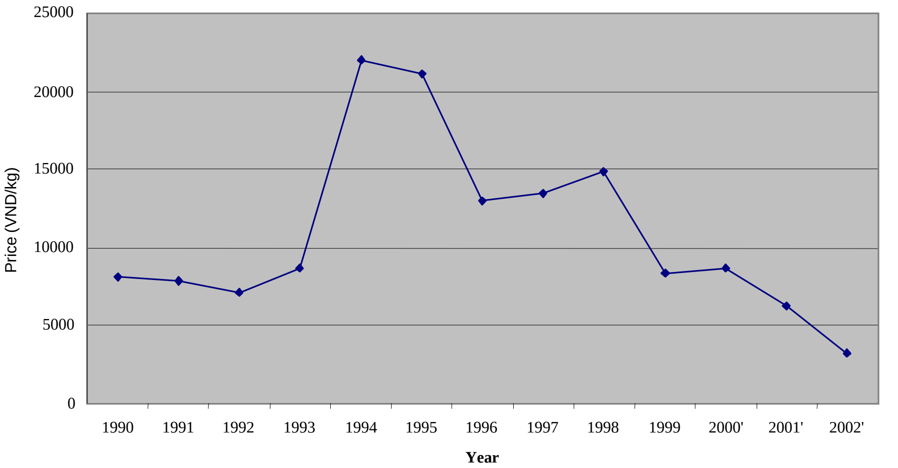
Looking beyond the average, growth and poverty reduction also occurred at different rates for different geographic regions and different ethnicities. Poverty has a strong spatial dimension in Vietnam. While for Vietnam, poverty declined by two-thirds between 1993 and 2004, the two poorest regions –, North West and Central Highlands – displayed relatively modest performance in terms of poverty reduction. Especially from 1998 to 2002, there were only little changes in poverty incidence in these two regions and out of

Figure 9.3: Composition of the Poor in Vietnam (1993-2002)



Source: MOLISA 2005.

Figure 9.4: Real Producer Prices of Coffee in Vietnam 1990-2002



Source: GSO.

100 poor people in 2002, 10 were from Central Highlands, an increase from only three in 1993 indicating how far Central Highland is lagging behind the other regions in poverty reduction. Although most of the poor live in two deltas and coastal areas with high population density but the highest poverty incidence is in the Northern Mountains and in the Central Highlands.

Poverty reduction also varies considerably among various population groups. Poverty is being reduced at a much slower rate for ethnic minority as compared with the ethnic majority, *Kinh*, and Chinese. As a result, it is estimated that the share of the poor with ethnic minority background in all poor people increases from 21 percent in 1992 to 36 percent in 2005, raising some concerns about having more measures to support ethnic minorities.

Another potential impact of trade liberalisation is the increased vulnerability caused by the volatility of international prices. A typical example of this is the case of coffee growers in Central Highlands who face enormous price fluctuation during 2000-02. Farmers in the Central Highlands have invested heavily in coffee since late 1990s and the subsequent fall in coffee prices left many of them struggling. The net income from coffee sales is equivalent to 72 percent of total household expenditures for coffee-farming household in the lowest quintile. Hundreds of thousands of farmers fell into heavy debt or became landless and many of them fell back into poverty or became poor because of price shock.

Another instance of vulnerability is what happened to seafood processing industry in Vietnam. Seafood has become a major source of income for farmers and made an important contribution to poverty reduction. Mekong Delta fish farmers quickly acquired a 20 percent share of the US catfish market, prompting charges of unfair trading practices by the Catfish Farmers of America (CFA). A US government attempt in mid-2002 to reduce trade volumes by prohibiting Vietnamese producers from marketing their product as catfish in the US did little to contain demand. The CFA's next move was to urge the US government to use anti-dumping legislation to impose tariffs on the grounds that Vietnam is a non-market economy and therefore local production costs are not a reliable indicator of the true cost of production. The case is interesting in that it both demonstrates Vietnam's remarkable capacity to penetrate export markets, and the vulnerability of these markets, which may lead to many farmers falling back into poverty in the absence of a reliable mechanism of dispute settlement. A recent study by ActionAid, Oxfam Hong Kong, and Ministry of Fisheries, Vietnam found that the increase of US tariff and trade ban on Vietnam's seafood exports will have possible impact on: (i) thousands of farmers will lose their jobs and will have no other alternative means of livelihood; and (ii) many households will end up with heavy debt for a long time.

9.4 Accommodating Policies

This section will illustrate the significant role of accommodating policies in poverty reduction brought about by trade reform in Vietnam. This will be done by reviewing the position of trade policy in the overall the reform agenda of Vietnam. In particular, the Comprehensive Poverty Reduction and Growth Strategy (CPRGS, Vietnam's PRSP), and the role of trade policy in the development agenda of Vietnam will be discussed.

Essential to Vietnam's very first achievements in poverty reduction and growth was property right reform in agriculture along with trade liberalisation; both took place in the late 1980s. The introduction of contract system for agriculture together with granting tradable long-term land use rights to farmers have released productive forces in the sector and resulting in tremendous productivity increase. In particular, the distribution of land was egalitarian and pro-poor by nature. Farming households were distributed with areas of land depending on the size of households as well as number of people in working age. Adequate attention had also been paid to ensure quality of distributed land does not differ across households.

At the same time, trade in agricultural products was largely liberalised, both domestically and internationally. Farmers were able to benefit from much higher output prices that had been suppressed considerably before the reform took place. As the vast majority of the poor lives in the rural area, the relatively equal distribution of land in conjunction with trade liberalisation had resulted in pro-poor distributional consequences with outstanding reduction in poverty, especially in the rural areas. The resulting growth was simply spectacular, not only it contributes to poverty reduction but also builds foundation for further success.

The success of Vietnam in early years of reform illustrates the importance of having an appropriate development agenda in which reform in trade policy is only necessary but far from sufficient to ensure that the poor will benefit equally from improved economic performance. Trade liberalisation alone could disproportionately benefit the rich if they own the redundant factors that used intensively such as land as in case of Vietnam's agriculture. Accommodating policies are required in order redirect resources and to achieve highest possible reduction of poverty and inequality.

Table 9.5: Major Changes in Trade policy in the First Few Years of Doi Moi		
	Changes in Trade and Exchange System	***Other Reforms***
1986		- VI Party Congress declares beginning of *Doi Moi*
1987	- *Law on Foreign Investment* — introduction of 'open door' policy	- Land law established private use of allocated land in agriculture - Creation of a central treasury to execute the budget
1988	- Foreign exchange control decree liberalises retention of foreign exchange, opening of foreign currency accounts, use of transfers to pay for imports and repay foreign loans - Devaluation of trade and invisible payments exchange rates - Restrictions on establishment of foreign trading organisations relaxed and central government monopoly of foreign trade terminated	- Creation of two tier banking system - Cooperative method of agriculture production abandoned in favour of households - Farming households given long term rights to use land for agricultural production - Encouragement of private enterprises becomes official policy - *Land Law* creates nontransferable. exclusive land use rights for agriculture
1989	- *Law on Import and Export Duties* introduces the customs tariff - Quotas removed on all but ten export and 14 import commodities (subsequently reduced to seven export and 12 import commodities - Requirement that SOEs fulfill CMEA export targets before exporting to convertible currency area removed - Number of export commodities subject to export duties reduced from 30 to 12 and most rates reduced - Producers of exportable allowed to sell to any appropriately licensed foreign trade company - Number of import commodities subject to duties reduced from 124 to 80, range of rates expanded from 5-50 percent to 5-120 percent - Foreign exchange rate system unified	- Nearly all forms of direct subsidisation of production and price control removed — end of 'two price' system - Domestic trading in gold legalised - *Ordinance on Economic Contracts* establishes rights for legal entities to enter into contracts - Bank interest rates made positive in real terms

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1990	- Special sales tax introduced - Turnover tax and profit tax introduced - *Law on Foreign Investment* revised	- *Law for State Bank of Vietnam and National Law on Banks, Cooperative Credit Institutions and Financial Institutions* enacted, prohibiting SBV from commercial banking and empowering it as central bank - *Law on Private Enterprises* establishes legal basis for establishment of sole proprietorships - *Law on Companies* establishes legal basis for, limited liability and shareholder business entities
1991	- Foreign exchange trading floors opened at SBV - Regulation on setting up export processing zones (EPZs) promulgated - Export duty on rice reduced from 10 percent to one percent - Imported inputs used to produce exports exempted from duty - Private companies allowed to directly engage in international trade	- Agriculture Bank of Vietnam allowed to lend to households
1992	- Harmonised system of tariff nomenclature introduction - Foreign investment law amended to reduce discrimination in favour of joint ventures against 100 percent foreign owned enterprises, and to introduce build operate transfer (BOT) concept for infrastructure projects - Trade agreement signed with European Union (EU) establishes quota on exports of textiles and clothing to EU and grants tariff preference on selected imports from EU	- New constitution allows individuals to exercise property rights over income producing assets and personal property - Pilot equitisation programme for SOEs introduced
Source: Excerpted from CIE 1998:5.		

Vietnam's Poverty Reduction Strategy Paper (PRSP), titled, CPRGS was approved in May 2002 contains a complex development agenda with adequate attention paid to reforms in all areas, not just trade policy.

The policy actions in the CPRGS of Vietnam can be classified into three main groups. The first group aims at completing the transition into a market economy, fostering competition in the production of goods and services, and leveling the playing field between private and SOEs. The second set of policy actions focuses on inclusive development, paying special attention to social aspects of development such as the delivery of educational and health services. The sustainability of environment is another focal theme of the second action set. The final set includes policy actions for building modern governance, and covers areas such as public financial management, public administration reform, and legal reform.

Together with the strengthening the financial sector and reforming the SOEs, deepening trade reform to accelerate the economic integration is an important priority of the first set of structural reform measures. Further liberalisation of trade is considered to be an important catalyst and means for improving the resource allocation, raise productivity and competitiveness of local enterprises.

The integration with the world economy is the policy area with most advanced structural reforms. In the last few years, the government of Vietnam has clearly demonstrated its firm commitments in further integrating the economy into world economy (participating in AFTA, signing BTA, supporting AEC, and negotiation efforts exerted to become a member of WTO in 2005). By the end of 2010, it is expected that the average tariff rate under the Effective Preferential Tariff Scheme (EPTS) will be about 9.3 percent, and all commitments under AFTA will be completed. Accession to the WTO will be essential for fostering competition in all sectors, especially the service sector which is at present dominated by a few state-owned corporations.

It is noteworthy to mention that trade and other related reforms are integral parts of CPRGS and not isolated from other reforms. The CPRGS is well-designed to include accommodating policies that protect the well-being of the people potentially disadvantaged from the structural reform. This benefits largely from the innovative process of developing and designing CPRGS that was characterised by strong ownership of Vietnam's Government with active participation of other stakeholders such as international donors, NGOs, localities and also the poor.

As mentioned earlier, there are at least three potential groups of losers from economic reforms, which can be identified in the case of Vietnam as: (1) workers in currently protected sectors and suppliers to those sectors, including workers in cottage industries; (2) farmers who are suppliers to SOEs trading in agricultural commodities; and (3) workers in restructuring and divesting SOEs. It is worth noting the considerable overlap between the first and the third groups of potential losers, as many of the enterprises operating in currently protected sectors are actually SOEs.

In CPRGS, adequate concerns, albeit with limited resources have been given to compensate potential losers. Notably, several measures have been introduced to improve the safety net. Vietnam has a series of programmes which transfer resources to specific population groups. These programmes explicitly favour or compensate households or communes with specific characteristics. Some of these programmes have deliberate poverty alleviation objectives such as the Hunger Eradication and Poverty Reduction (HEPR) programme and Programme 135.

The government also set up a special Social Safety Net Fund (SSNF) for redundant SOE workers, run by the Ministry of Finance. Workers who are either separated from their jobs or volunteer to leave them are offered two months of basic salary per year of service, plus a training allowance equivalent to six months of salary, plus six months of salary to support their job seeking process, plus a lump-sum of Vietnamese Dong 5 million (US$316). The design of this compensation package was aimed at minimising the expected welfare loss of separated workers. The SSNF has been in operation since mid-2002. It has assisted 8,000 separated workers from 230 SOEs, paying an average compensation package of Vietnamese Dong 28.8 million (US$1,821). A tracer survey of 2,600 workers, randomly selected among those assisted by the SSNF, was completed in the summer of 2003.

Significant amount of resources has also been mobilised to address the issue of vulnerability of the poor. Diversification of agricultural production and agricultural extension are two important measures to assist poor farmers to increase their productivity and diversify their output. Several "demonstration models" in agricultural extension have been developed to provide farmers with user-friendly guidelines. The government also initiated the model with close cooperation among four parties: government, farmers, investors, and business men to create reliable and effective chains for agricultural products.

Perhaps one of the most important policies to address the potential adverse impact of trade liberalisation on the poor is the promotion of the development of private sector. Since the commencement of *Doi Moi*, the private sector has been strongly encouraged to participate in the economy. The Law on Private Enterprises and the Law on Companies were promulgated in 1990 established the legal basis for the establishment and operation of sole proprietorship, limited liability, and shareholding business entities. The (new) Enterprise Law, promulgated in 1999, has substantially removed barriers to establish a business entity in Vietnam. Since the Law came into effect in the year 2000, 73,000 new private enterprises have been registered, and contribute significantly to create non-farm employment.

9.5. Concluding Remarks and Policy Recommendations

There are some groups of population who may potentially be disadvantaged by changes in trade regime. Many potential losers such as farmers supplying their output to agricultural SOEs and migrant workers of protected industries may not have necessary means to cope up with trade-induced negative shocks and hence need social support from the government. The emerging evidence on the links between trade reforms and poverty points to the need for carefully targeted social safety nets and complementary policies to ease the transition of workers from contracting to expanding sectors. The government needs to help the disadvantaged by strengthening social safety nets.

Trade integration while reducing poverty can also contribute to rising income inequality between regions and sectors. While Vietnam has already established a relatively effective system of targeted programmes to support the poor, there are still concerns about widening development gap between the rich and the poor and about remote areas or ethnic minorities lagging behind. More efforts could be devoted to improve the effectiveness of the targeted programmes especially aiming at sustainable poverty reduction by continued investing in infrastructure and improving the livelihood of the poor areas.

Appropriate institutions should be set up to protect the poor and the vulnerable from the negative impacts of external shocks associated with Vietnam's further integration into the world economy. It is a complex and time demanding task to build up the administrative and institutional capacity required to design and implement safety nets that are well targeted and that avoid leakages.

Despite impressive performance in poverty reduction, employment generation seems to lag far behind and priority in poverty reduction in coming years should be given priority to create non-farm jobs. In addition, evidence of labour market segmentation implies that work should also be done towards reducing the gaps between returns to human capital of workers in different segments.

Another priority in poverty reduction is training. Empirical evidence shows that poverty incidence is much lower among people with higher level of educational attainment. This emphasises the need for complementing economic growth and reform programmes with increased investment on education and skill development.

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Endnotes

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3 See, for instance, Niimi, Vasudeva-Dutta and Winters (2002).
4 Justino and Litchfield 2002.
5 ActionAid/CRP, 2000.

CHAPTER 10

Trade Policy Reforms and Poverty in Kenya: *Processes and Outcomes*

– Walter Odhiambo[1] and Gloria Otieno[2]

10.1 Introduction

This chapter reviews Kenya's experience with the implementation of trade reforms and their implications for sustainable development. The aim is to assist in understanding the role and effects of policy reforms in achieving sustainable livelihoods in the country. The paper focuses on a number of critical questions that include: (i) whether the government undertook policy reforms in order to meet the domestic political objectives or merely to meet the requirements imposed by the donors; (ii) how the reform measures were adopted and implemented; (iii) how the previously implemented policies have succeeded or failed in promoting sustainable development; (iv) whether the changes improved access to international markets; and (v) how the current policies need to be changed or reforms deepened for poverty reduction.

The chapter starts with a brief conceptual framework on the trade poverty nexus. This is followed by an assessment of the nature and processes of trade reforms in Kenya. Based on research findings of different studies, the paper reviews the impact of trade reforms on poverty in Kenya. Finally, the paper draws lessons for the design of pro-poor trade policies in the country.

10.2 Nature and Processes of Trade Reforms in Kenya

Trade Liberalisation in the Era of Import Substitution

Since independence Kenya has embarked on structural and macro-economic reforms, including trade to establish a more growth-conducive economic environment. At the time of independence, Kenya inherited a policy of import substitution from the colonial government, which had been seriously pursued since 1967, with devaluation practices being rampant. After the foreign exchange crisis in 1971, the government chose to introduce strict import controls rather than devaluation, and at the same time undertook macroeconomic adjustment (Bigsten and Durevall, 2004). During this period controls included: (i) quantitative restrictions (QRs); (ii) high tariffs on competing imports; (iii) overvalued exchange rates; (iv) controls on importation and licensing; (v) controls on domestic prices and wages; (vi) taxation of exports (N'geno *et al*, 2003); and (vii) requirement of "no objection certificates" from domestic producers. These controls were however relaxed temporarily when the coffee boom led to massive inflow of foreign exchange (Bigsten and Durevall, 2004).

During this period there was an impressive economic performance with an average gross domestic product (GDP) growth rate of about 6.2 percent. This growth was mainly attributed to dynamism and prudent macro-economic management, increased protectionism and a stable political and economic environment that was attractive to both domestic and foreign investors (Ikiara et al, 2004 in Soludo et al, 2004). However, as coffee prices shot down and oil prices shot up in 1979 – coupled with the small size of the domestic market – the economy slowed down leading to serious balance of payments (BOP) problems (Ronge and Nyangito, 2000). Hence, Kenya was forced to seek financial aid from the World Bank and the International Monetary Fund (IMF) under certain pre-conditionalities associated with the so-called Structural Adjustment Programme (SAP).

Kenya signed the first Structural Adjustment Loan (SAL) in March 1980. With this loan the World Bank emphasised promotion of non-traditional exports and market liberalisation as part of its overall Structural Adjustment Package (IPAR Policy debate, 1995). The government stopped requiring 'no-objection certificates' from domestic producers, gradually replacing QRs with equivalent tariffs (Bigsten and Durevall 2004). During the 1984-88 development plan, there was an emphasis on the role of private enterprises in industrial development and promises to support export oriented industries, while on the other hand, some of the apparatuses of import substitution such as import licensing and government's direct involvement in production were maintained.

By 1985, the weaknesses of the import substitution strategies were clear and the SAPs were not being implemented. This coupled with the publication of Sessional Paper No. 1 of 1986 entitled, *Economic Management for Renewed Growth*. This Sessional paper proposed a broad strategy of economic change for the remainder of the century. There was an emphasis on change from reliance on import substitution and protectionism towards a policy of exposing industry to international competition and encouraging non-traditional exports (GOK, 1986 pp.3), which marked the beginning of export promotion strategies.

The paper also committed the government to movement away from restrictive import licensing and gradual reduction in tariffs and laid out a system of incentives designed to encourage exports which involved: (i) Manufacturing Under Bond (MUB) – in which import duty and other taxes on imports used for manufacturing export goods were waived; (ii) general import duty and VAT exemption scheme; (iii) The "Green Channel system" to hasten administrative approvals; (iv) government financed export credit guarantees; and (v) proposal of a fully functioning Preferential Trade Area (PTA). Apart from the export promotion strategy in the period of 1985-90, there were other changes such as the adoption of tariffication of quotas and harmonisation of tariffs.

Reforms in the 1990s

The second push to liberalise the trade regime began in 1988 and was more successful. The 1989-93 Development Plan elaborated the export promotion strategy which centered on the creation of an enabling environment for export growth through institutional reform; reduction and restructuring of tariffs; abolition of export duties; introduction of export retention schemes; improvement of foreign exchange; and insurance regulations and the establishment of National Export Credit Guarantee Corporation (NECGC). It is during this period that commercial attaches were stationed in major trading partner countries and trade missions were organised to emerging markets (Ng'eno *et al* 2003).

Other trade liberalisation measures included: (i) introduction of the foreign exchange bearer certificates and the abolition of the foreign exchange allocation licence; (ii) re-introduction of foreign exchange retention accounts for exporters of traditional products and liberalisation and expansion of coffee and tea-marketing systems'; (iii) completion of domestic price decontrols; (iv) reduction of maximum tariffs from 170 percent to 25 percent and the number of tariff bands reduced from 24 to 4 (the average tariff fell from 49 percent to 17 percent); (v) import licensing schedules were abandoned in 1993 and virtually all capital account transactions were fully liberalised.

The 1994-96 Plan made two changes in export incentives that had already been announced: the Export Compensation Scheme had been discontinued due to limited product coverage and administrative problems, and a duty/VAT exemption scheme was introduced. The plan also proposed regulatory changes designed to make investments in bonded factories and export processing zones more attractive. By the end of 1994, 40 enterprises (IPAR, 1995) were approved to operate in six gazetted Export Processing Zones (EPZs).

Table 10.1 shows the evolution of trade policy as represented by changes in the coverage of goods by different tariff levels. It is clear from the table that the proportion of imported goods attracting tariffs over 50 percent has gradually declined. This trend has been reinforced and made more predictable by the recent signing of the East African Community (EAC) Customs Union protocol in February 2004. The Common External Tariff (CET) approved under this trade agreement were placed in three bands with 25 percent being the top band for finished goods, 10 percent for intermediate goods and zero percent for capital goods. This negotiated tariff structure was agreed upon in order to protect the existing private sector interests.

Progress in the liberalisation of trade regime in Kenya has been sporadic, with periods of significant progress followed by slower movement and even reversals. This in many ways is indicative of the lack of a shared vision among the key actors in the reform process, namely the government, donors and Kenyans themselves. Thus much of the

Table 10.1: Distribution of Goods by Tariff Bands 1990-91 to 2002-03

Tariff band (%)	Percent of tariff lines						
	1990-91	1992-93	1994-95	1996-97	1998-99	2000-01	2002-03
0	6.1	2.9	3.2	3.3	3.2	3.5	20.2
1-10	1.6	4.6	4.9	12.8	14.9	22.3	7.4
11-30	37.4	47.6	67.8	60.0	81.9	66.1	56.2
31-50	21.6	20.9	24.1	23.9	-	8.1	15.8
51-60	6.3	24.0	-	-	-	-	0.4
61-70	-	-	-	-	-	-	-
71-	27.0	-	-	-	-	-	0.1
Total	100	100	100	100	100	100	100

Source: Ronge (2005).

aid conditionalities in the 1980s were focused on forcing the country to adopt and then implement the policy of liberalisation and re-orientation of the government's role. Kenya was forced to implement SAPs at a time when the country was facing severe macro-economic instability. Thus the total SAP reform agenda proved to be extremely demanding for the country. Undertaking major policy reforms simultaneously across the entire span of the economy proved beyond the capacity of the government. A number of external factors such as adverse weather conditions, public resistance and political developments such as the *Coup* attempt in 1982 made matters worse.

The IMF and the World Bank played a dominating role in the implementation of SAPs in Kenya. Throughout the reform period, there was a division of labour between the two institutions. Conditionalities relating to the overall BOP gap and its financing, and the exchange rate were incorporated in the IMF programme, while QRs on import tariffs, and the foreign exchange licensing were taken by the World Bank. This, as noted by O'Brien and Ryan (1999), did not lead to coordinated policy advice to the government. It, in many ways, stretched the capacity of the government in responding to demands by the two institutions. The reforms took place under a regime of limited democratic governance. The government thus did not consult the private sector, civil society or the general populace on the implementation of SAPs.

***Liberalisation under the WTO Arrangement*[3]**

Kenya was among the founding members of the World Trade Organisation (WTO), which came into existence in 1995. Although the reforms implemented under SAPs coincided with Kenya's membership to the WTO, the country's current trade regime is more of a reflection of SAPs than the WTO agreements. Increasingly, however, the impact of WTO on Kenya's trade regime is becoming evident as it moves towards integrating WTO laws into the economy. It can hence be concluded that the process of implementation of the WTO commitments especially relating to tariffs, import licensing and other trade interventions was made much easier because of the government commitment, albeit reluctantly, to liberalisation under SAPs.

Kenya had already initiated market reforms for most of the agricultural products when it became a signatory of the Uruguay Round of Agreement on Agriculture (URAA). The country had by then also removed domestic support on agriculture and abolished the minimal export subsidies. This implies therefore that the reduction of tariffs as was required by the URAA was already underway and therefore compliance was made easy. The government made changes to the tariff regime initially putting the tariff ceiling binding on all agricultural commodities at 100 percent. The country also did away with the use of non-tariff barriers (NTBs) as required by the URAA. Kenya presented a detailed schedule on domestic support measures under the 'Green Box' provision. By then, however, the country had already reduced its support on agriculture spending particularly on extension, research and the delivery of such services to farmers as animal health, mechanisation and subsidised credit.

The removal of tariffs is associated with the inflow of cheaper products to compete with domestic goods. This is likely to increase as result of further liberalisation under the Doha Framework. This is particularly serious in Kenya where the cost of production tends to be high. In fact, for countries like Kenya, there is a major concern for it to becoming a dumping ground for over-produced, subsidised agriculture from the developed countries. The participation of the developing countries in the WTO meant that they can no longer use trade policies to safeguard their markets. Trade remedies permitted under the WTO agreement include anti-dumping measures, countervailing duties and safeguard measures. These measures have, however, been used more on the developing countries, who generally have lacked the capacity to impose and defend such measures of developed countries.

Kenya has also been implementing the Sanitary and Phyto-sanitary (SPS) measures and the Technical Barriers to Trade (TBT) agreement of the WTO. The implementation of the SPS and the TBT agreements in Kenya has been associated with some institutional and policy changes. In Kenya, most of the rules and regulations governing SPS and TBT measures were already in place. The challenge was thus more of harmonising existing laws and regulations with SPS and TBT requirements rather than formulating new ones. This was done mainly through revisions of existing Acts. The Standards Act (Cap 496) has undergone various revisions to accommodate some of the emerging issues. The revision was meant to include import inspections, training of assessors, auditors, quality system assessment; accreditation being carried out through a legal notice; and the establishment of Quality System Accreditation Committee (QSAC).

Implementation also took the form of establishing new structures. On becoming a member of the WTO, Kenya's initial response was to identify competent institutions and to equip them for the implementation of the agreements it had endorsed. For the TBT agreement, the government identified Kenya Bureau of Standards (KEBS) as the competent authority and moved fast to make it the National Enquiry Point (NEP). For SPS, the Kenya Plant Health Inspectorate Service (KEPHIS) was designated as the competent authority. Apart from creating new structures and arrangements to implement the WTO agreements in Kenya, the existing institutions also assumed new roles and functions. In a few cases, the roles have been scaled up to meet the strict WTO requirement.

The implementation of the WTO agreements in most developed countries has gone beyond trade related policy. Implementation of the WTO agreements meant changes in domestic policies such as fiscal policies. For most developing countries, including Kenya the liberal systems emerging from the WTO agreements meant reduced tariff revenues. In Kenya, tariff revenue accounts for about 20-25 percent of the total revenue of the government. If tariffs are to be reduced further or eliminated in Kenya, it means that the government will not only be losing but will also find alternative sources. The dependence on trade tax revenue constitutes a major hurdle for tariff liberalisation in Kenya and other countries with implications on trade and fiscal policies. This may in the case of Kenya's call for a change in the fiscal policies with a view to expanding the existing tax base or increasing the efficiency of revenue collection.

Liberalisation under the Regional Trade Arrangements

Kenya participates in regional integration initiatives within Africa and outside as it is a member of various regional trade organisations, including the Common Market for Eastern and Southern Africa (COMESA) and the EAC. The country also participates in the Cotonou Partnership Agreement involving the African, Caribbean and Pacific (ACP) group of countries and the EU. Kenya also benefits from the African Growth and Opportunity Act (AGOA) initiative of the US and is eligible for preferences under the Generalised System of Preferences (GSP). Participation in these regional arrangements has had certain influences on the trade regime of Kenya.

The trade liberalisation programme within COMESA started in 1984 under the free trade area (FTA) framework. Under this programme, trade liberalisation only applied to a group of selected commodities. Member countries are required to give effect to the reduction and elimination of tariff and NTBs in respect of these commodities. A programme for progressive reduction of tariffs was adopted that contained a 10 percent reduction every two years starting in October 1996 until 1998, and a reduction of 20 percent in 1998 and the final reduction of 30 percent in 2000. The formation of the COMESA Customs Union is now set for 2008, which is to establish a common external tariff for the regional arrangement.

Like other sub-Saharan African (SSA) countries, EAC member countries have carried out substantial reforms since the 1980s. These reforms have not been uniform across the EAC member states, and have therefore had varied impacts on the trade regimes in the countries. Overall, the reforms have led to substantial reductions in the level of tariffs in the three countries (see Table 10.2). The countries have liberalised their import regimes by lowering tariffs, reducing tariff dispersion and reducing/eliminating QRs. Import licences have been removed while little or no export restrictions exist in the three countries. The three EAC countries also no longer levy export taxes and duty exemptions, and have relaxed foreign investment restrictions.

Table 10.2: Evolution of Tariff in EAC Countries

Country	Tariff rates	1997	1999	2001	2002
Tanzania	No of tariff bands	7	5	4	4
	Top rate	50	25	25	25
	Simple average tariff	23.5	16.4	12.8	12.1
	Weighted average tariff	18.4	20.9	12.8	12.1
Kenya	No of tariff bands	5	5	5	5
	Top rate	40	35	35	35
	Simple average tariff	20.8	15.2	16.6	16.2
	Weighted average tariff	16.1	11.1	13.6	10.9
Uganda	No of tariff bands	5	3	3	3
	Top rate	30	15	15	15
	Simple average tariff	13.2	9.2	9.1	6.1
	Weighted average tariff	10.7	..	7.4	7.7

Source: World Bank (2003).

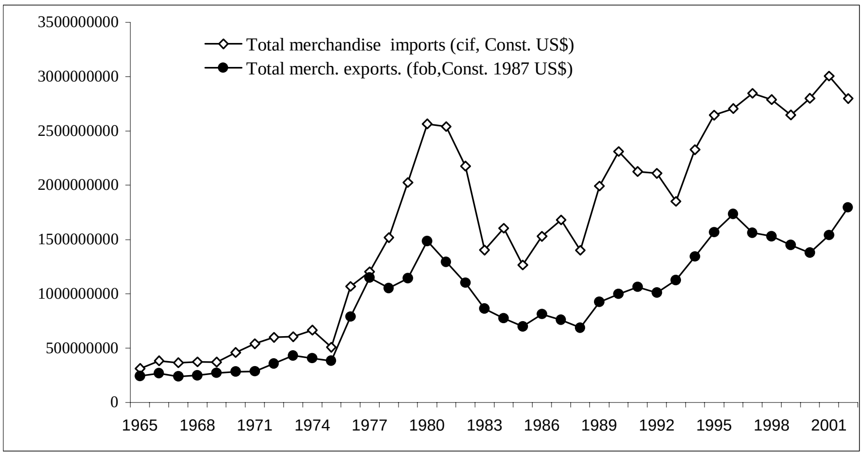
The main trade policy agenda under the EAC has been to form a single investment and trade area in order to increase the volume of trade among the EAC member states and with the rest of the world. Under the agreement, the countries agreed to remove the internal tariff between them and adopt a common external tariff.[4] The CET structure adopted a minimum rate of 0 percent for raw materials and capital goods, a middle rate of 10 percent for intermediate goods, and a maximum rate of 25 percent for final goods.[5]

10.3 Macro-economic Effects of Trade Reforms in Kenya

Kenya's current trade regime is fairly liberal due to the liberalisation process initiated in the 1990s. Tariffs are now the government's primary instrument for trade policy.[6] Generally, trade policy has been liberalised in the country as is evidenced by the real trade-GDP ratio which has increased over time. During 1964-2000, imports have exceeded exports in most of the post-independence period, with the difference widening substantially following liberalisation. The widening gap is underpinned by the massive import expansion and a moderate growth in the country's exports.

The modest expansion in the country's exports has largely been attributed to the growth of the horticultural sector. In 2001, horticultural exports reached Kenyan Shilling 23.6 billion (US$300mn). Of this total, fresh cut flowers account for about 54 percent, vegetables 35 percent while the rest were fruits. The value of horticultural exports have since risen to about Kenyan Shilling 28.6 billion (US$380mn) in 2003 making the sector the second most important foreign exchange earner after tea. The sub-sector is also important for the country's food security and supply of raw materials to the agro-processing industry. The relative success of the horticultural sector in Kenya has been attributed to a host of factors including a favourable climate, ability to attract foreign technology and expertise, and to integrate them well with local skills. Other reasons for the relative success include the fact that the industry is entirely dominated by the private sector, with the government playing only a facilitating role.

Figure 10.1: Kenya: Imports and Exports, 1964-2000



Source: World Bank: African Development Indicators, 2004.

Although the horticultural sector has expanded considerable in the last decade, it faces a number of challenges. Beside competition from other African exporters in the EU market, the country faces challenges in meeting stringent SPS measures that have been put in place by the EU through numerous directives and regulations, which are wide ranging, complex at times, expensive to attain and have negatively impacted on Kenya's exports to the EU. For instance, Kenya suffered from fish export bans to the EU because of non-compliance with EU SPS requirements. Some of the measures, which are consumer driven, such as EUROGAP, are already having a negative impact, particularly on Kenya's small-scale producers who are being edged out of production and have a doubtful future as growers and active participants in the country's horticulture sector in particular and the economy in general.

What has been the effect of trade reforms on overall economic performance? While there is no conclusive evidence on the effects of trade reforms on growth, reforms have largely been associated with declining economic performance. Over the reform period, the GDP growth rates fell tremendously reaching its lowest of –0.2 percent in the year 2000. There was a slight improvement of GDP growth rate as is evident by GDP growth, which increased from 2.8 percent in 2003 to 4.3 percent in 2004. There was also an increased growth in exports from 8.2 percent in 2003 to 17.3 percent in 2004; imports also recorded a substantial growth by 29.2 percent. Of major concern is the fact that despite the growth in GDP most of these gains have not been able to benefit the poor as levels of poverty both in rural and urban areas have increased tremendously, as is discussed below.

10.4 Implications of Trade Reforms on Poverty in Kenya

The Poverty Situation in Kenya

Available statistics in Kenya shows that the level of poverty has been on the increase. It is currently estimated that 56 percent of Kenyan population live below the poverty line, up from 48 percent in 1992 and 52 percent in 1997. The increase in poverty has resulted in decreased food security, inadequate access to basic social amenities such as health and education, unemployment, escalating insecurity, lawlessness and general economic decay (Government of Kenya, 2001c).

Poverty in Kenya is largely rural, with rural households being twice as likely as the urban population to be poor or very poor. But urban poverty is increasing alarmingly in terms of both incidence and severity. Aggregate figures broken down only into rural and urban categories conceal the sharp regional disparities in poverty incidence that exist in Kenya. The provinces with the highest incidence of poverty in 1997 were Nyanza (63 percent) and Coast (62 percent). Central Province had the lowest incidence at 31 percent. Coast has seen the most significant rise in poverty.

Poverty in Kenya has been associated with a number of factors. These, according to the PRSP, include: lack of or slow economic growth; income inequality and unequal access to productive resources such as land; natural shocks such as drought, floods and fire; inadequate spread and access to basic social services especially education and health; poor implementation of development programmes; lack of effective social policies and mechanics; and diseases such as TB and HIV/AIDS (Kenya, 2001).

Table 10.3: Poverty Trends in Kenya						
	Percentage of poor			Percentage of extreme poor		
Rural Areas	**1992**	**1994**	**1997**	**1992**	**1994**	**1997**
Central	35.89	31.93	31.39	67.83	32.95	29.73
Coast	43.50	55.63	62.10	63.00	50.95	59.46
Eastern	42.16	57.75	58.56	62.31	59.50	56.82
Nyanza	47.41	42.21	63.05	70.72	41.31	58.16
Rift Valley	51.51	42.87	50.10	81.02	45.75	48.02
Western	54.81	53.83	58.75	78.41	52.25	58.58
North Eastern	-	58.00	-	-	56.55	-
Total Rural	*47.89*	*46.75*	*52.93*	*71.78*	*47.19*	*50.65*
Urban Areas						
Nairobi	26.45	25.90	50.24	41.92	27.26	38.38
Mombasa	39.17	33.14	38.32	44.84	33.12	38.57
Kisumu	-	47.75	63.73	-	44.09	53.39
Nakuru	-	30.01	40.58	-	37.18	26.81
Other towns	-	28.73	43.53	-	27.07	37.91
Total Urban	*29.29*	*28.95*	*49.20*	*42.58*	*29.23*	*38.29*
Total Kenya	44.78	40.25	52.32	-	-	-

Source: Ministry of Finance and Planning, (2000a), Welfare Monitoring Surveys - 1992, 1994 and 1997.

10.5 Sectoral Impacts of Trade Liberalisation in Kenya: Winners and Losers

Agriculture

Tea, horticultural crops and coffee are major agricultural products and sources of foreign exchange, employment and income growth in Kenya. These three commodities jointly contribute about 34 percent of the agricultural GDP, employ over 40 percent of the agriculture labour force and jointly contribute to over 60 percent of foreign exchange earnings in the country. They are thus the most significant in terms of poverty reduction in the rural agricultural setting. However, changes in world market prices of primary commodities have been on a downward spiral and have led to poor farm prices.

Other major constraints facing agricultural exports include: increasingly stringent SPS standards; and tariff escalation (which discourages value addition of export products) in developed countries. At the local level constraining factors are: poor road infrastructure; high cost of farm inputs; high incidence of pests and diseases; lack of good quality planting materials; inaccessibility to affordable credit; and high power and water tariffs, among others.

The impact of trade reforms on employment and poverty in Kenya is context specific and needs to be subjected to detailed analysis both at the macro and sectoral levels. In this section we present brief case studies on sugar, cotton, horticulture and fisheries sectors. These have been selected because in Kenya they are dominated by small-scale producers, and are significant in the livelihoods of a large number of poor and very poor households. The sectors predominate in regions with high concentrations of poverty (Welfare Monitoring Survey of 1997).

The Sugar Sub-sector

The Kenyan sugar sector is currently protected by tariffs which are set at the maximum permitted by the WTO. It is suggested that the Kenyan production prices of sugar are three times the average world price (Kariuki, 2003), and the country's small-scale producers growing sugarcane in sub-optimum agronomic conditions are unable to compete with bulk producers from Sudan and Brazil. Therefore, without the tariffs the inefficient and uncompetitive Kenyan sugar sector would collapse. If this were allowed to happen without transitional support to producers and other workers, poverty incidence and severity would climb in some of Kenya's poorest areas.

Sugar production provides direct and regular employment for approximately 35,000 workers and thousands more are employed as casual workers on farms. If we include small scale producers and the up and downstream enterprises linked to the sector, 500,000 livelihoods are significantly supported (SUCAM, 2003b), and if the families of these workers are considered, around 2.6 million people (7-8 percent of the population) rely on the sugar sector. It is coincidental that poverty has increased dramatically in the sugar growing areas in Kenya. Poverty in Nyanza Province has sharply increased and stood at 63 percent in 1997. Poverty in the Western Province, another key sugar growing area was also on an upward trend, and was the second poorest Province by 1997 (59 percent)

The Horticultural Sector

The horticultural sector in Kenya has been growing rapidly and employs – both directly and indirectly – nearly three million people (Ikiara *et al*., 2003). The sector is currently Kenya's third most important sector of the economy in terms of foreign exchange earnings after tea and tourism, and contributes 30-35 percent of GDP (Kenya, 2002a). The majority of Kenya's horticultural exports are sold in the EU, which is the largest importer of fresh horticultural products (from non-EU countries) in the world (FKAB, 2001). This dependence has exposed exporters to risks, which include compliance with stringent standards by the importers, and which is a challenge, particularly for small producers and the ending of Lomé Agreement tariff waivers for exporting to the EU.

The involvement of a large number of smallholder farmers and unskilled and semi-skilled workers in production, packing and processing of horticultural products has been shown to have a significant impact on household incomes and poverty (McCulloch and Ota, 2002). Smallholders benefit through higher income and improved access to credit and extension services. In addition to reducing poverty amongst smallholders, significant amount of employment is generated on both farms owned by the major exporters and on those producing under contract. Many of the workers are landless women with a few other income earning opportunities (McCulloch and Ota, 2002).

The Cotton Sub-sector

Cotton in Kenya tends to be a smallholder crop and is estimated to involve over 140,000 farmers growing cotton under rain-fed conditions on small holdings. If the people involve in ginneries, spinning units, textile mills and clothing manufacture, then the total employment contribution of the sector will go up. During the 1980s, labour-intensive technology enabled the textile and clothing industries to absorb such large volumes of labour that it was the second largest employer in Kenya after the civil service (McCormick, 2001). It now has nowhere near this level of importance, but the cotton-textile industry is still a significant employer.

Liberalisation in the cotton industry in Kenya began in 1991, when the sector was opened to private sector investment. The role of the Cotton Board was substantially reduced and all its ginneries sold to private sector. Many private agents entered the industry especially in primary purchase, the sale of pesticides and other farm inputs, transportation, ginning and clothing manufacture. But, by this time the industry was in tatters; cotton production had almost ground to a halt;[7] many ginneries had either collapsed or had excess capacity and many textile firms had closed or virtually closed, with production falling to 1976 levels, causing substantial unemployment (Kegonde, 2003, McCormick, 2001).

The sub sector is also adversely affected by cheap imports of second hand clothes – a sector which employs over 500,000 Kenyans. Thus the dilemma is whether to ban cheap imports or not because they are also a source of livelihood to a good number of people and have an impact on poverty. Besides, for most poor Kenyans these cheap second hand clothes are important necessities.

The Fish Sub-sector

It is estimated that more than 500,000 Kenyans are employed directly or indirectly in the fisheries sector. The sector is has also played a key role in absorbing people who had lost their formal sector jobs in recent years (Kenya, 2001). In addition to those employed directly in fishing, export market generates employment opportunities in processing and packaging, boat building, and net making (UNIDO, 2002). Salt-water fish provide only a small proportion of all the fish landed in Kenya and are either consumed domestically or exported. The government currently controls marine fish (though not fresh water fish) prices. These controls would have to be removed under the WTO. Kenyan fisheries are heavily dependent on Lake Victoria (93 percent of total production, which is shared with Uganda and Tanzania. Lake Victoria spans across Nyanza and Coast Provinces – two of the poorest parts of the country and the fisheries have the potential to contribute to poverty reduction in these areas.

The main export markets for Kenyan fish are the EU, US, Israel, Japan, Australia and Malaysia. About 70 percent of the Kenya's fish exports go to the EU, with Spain as the lead (EU-based) importer.[8] Kenyan exporters have therefore been vulnerable to the various import bans that the EU has imposed during the late 1990s. These have led to the share of fish exports going to the EU during the late 1990s varying between 0 percent and 58 percent.[9] Table 10.4 shows why the bans were called and briefly describes their impact. Fish exporters complain that the standards set by the EU are unrealistically high

Table 10.4: EU Fish Import Bans

Date	Countries	Reason	Impact
Nov 1997	Spain and Italy	identifying salmonella in imported Kenyan fish	fish exports dropped between 1997 and 1998 by 33 percent and the foreign earnings by 13 percent.
June 1998	EU-wide (on chilled fresh fish[10] from East Africa and Mozambique)	cholera epidemic[11]	fish exports fell by 66 percent between 1997 and 1998
March 1999 – Nov 2000	EU-wide (fish from Uganda, Tanzan0ia and Kenya)	Use of chemicals for harvesting fish in Lake Victoria.	68 percent decline in Nile perch exports between 1998 and 1999. A number of fish processing firms closed down, affecting artisanal fisher folk who supplied them

Sources: Ikiara et al, (2003) and UNIDO, (2002).

and have involved 'moving the goal posts', leading to many smaller fish exporters' going out of business.

The Non-agricultural Sectors

The manufacturing sector is one of the most important sectors of the economy as it contributes to about 13 to 14 percent of the GDP providing for about 18 percent of employment. The sector has performed dismally in the recent past with the growth for 2004 being 2.4 percent and 1.4 percent in 2003. In terms of sub-sectors, the key ones have been clothing, paper and paper products, petroleum and other chemicals. Like in agriculture, liberalisation has affected different sub-sectors differently.

The Textile and Garment Sub-sector

Kenya's textile industry is quite diverse with firms of varying sizes and using different technologies. Firms producing textiles are large, while garment producers range from large factories to micro-enterprises. At the time of independence, the sector performed exceptionally well but declined remarkably following the import liberalisation. The poor performance of the sub-sector is also attributed to the collapse of the local cotton-processing industry. It is found that the effects of liberalisaiton on the sector include: (i) closure of a large number of factories and mills; (ii) massive loss of employment estimated at over 70,000 jobs; (iii) loss of government revenue due to closure; (iii) loss of investor confidence; and (iv) shrinkage of local economic activities in the areas with concentration of textile mills.

The implementation of AGOA spurred the revitalisation of Kenya's textile and apparel sector, creating alternative employment opportunities. The EPZs in Kenya have attracted investment in apparel production for exports to the US. The effect of AGOA arrangement on Kenya's economy has been positive. In 2003, Kenya's exports to the US market stood at Kenyan Shilling 14.7 billion (US$184mn). EPZ firms in Kenya have also created a sizeable number of jobs. In 2003, EPZ firms employed some 39,000 people, or about 18

Table 10.5: Selected EPZ Performance Indicators 2000-04					
	2000	**2001**	**2002**	**2003**	**2004**
Gazetted zones	19	23	31	37	41
Enterprises operating	24	39	54	66	74
Employment (locals)	6,487	13,444	26,447	38,199	37,723
Number of expatriates	133	314	701	912	837
Total workers	6,620	13,758	27,148	39,111	38,560
Export sales (Kenyan Shilling Million)	3,635	5,962	9,741	13,812	23,047
Domestic sales (Kenyan Shilling Million)	755	538	932	619	651
Total sales (Kenyan Shilling Million)	4,390	6,500	11,040	14,817	24,211
Foreign imports (Kenyan Shilling Million)	2,349	299	7,043	9,920	13,029
Local purchases of goods and services (Kenyan Shilling Million)	279	718	1,127	1,176	1,893
Investment (Kenyan Shilling Million)	6,107	8,950	12,728	16,716	17,012
Source: Economic Survey, 2005.					

percent of the total manufacturing employment. A great majority of the people employed in the EPZ have been women. Table 10.5 summarises some other selected performance indicators of the EPZs.

The Services Sector[12]

Since independence, the services sector has experienced significant growth and contributed tremendously to the GDP, thus making it the most important sector in terms of revenue earnings to the government. Since 1960 the service sector's contribution to the country's GDP and wage employment has been higher than that of either agriculture or manufacturing (see Table 10.6). Currently, the sector accounts for about 64 percent of total wage employment and with regard to exports, the sector accounted, on average, for over 50 percent of foreign exchange inflows. Despite this huge contribution, the country's policies have focused more on agriculture and industry. Trade liberalisation did well for the services sector as with a more open economy, and deregulation of foreign exchange controls services sector was able to attract more FDI than any other sectors.

Table 10.6: Broad Structure of the Kenyan Economy (percent of GDP at Factor Cost)										
Sector	**1960**	**1965**	**1970**	**1977**	**1980**	**1988**	**1990**	**2000**	**2002**	**2003**
Agriculture	38	35	33	35	32.8	31	29	20	24.0	23.9
Industry (Manufacturing)	18 (9)	18 (11)	20 (12)	20 (12)	21 (12)	20 (12)	19 (12)	18 (13.1)	18.0 (13.0)	18.0 (13.0)
Services	*44*	*47*	*47*	*45*	*46*	*49*	*52*	*62*	*58.0*	*59.0*
Source: Republic of Kenya, Economic Survey (various issues).										

The Tourism Sub-sector

Tourism is an important sector with important economy-wide linkages. Kenya has shown that it has a comparative advantage in the tourist sector and has built through the private sector a lot of tourist facilities. Following liberalisation of the foreign exchange controls in 1990s, the sector picked up pace quite well and has been a major source of employment and government revenue. Thus in the year ending 2004, tourist earnings increased by 51.9 percent (Goovernment of Kenya. Economic survey, 2005). This was also accompanied with increased employment in the tourist sector, which has helped boost the economy as well as provide much needed income.

Information and Communications Technology Sub-sector

The information and communication technology (ICT) sub-sector has undergone major transformations since independence. The growth of this sector has been significantly influenced by global trends. The sector's growth can be evaluated in terms of number of fixed and mobile telephone lines, the tele-density, the number of computers and services, internet service providers (ISPs), the number of internet users, broadcasting stations, and market share of each one of them.

The period of 1963-92 had been characterised by state monopoly on the provision of infrastructure and services which was the sole responsibility of Kenya Post and Telecommunications Corporations (KPTC). The sector was strongly regulated by government, use of advanced technology and communication was limited, and there were poor conditions of networks and exchanges (Kasuku and Mutua, 2002). Reforms in this sector began in the early 1990s, and in 1997, KPTC was split into three autonomous bodies. This marked the era of improved performance, which is demonstrated in Table 10.7. Amongst others, it is obvious that today there are over 4 million mobile phone users, who are benefited from cheaper, easier and improved communication. Other major developments have been in the ICT sector in which Internet access and Internet services

Table 10.7: Postal and Telecommunications Services in Kenya (1985-2004)

Unit	1985	1990	1995	2000	2002	2004
Post offices (number)	829	1,055	1,061	890	869	8 6 5
Private letter boxes (in thousands)	189	243	302	387	721	6 9 7
Registered and insured items posted (in millions)	3.1	3.7	2.4	2.2	3.3	3 . 5
Parcels handled (in thousands)	334	378	257	148	187	-
Public call boxes (in thousands)	2,189	5,135	5,922	8,938	11,000	19,000
Mobile phones (in thousands)	-	-	2.58	85	2,583	4,295
Manual telephone calls made (in millions)	13.7	10.9	5.7	3.7	5,412	2 7
Money orders (in millions)	1.6	2.1	1.5	1.8	1,487	1,675
Postal orders (in thousands)	118	73	48	32	29	7

Source: Economic Surveys, various issues.

have improved greatly. Today many cyber cafes have been licensed which has ultimately led to more job creation and better (cheaper) communication services. Today there are over 2 million daily internet users and Internet coverage has reached most major towns and even some rural areas.

Trade Policy Agenda and Pro-Poor Trade Policies in Kenya

As already indicated, due to SAPs and for participating in multilateral and bilateral arrangements Kenya's trade regime has almost completely been liberalised for most goods sectors. This meant that trade strategy will now be largely driven by multilateral and bilateral agreements. It is therefore not surprising that the country has not articulated its trade policy. The lack of a clear policy on trade is reflected on recent policy documents – PRSP and the Economic Recovery Strategy (ERS) for Wealth Creation and Employment.

A review of Kenya's PRSP indicates that the document has a small section that discusses trade. The focus of the section is on both international and local trade, with the latter getting more prominence. At the international level, the document merely alludes to the effects of implementation of the liberal world trading order and their effects on the poor. There is however no discussion or analysis of these effects. The document also touches on regional trade, specifically the EAC and COMESA. The discussion on regional trade is also at best only cursory. The ERS is the other important policy document which again does not address the whole issue of trade and poverty. The only mention of trade in relation to livelihoods is in expanding exports in the regional and international markets. The other mention is with regard to the implications of privatising state-owned enterprises (SOEs) in order to increase competitiveness. Thus generally, Kenya's policy documents have not explicitly addressed the issue of trade and its implications on poverty.

Although the trade content in PRSP and ERS are minimal, the two documents in many ways provide a good framework for fighting poverty. This was the verdict of the IMF and the World Bank among other reviewers. The challenge it seems lies with implementation. A recent DFID assessment points to a number of weaknesses that have prevented the country from implementing its development embodied in the policy documents including trade objectives therein. The report identifies the lack of capacity in ministries to effectively rationalise PRSP priorities with the medium-term expenditure frameworks (MTEF) constraints. Also lacking is a framework for ranking and prioritising trade issues. Missing also is a system of monitoring expenditure and impacts especially on poverty. Another concern has been the lack of a mechanism/forum for national consultation on trade matters other than for WTO related ones.

10.6 Conclusions and Policy Implications

The discussion in this paper has set out an analysis of Kenya's experiences with the implementation of trade reforms in Kenya and their implications on poverty reduction. The focus has been on understanding the processes and the outcomes of trade policy reforms. The following conclusions emerge from the analysis:

- Trade policies have evolved from a more controlled and restrictive regime in the 1980s and early 1990s to a more liberalised regime since 1995. The result is that the country is more open today than it was a decade ago.
- Kenya's trade liberalisation efforts were largely driven by external pressure from donors. The oil crisis in 1977, collapse of the EAC and economic mismanagement

also acted as catalysts towards the liberalisation processes. Furthermore, the liberalisation process and consequent trade policy processes were plagued by policy reversals, rent seeking opportunities and political patronage and therefore failed to address issues of gains from trade liberalisation efforts.

- International trade policy in Kenya in the post-SAP is largely driven by multilateral and bilateral agreements such as obligations under WTO, the ACP-EU economic partnership agreements, EAC and COMESA tariff reductions and bilateral trade agreements.
- Trade reforms agenda failed to spell out a clear long-term path towards economic growth. Most policies were not sustainable and this was mostly due to a weak institutional framework and lack of consultations with private sector and civil societies, policy formulation was not an all-inclusive process and hence was bound to be weak.
- Despite liberalisation and increased openness trade has not managed to translate into growth that would meaningfully help in alleviating poverty. Kenya's trading regime has been in the past plagued by a myriad of problems and constraints which have in turn derailed the export development progress. Some of these constraints are due to: poor road and rail infrastructure; lack of telecommunication and ICTs; costly/low access to credit for producers and manufacturers, poor governance and lack of enabling environment, low labor productivity; and low value addition which translates into poor prices at world markets. It is therefore important to address these issues as a country so as to facilitate export growth and development, to lower cost of production of vital industries and to increase value addition for our export products with the hope of increasing trade and subsequent economic growth.
- Existing studies reveal that poverty in Kenya has been on the rise. Current estimates show that that about 56 percent of the population is currently living below the poverty line. The poor in Kenya tend to be clustered into certain social categories such as: the landless; people with disabilities; female headed households; households headed with people without formal education; pastoralists in drought prone districts; unskilled and semi-skilled casual laborers; AIDS orphans; street children and beggars; unpaid family workers; large households; single mothers and fathers; subsistence farmers; urban slum dwellers; and unemployed youth (Kenya, 2001c).
- Kenya lacks empirical studies on the impact of economic and trade reforms of economic performance and poverty. Evidence at the sectoral levels suggests that the reforms process in Kenya created winners and losers. However, there is still a need to do analytical studies to assess the impact of liberalisation on sustainable development and poverty reduction
- The lack of analytical capacity is also evident from government policy-making ministries and departments. Although some of the ministries have economists, policies are implemented without analysis on the opportunities, constraints and the various poverty groups that are likely to benefit or to be disadvantaged as a result of such a policy.
- Weak commitment to reform process, and policy reversals due to corruption and poor governance have also had a negative impact on the trade reform process. This is coupled with a lack of clear focus on complimentary policies that could have been implemented alongside the trade reforms especially on the part of the government and the international financial institutions (IFIs).

What are the lessons for Kenya based on the above findings? And what then would be the most appropriate steps to be taken in ensuring pro-poor trade policies and growth? Following are some of the policy options that could be considered while ensuring pro-poor growth:

(i) ***Pursuance of high, but pro-poor economic growth*****:** To effectively reduce poverty in Kenya, high and sustained growth of at least seven percent GDP growth rate is necessary. The ERS and the PRSP documents place a lot of emphasis on this. What is critical is however is that such growth must be able to benefit the poor. In this regard, a 'take –off' in the agricultural sector is key. Recent history suggests that before a country can move from low intensity, semi-subsistence agriculture to generating surplus, there is need for targeted interventions by the state.

(ii) ***Need for strong complementary policies*****:** Trade policies reform must be implemented in the context of a variety of complementary policies. Trade liberalisation involves reducing discrimination against foreign suppliers of goods and services. This is achieved not simply be eliminating quotas and reducing average tariffs and dispersions across tariffs, but also by strengthening trade-related institutions. In Kenya, the following complementary policies would be required:
- Macro-economic and exchange rate policies
- Fiscal revenue policies
- Infrastructural policies
- Policies for the labor and other factor markets

(iii) ***Need for safety nets:*** One of the most important complementary policies for the poor is an efficient social safety net**.** This should always be in place where reforms are taking place, whether trade or not. Especially in the short-run, there is bound to some effects on some groups of poor who may be incapable of sustaining even short periods with adverse adjustment costs.

(iv) ***Timing and pacing of liberalization:*** Whether trade is beneficial to the poor remains controversial, and is if at all, circumstantial. Those who are receptive to the argument that trade liberalisation has potential benefits for the poor generally argue for a phased and asymmetric reduction in trade barriers, with developing countries allowed to liberalise more slowly and to protect for longer periods, vulnerable sectors of importance to the poor.

(v) ***Trading Strategically*****:** Kenya should identify sectors with significant linkages to the poor, once identified, then strategies that include identification of markets, export promotion and trade facilitation should be done coupled with efforts to boost production in the specific sector. Through value chain analysis, linkages can be identified right from the onset at farm level all throughout the level of exporters. Further policies must ensure significant gains to farmers and other groups at the bottom of the chain through a sound legal and regulatory environment.

(vi) ***Identification of winners and losers:*** As is evident in the case of Kenya, policy changes generate both winners and losers. Different aspects of trade liberalisation are likely to have different effects on different groups. This needs to be identified fairly accurately in advance.

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3 This section heavily draws from the work by Odhiambo (2005) and Odhiambo *et al*. (2005a).
4 EAC common external tariff came into force in January 2005.
5 This is to be reviewed after five years from the date of coming into force of the Customs Union.
6 The government, however, still maintains a small list of import licensing controls based on health, environmental and security concerns. A fee of Kenyan Shilling 5,000 or 2.75 percent of the CIF value of all imports is charged as import declaration fees.
7 By 1994-95, lint production had dropped to about 20,000 bales and has been fluctuating around this amount ever since (Ikiara, et al, 2002).
8 The Nile perch is the dominant fish species in the lake and accounts for just over 90 percent of export (both volume and value). Other important species include: Kenya's fish types (species) are mainly, nile perch, tilapia, naked catfishes, North Africa catfish, rainbow trout, tuna, marine shells, cray fish, prawns, lobsters, shark, and silver cyprinid.
9 1996 – 58 percent, 1997 – 56 percent, 1998 – 36 percent, 1999 – 34 percent, 2000 – 0 percent, 2001 – 21 percent
10 Fresh fish sells at a premium to frozen fish.
11 The legitimacy of this ban is questioned by some (e.g. Ikiara et al, 2003) who state that cholera cannot be transmitted to humans through hygienically processed fish.
12 The services sector includes: trade, restaurants and hotels, transport, storage and communications, finance, insurance, real estate and business services and government services.

11 CHAPTER

South Africa's Trade Policy and Its Linkage to Poverty Reduction

– Barbara Kalima-Phiri[1]

11.1 The origins of South Africa's Economic Policy

South Africa's democratic transition was considered one of the 'miracles' of the 20th century. In the epoch that highlighted the horrors of the Balkans war, the Rwandan genocide and the Israeli-Palestine conflict, the seemingly intractable crisis between the apartheid state and the liberation struggle ended in a negotiated political settlement which refuted the claims of history. While post-apartheid South Africa was celebrated as a model for conflicted societies seeking peace, the challenges that the newly elected democratic regime faced were immense.

At the core of it was the debilitating crisis that underpinned the economy following two decades of steadily worsening difficulties that manifested themselves more potently after the 1973 oil shocks: feeble gross domestic product (GDP) growth rate, low rates of investment, spiralling inflation, and chronic balance of payment (BoP) difficulties. Although the external shocks of the 1970s heightened South Africa's economic stagnation, internally the policies of the apartheid regime also contributed to the crippling of the economy. Part of this related to how the apartheid system was modelled, namely it thrived on a system of cheap low skilled labour. The attendant impact this had on skills development and labour relations in South Africa led to a skewed path of development between the minority and majority of South Africans bound by race, class and gender.

Moreover, the imposition of sanctions effectively froze South African corporates from trading with the world, while global multinational corporations (MNCs) were barred from trading with South Africa and foreign direct investment (FDI) came to almost a halt due to sanctions and the unstable nature of the state. Despite the structural malaise of the economy, the post-apartheid regime also had to correct the distortions that the apartheid policy created within the economy, particularly the issues of exclusion from the formal 'first' economy, the education and skills deficit of the majority of the population, the racially biased distribution of wealth, services and infrastructure and worsening poverty amongst the majority of its black population.

In so doing, the democratic regime had to be mindful of the changing nature of the international economic policy setting, i.e. the ascendance of the neo-liberal economic paradigm. The government had to find common ground between what the majority of the electorate expected, namely their effective reintegration into the mainstream economy, and South Africa's renewed and successful participation in the global economy through competitiveness, higher value-added production, reduction in tariff barriers and a shift from import substitution to an export based growth path.

In 1982, the National Party (NP) government accepted a loan from the International Monetary Fund (IMF) with conditions in line with neo-liberal orthodoxy (Marais 1998). By 1985 the NP introduced duty-free import provisions for the clothing industry and import volumes of clothing started to grow (Sellars, 2000; Altman, 1993). In 1989, the NP government's Structural Adjustment Programme (SAP) increased exposure to international competition and boosted import penetration to over 40 percent of the local market between 1989 and 1991. Worn clothes constituted a substantial part of these imports, increasing by more than 64 percent between 1989 and 1990 (Altman, 1993).

This phase from 1982 marked the shift to trade liberalisation and such developmental challenges compelled the democratic regime to design key objectives and strategies for revitalising the economy. If the twin challenges of the domestic developmental concerns were to be reconciled with the commitments of the global economy, then the most logical approach was to frame a policy perspective that incorporated both these elements.

This chapter attempts to provide a concise and holistic overview of post-apartheid South Africa's competing imperatives in designing its economic policy in which its trade and industrial strategy feature prominently. It shows how South Africa's trade policy was developed in order to address the twin challenges of reversing the skills deficit found amongst the majority of its people and its economy's reintegration in the global economic system based on a competitive advantage.

The chapter also highlights South Africa's attempts to move towards a trade strategy that aimed at effectively reducing the distortions created by the apartheid regime and tackling the scourge of underdevelopment and poverty that are prevalent in the daily lives of the majority of people. It is important to understand how democratic South Africa's growth and economic development pattern has been influenced by the type of industrial policy it has adopted in the past.

11.2 The Economic Challenge of the Historical Apartheid Legacy

On assuming power in 1994, the newly elected democratic government faced a set of developmental challenges that posed serious structural setbacks to its vision of creating a society where everyone enjoyed the economic benefits of the democratic dividend. According to Gelb (1999), the dire state of the economy was reflected in, amongst others: (i) a feeble GDP growth rate which descended from its 5.5 percent average during the 1960s to 1.8 percent in the 1980s and eventually plunging into the negative territory (-1.1 percent) in the early 1990s; (ii) declining rates of gross fixed investment (which plunged as low as -18.6 percent in 1986, and stayed negative from 1990-1993) and high rates of capital flight; (iii) low rates of private investment, which led to under-utilisation of manufacturing plant capacity (dropping from 90 percent in 1981 to 78 percent in 1993) and declining competitiveness; (iii) plummeting levels of personal savings, which as a proportion of disposable income, dropped from 11 percent in 1975 to 3 percent in 1987; (iv) very high levels of unemployment and the economy's inability to create enough new jobs to absorb even a fraction of new entrants into the labour market, a trend exacerbated by under development in labour intensive sectors; and (v) chronic BP difficulties.

Marais (2001) argues that the debilitated economy was further bedridden by: (a) a oshortage of skilled and a surplus of unskilled, poorly educated and low productivity labour – the cumulative result of business treating 'black workers as a replaceable factor of production rather than as a human resource; (b) poor, conflict-ridden industrial relations; (c) the state's failure to reverse the latter trend by encouraging or compelling productive investment by business, and which unleashed speculative investment and the shrinking of the manufacturing sector; (d) industrial decay, which was reflected in ageing capital stock, limited capital goods production and the failure to develop exports by beneficiating raw materials and expanding the scope of manufacturing sector thereby adversely affecting the export performance; (e) low levels of investment in research and development, with most technological development occurring in the armaments and telecommunications industries; (f) a heavy bias against the small and medium-sized business sector; (g) mal-distribution of social infrastructure such as housing, education facilities, healthcare and transport, which restricted labour productivity; and (h) rampant poverty entrenched by a very high unemployment rate, which stifled productive potential and domestic demand for manufactured goods, the latter having been depressed by deflationary policies.

These inherited weaknesses were accompanied by an economy that was heavily reliant on resource and energy-based products that were of declining importance in world trade and subject to drastic price fluctuations. In short, the South African economy, which was outward looking, rested on the following narrow pillars: a primary product (mainly minerals) exporter, and an importer of capital goods and technology. To make matters worse, by the early 1990s as much as 40-45 percent of the economically active population was found outside the formal economy, while labour absorption into the formal economy plummeted from 60 percent to under 40 percent during 1994. Net job creation during this period amounted to just 440 000 compared to growth of over 5 million in the economically active population. This implied that less than one in every 10 new entrants into the economically active population was being absorbed into formal employment (Michie and Padayachee, 1997). Employment in the private sector also fell consistently while pre-1994 income and wealth inequality is now cited as the second worst in the world after Brazil. Against this background and in light of the competing challenges of competitive reintegration into the global economy, the ANC-led government had to fulfil its electoral promise of reconstruction and development.

11.3 Competing Debates on South Africa's Post-apartheid Macroeconomic Strategy

The debates shaping South Africa's macroeconomic strategy were essentially influenced by the historical legacy of apartheid and the competing economic imperatives that unfolded following the demise of the Cold War. Effectively, the collapse of the communist bloc in Eastern Europe and the Soviet Union introduced a new set of variables around whether a state-led macroeconomic policy was applicable as opposed to a market-led approach. This divide between which approach was more conducive in the post-Cold War era forced governments like the ANC regime to reconsider their economic vision allied to the long drawn out battle against apartheid and the Freedom Charter's famous clause that called for the restoration of the national wealth to the people.

While the ANC's economic elites and their tripartite partners recognised that the market alone could not engender a redistributive focus without some form of state intervention, the newly elected ANC-led government was forced to confront this dichotomy in the context of the global economic forces that promoted the ascendancy of the neo-liberal paradigm and its free market principles. This generated debates on the most appropriate form of macro-economic policy to be applied in the post-1994 period.

The most pressing challenge, however, that faced the democratic regime in 1994 was redressing the imbalances and distortions that the apartheid regime created in the economy. Vast discrepancies in wealth creation and inequality that situated itself in race and class terms compelled the post-apartheid government to seek ways and interventions that would find a common ground to reconcile its domestic commitments while taking South Africa back into the global economy. Of course, reintegrating South Africa into the global economic engine meant that the democratic regime would have to advance South Africa's competitive trajectory outside of the realm of being a primary exporter of goods. This meant finding an industrial policy which succinctly incorporated South Africa's competitiveness in the areas of value-added and labour-intensive export production.

So it came to pass that one of the most fraught tests that the ANC faced before assuming power in 1994 was what kind of macroeconomic policy it could fashion under its rule. As noted elsewhere in this paper, part of the dilemma faced by the ANC was meeting the expectations of the electorate, who demanded that a substantive focus of the macroeconomic policy would engender a redistributive element in the form of wealth restoration, and access to service delivery that would improve the quality of daily life. While the intention of the ANC was to strive to ensure that this was sufficiently captured in its economic policy, it also had to confront how this would be funded in the face of mounting resistance from big business, capital flight, and an overall structural economic crisis evident in low domestic savings, FDI and BOP difficulties (Habib and Padayachee 2000; Marais 2001).

This was to be encapsulated in the economic vision of the ANC's electoral manifesto called the Reconstruction and Development Programme (RDP) Policy Framework (also known as the Base Document), but was later followed by the RDP White Paper – a post-election document of the Government of National Unity (GNU), within which the ANC was the majority partner. The White Paper departed from the redistributive ambitions outlined in the RDP Base Document, adopted a fiscally conservative position, and promoted trade liberalisation and an export-oriented industrial strategy.

11.4 South Africa's Macroeconomic Policies

The Reconstruction and Development Programme

The Reconstruction and Development Programme (RDP) Policy Framework or Base Document broadly argued that apartheid had generated massive inequalities and poverty, which in themselves was a central obstacle to broad-based growth and employment creation. On the one hand, these factors reduced the ability of the poor to generate incomes for themselves outside of the formal sector. On the other, they limited domestic demand, especially for basic goods and services which are relatively labour-intensive. The Base Document was structured around five core chapters, representing the key programmes for ensuring reconstruction and development. Crucial to these objectives were the sustainability of the process and its results. The five key programmes were:

1. **Meeting basic needs:** Improving infrastructure and government services for the poor, which would increase local demand especially for relatively labour-intensive industries.
2. **Developing human resources:** Supporting a strong industrial strategy and land reform to expand sustainable labour-intensive sectors and broaden ownership and control.
3. **Building the economy:** Encouraging new centres of capital and expanding the access of the majority to productive assets and skills, including through co-operatives and support for SMEs.
4. **Democratising state and society:** Improving the democratic process in the governance system to create a just and equitable society.
5. **Implementing the RDP:** Putting the vision created in RDP in practice in true spirit.

The point of departure for the Base Document was the end of the apartheid era. It drew extensively upon the concrete residues of the era in asserting the need for transformation, reconstruction and development in South Africa. One of the major strands of the RDP strategy argued that the market would not end structural problems. It proposed that government shift to more equitable, job-creating type of strategies.

This analysis pointed to the importance of production for the domestic market – both to build productive capacity and to support greater equity. Export industries, while obviously an important component of any development strategy, by themselves would not create adequate employment or meet the needs of the majority. The RDP, therefore, emphasised land reform, support for co-operatives and micro enterprises, and a massive expansion in basic infrastructure, housing, education, welfare and health care for poor communities.

This strategy had important implications for the formal sector. In effect, it required a re-orientation to meet growing domestic demand for basic goods and services for the poor (such as housing, basic infrastructure, education and healthcare). Much of this demand would be funded through the state. According to the recent Central Committee Review of industrial policy for COSATU (2005), the RDP itself was markedly unclear and in fact contradictory on the transformation of the formal economy.

A second strand of the RDP, however, focused on export-oriented growth. This strand emerged almost exclusively in the section on the economy, specifically in the objectives for industry, trade and commerce policy:

"… In general our objective is to enhance our technological capacity to ensure that as part of the restructuring of industry, South Africa emerges as a significant exporter of manufactured goods. The industrialisation strategy aims at the promotion of a more balanced pattern of industrial development, capable of overcoming the acute over-concentration of industrial activities in certain metropolitan centres of the country" (para 4.4.2.1).

Industrial policy, in this view, was largely focused on increasing beneficiation for the purpose of exporting, rather than meeting basic needs, ensuring more equitable ownership or creating jobs. As the RDP Base Document declared:

"While trade policy must introduce instruments to promote exports of manufactured goods in general, industrial policy must support and strengthen those internationally competitive industries that emerge on the basis of stronger internal linkages, meeting the needs of reconstruction and raising capacity utilisation" (para 4.4.2.3).

The RDP could not lead the economy to consistent proposals for restructuring. Instead, two contradictory strategies emerged: a redistributive strategy that proposed raising local demand by ensuring more equitable income distribution, and a competitiveness strategy focusing on macroeconomic stability and driving exports.

In a nutshell, the RDP as a whole focused on a redistributive strategy, where a more equitable income distribution would lead more or less automatically to balanced growth. But the economic section already reflected a second, more conservative tendency, which focused on encouraging exports by the high end of manufacturing, including refined metals. This approach held that rapid growth in formal manufacturing for export would lead to substantial expansion in the economy as a whole.

The Growth, Employment and Redistribution Strategy

The Growth, Employment and Redistribution Strategy (GEAR) was adopted in June 1996 as the government's overarching strategy for economic development, overriding the often-contradictory macroeconomic principles and objectives of the RDP. In contrast to the RDP's commitment to driving balanced growth through redistribution, GEAR sought to constrain government spending. Its central argument was that high government spending reduced saving and investment by the private sector. It set various targets for macroeconomic policy outcomes, and for growth and employment, *inter alia*: (i) 400 000 non-agriculture jobs *per annum* by the year 2000, (ii) six percent growth by the year 2000' (iii) 10 percent per annum increase in exports (13-14 percent increase in manufactured exports); and (iv) US$2bn of FDI *per annum*.

The GEAR rested on two pillars: a rapid expansion of non-traditional (i.e. non-gold, manufactured) exports; and an increase in private sector investment. In terms of industrial strategy, GEAR thus explicitly focused on competitiveness, liberalising trade, and growing exports. This marked a shift away from developing domestic industry to meet basic needs, while reinforcing the export orientation. The GEAR did argue, however, for support for labour-intensive industries, mostly through tax incentives and the public service.

When the policy was introduced, macroeconomic targets were expected to lead to more rapid growth, permitting continued expansion in government spending while reducing the deficit relative to the economy. In the event, however, economic growth slowed through the late 1990s, at least in part as a result of constrained government spending. As a result, the deficit targets translated into real cuts in the budget.

In these circumstances, the GEAR actually slowed delivery of services to the poor and led to downsizing of the public sector (COSATU Central Committee Review, 2005). It also supported commercialisation and privatisation of basic services, leading to big cost increases for low-income households. Investment in infrastructure was also heavily reduced. These policies reversed the RDP's focus on redistribution and anti-poverty measures as a stimulus for local demand and ultimately production.

Although GEAR has delivered greater macro-stability and fiscal discipline, it has been criticised, particularly by the trade unions and the left, for its failure to deliver in several key areas (particularly job creation, economic growth, manufactured exports and redistribution). By 2000, the official endpoint for the GEAR targets, it was clear that conservative fiscal policies had failed to stimulate investment or growth. Unemployment soared from 16 percent to 29 percent between 1995 and 2000, while the rate of public and private investment relative to the GDP had fallen to a 10-year low.

According to COSATU, an assessment of the GEAR using its own criteria demonstrates the failure to meet its economic goals. The only exceptions are targets for policy instruments - the government deficit and average tariffs – and inflation. The decline in inflation reflected world-wide trends, with almost every other country seeing similar trends.

The democratic government has made attempts to break out of the poverty trap through redirecting of government expenditure and new labour laws. However, GEAR and trade and industrial policy which narrowly emphasise the need for South African industry to be internationally competitive continue to reinforce the negative impact of trade liberalisation on poverty reduction.

It is now widely acknowledged that GEAR has, despite its name, failed in terms of economic growth, the creation of quality jobs and redistribution towards the poor. The failure of GEAR was apparent that the strategy was intended for narrow financial stabilisation purposes only. With stabilisation having been largely achieved, government is increasingly feeling the pressure to address the wider socio-economic failures of economic policy.

There is a growing frustration among different actors that the current economic policy cannot be sustained under current social conditions. The new debate attempts to side-step GEAR's ideological barrier through a pragmatic focus on identifying the main drivers of growth and strategies that can ensure that the poor benefit most.

At the same time, there is a recognition that the impetus for growth and development must come from the state and should focus on shifting the national budgetary process towards a more developmental, expansionary vision.

Microeconomic Reform Strategy and Integrated Manufacturing Strategy

The South African Government implemented a Microeconomic Reform Strategy (MERS) in 2002 to complement progress made on the macroeconomic front. This MERS identifies six key performance objectives, namely: enhancing economic growth; employment; small business development; Black Economic Empowerment (BEE); competitiveness; and the geographical spread of growth and development. The MERS rests on three pillars: (a) cross-cutting issues like human resource development, infrastructure, access to finance, technology, and research and development; (b) actions to improve the efficiency and lower the costs in three input sectors, namely transport, telecommunications, and energy; and (c) growth sectors that demonstrate a high potential for growth and employment, such as tourism, exports, agriculture, information and communication technology (ICT), and cultural industries.

The Integrated Manufacturing Strategy (IMS) is the industrial policy component of the MERS, and similarly targets key growth sectors for attention. These include: ICT, agro-processing, bio-technology, chemicals, textiles with value-added, tourism, craft and cultural industries, and the services sectors in general. This could lead to the creation of sector specific incentives, as is the case in the motor industry.

ASGISA and a New Industrial Strategy

Since 2004, the government and the ANC have increasingly espoused the need for the South African state to become far more developmental and play a more active role in facilitating economic growth and development. With this in mind, the government has launched the Accelerated and Shared Growth Initiative for South Africa (ASGISA) and a more active and robust industrial policy is currently being developed. In contrast to the rolling-back of the state under GEAR, the state is now becoming far more interventionist to ensure that economic policy delivers on poverty reduction, job creation, and economic growth. This has sparked a debate on whether South Africa can be a 'developmental state', and the challenges in emulating the growth trajectories of the East Asian Tigers.

ASGISA is a growth strategy that seeks to contribute to halving unemployment and poverty by 2014. In this regard, it aims to catalyse an annual growth rate that averages 4.5 percent or higher between 2005 and 2009, and a growth rate of at least six percent between 2010 and 2014. It is not an industrial policy, but consists of a limited set of interventions to overcome key constraints in the macroeconomic environment, in infrastructure and logistics provision, in skilled labour availability, in the competitive environment and cost structure of the economy as well as in the regulatory environment and in the institutional capacity of government to deliver. A key component of the strategy is a public expenditure programme of South African Rand 370 billion (US$52bn) with many multiplier effects, and the identification and nurturing of sectors that can immediately contribute to growth and job creation. In this regard, ASGISA is targeting the tourism and business process outsourcing (BPO) sectors, with others to follow.

In addition to ASGISA, the government is finalising a broad industrial policy framework to fast-track South Africa's industrial development. This new policy regime will better focus human and financial resources on a narrower range of high impact sectors, and increased financing and improved incentives (with greater conditionality) will be made available for industrial development. There are four broad areas that have been identified for focused attention. These are: firstly, sectors identified by ASGISA as ripe for growth and job creation, namely business process outsourcing and off-shoring, and tourism; secondly, sectors with potential for growth and employment creation in the medium term, but which need significant restructuring, including clothing and textiles, the motor industry, chemicals and agro-processing; thirdly, sectors that have not been the subject of industrial policy up to now, but with the potential for significant job creation; fourthly, sectors in which South Africa could develop cutting edge technological excellence and become a world leader, namely parts of the aerospace industry, parts of the hydrogen economy, medical technology, and biotechnology.

In addition, there are cross-cutting interventions identified in the MERS and refined by ASGISA. They include the infrastructure development programme, regulatory reviews, and the skills initiative and other training programmes.

11.5 South Africa's Trade and Industrial Strategy

After the lifting of sanctions, South Africa actively participated in trade negotiations on both a bilateral and multilateral level. This has led to a significant increase in market access. The government also reinforced the need to increase investment and re-orient resources away from a highly capital-intensive industrial structure that characterised the economy throughout much of the apartheid era. Trade liberalisation at the multilateral, regional and bilateral levels has been pursued to discipline inefficient and uncompetitive domestic producers, and to gain market access for South African exports.

Multilateral Negotiations

South Africa signed the Marrakesh Agreement establishing the World Trade Organisation (WTO) with commitments as a *developed* country. A formal programme of phased tariff reductions and tariff harmonisation was commenced in 1995 in terms of an offer presented in 1993. Since then, South Africa has made significant reductions in tariff barriers, ahead of the WTO timetable, resulting in the lowest trade weighted average rate of protection in the Southern African Development Community (SADC) region. The steepest reductions have been in those sectors previously most heavily protected. South Africa's multilateral obligations have included: (i) a phased reduction in (simple) average tariff levels from 11.7 percent in 1995 to 5.5 percent over five years; (ii) replacement of all remaining quantitative restrictions (QRs) and formula duties on imports by *ad valorem* duties; (iii) reduction in the number of tariff bands to six ceiling rates (0, 5, 10, 15, 20 and 30 percent), and a significant reduction in the number of tariff lines' (iv) binding 98 percent of tariffs lines; and (v) the introduction of a cascading tariff structure promoting value-addition, i.e. primary products and capital goods (0-10 percent), components (10-15 percent) and consumer goods (15-30 percent).

In addition, South Africa committed to make its policies more WTO-compliant, particularly by removing explicit export subsidies. In other words, there has been a salient shift away from price-distorting demand-side measures, towards productivity-enhancing supply-side measures. For this reason, the government phased out the highly inefficient and costly General Export Incentive Scheme (GEIS) in 1997, and replaced it with market-led support measures. A wide range of WTO-compatible supply-side measures, i.e. financial and non-financial have been established to facilitate industrial restructuring, technology upgrading, investment and export promotion, skills development, and small, medium and micro enterprises (SMMEs) development. These measures are geared to supporting higher value-added manufacturing projects as well as major infrastructure projects, such as the Industrial Development Zones (IDZs). Export Councils were introduced in 2000 to provide matching grant funding. This enabled exporters who could not afford to market themselves abroad individually to do so collectively.

Regional and Bilateral Negotiations

South Africa has diversified its export markets and trading relationships. Apart from the country's traditional trading partners, South Africa has developed more extensive relations with South America, Asia and Africa (the so-called 'butterfly' approach which seeks to open up South Africa's 'trading wings' from Africa to Latin America and East Asia). As part of this trade strategy, South Africa has negotiated the following free trade agreements (FTAs), or is in the process of doing so:

- Following protracted and difficult negotiations, the Trade, Development and Cooperation Agreement (TDCA) with the European Union (EU) was finally signed in late 1999 and came into effect on January 01, 2000. This agreement involves the EU liberalising 95 percent of its imports from South Africa (worth US$9.7bn) over a 10-year period, with an asymmetrical obligation for South Africa to liberalise 86 percent of its EU imports (worth US$10.3bn) over 12 years. Of South African farm products, 63 percent were granted unrestricted access to EU markets, with a further 12 percent entering under duty-free quotas. EU imports of several products originally on the 'excluded' list were partially liberalised. The annual duty-free quota for South African wines was increased by three percent, but South Africa agreed to phase out its use of the terms 'sherry' and 'port' over 12 years. It was also agreed to conclude separate substantive negotiations on fishing rights (Blumenfeld 2006:444). The value of two-way trade has increased in the wake of the TDCA, although it has not necessarily spurred FDI.
- The SADC Trade Protocol was signed in 1996 and came into force in September 2000. In recognition of the severe imbalance of the regional economy, South Africa/SACU negotiated an asymmetrical FTA with the rest of SADC. The Southern African Customs Union (SACU) will accordingly phase down tariffs in 8 years by 2008, while the rest of SADC will do so in 12 years.
- The SACU Agreement between South Africa and Botswana, Lesotho, Namibia and Swaziland (BLNS) was renegotiated and came into effect in 2004. It provides for more democratic decision making on tariff policy and trade remedies.
- Negotiations between SACU and the four non-EU European Free Trade Area (EFTA) members – Switzerland, Liechtenstein, Norway and Iceland - have been concluded. South African exports of all industrial goods, including clothing, and fish products, will have duty-free and quota-free (DFQF) access to EFTA countries. The purpose of this negotiation was to bring trading relations with EFTA in line with the TDCA.
- SACU-US FTA negotiations started in June 2003, with the aim of locking-in the preferential access granted under the unilateral African Growth and Opportunity Act (AGOA). Under AGOA, SACU nations are the leading suppliers of non-fuel goods to the US, accounting for more than a third of the US' non-fuel goods imports from eligible sub-Saharan African (SSA) countries. However, SACU's resistance to the inflexible approach of the US and its insistence on the onerous inclusion of the new generation trade issues led to a downscaling of the talks in April 2006. While consolidating trade and investment ties, the parties will work towards an FTA vision in the future.
- In late 2004, SACU concluded a Preferential Trade Agreement (PTA) with the Southern Common Market (MERCOSUR) free trade bloc, consisting of Brazil, Uruguay, Paraguay and Argentina. The agreement only covers 2,000 product lines, since the critical conditions and interdependencies for a full FTA were simply not present in bilateral trade between the two groupings.
- Substantive FTA negotiations with China and India are due to begin as soon as the exploratory phase underway is concluded. Similar agreements with Nigeria, Egypt and Kenya have been mooted.

11.6 Success and Failure of South Africa's Trade and Industrial Policy

The South African government has had mixed success over the last decade in strengthening and developing the country's economy. This is according to a discussion document reviewing the impact of its policies over the first 10 years of democratic rule, namely *Towards a Ten Year Review, 2004.*

Its decisive moves towards outward orientation with a focus on export promotion by means of a wide variety of incentives, such as tariff concessions and credit facilities have seen an improved balance of trade but also brought about serious market distortions at which the current trade policy is aiming to reduce. The Congress of South African Trade Unions (COSATU) warns, however, that if industrial policy comes to be characterised by such a concession-driven approach rather than a clear, policy-driven strategy, South Africa will be embarking on the same self-defeating path as those countries which compete for investment through offering loopholes and lower standards. This has been described 'a race to the bottom'.

By international standards, the competitiveness of the South African economy has improved since the early 1990s. In the same Report, reviewing South Africa's economic performance, the exports have improved and diversified and there have been significant gains made in labour productivity. However, the availability of skilled labour and the cost of transport and telecommunications are still a source of concern.

Jarvis (2001) critiques the current thinking that South Africa's industrial strategy should aim to reduce market distortions to allow for the growth of sectors where a country may have a perceived comparative advantage. This is insufficient for a number of reasons. First, it ignores the past, where the development of certain industries was based on market distortions, usually caused by the private sector lobbying government. Second, it neglects the developmental role that industrial growth plays within a country, relegating economic activity to only the realm of the market. Third, it ignores external factors, and assumes a free and fair playing ground and thereby fails to take into account the power of other actors such as trading blocs, international agencies and multi-national corporations.

Thus far, South African government policy has focused only on increasing competitiveness and strategies to expand exports forming the state's entire industrial strategy. The absence of a comprehensive industrial development strategy means that economic development in South Africa follows the dictates of the markets. Civil society is increasingly raising alarm at the negative effects of trade liberalisation policies and the possible de-industrialisation that will ensue. According to a senior trade unionist from COSATU:

"The clothing sector has lost 75 000 jobs as a result of rapidly increasing imports. Our footwear industry has practically disappeared. The furniture sector, which is hailed by some as a success story because it has increased exports, has also lost significant numbers of jobs as a result of trade. Plastic companies have retrenched workers, dairy farms have closed down, pharmaceutical companies turned manufacturing sites into distribution facilities for imported drugs. The list goes on and on".[2]

Table 11.1: Components of GDP, 1971-2001 (1995 constant prices)					
	Avg. share 1971-1980 (%)	Avg. share 1981-1990 (%)	Avg. share 1991-2001 (%)	Avg. share 1991-1996 (%)	Avg. share 1997-2001 (%)
Primary	16.1	13.3	11.4	12.1	10.7
Secondary	29.5	29.6	27.6	27.9	27.1
Tertiary	54.3	57.0	61.0	60.0	62.2
Total	100.0	100.0	100.0	100.0	100.0

Source: TIPS, A Review of the Changing Composition of the South African Economy.

Sectoral Contributions to the Economy

From a broad perspective, there have been important structural changes in the reasonably diversified South African economy since the 1970s (see Table 11.1). The share of the primary sector (agriculture and mining) in overall GDP has decreased over the past three decades, although the secondary sector's share of GDP has maintained a more or less constant between 1970-2001. The tertiary sector (including services), which has traditionally had the largest GDP share, is increasingly growing, at the expense of the primary sector. This is in line with the trend towards less reliance on primary products and more on high value-added services.

However, despite recent strikes in the mining sector, this sector and related activities remain at the centre of the South African economy and account for some 40 percent of export earnings from merchandise trade. As the backbone of the economy with various linkages to manufacturing (e.g. iron and steel products) the mining and quarrying sector receives the largest share of financial assistance from the government.

The manufacturing sector, largely centred upon capital-intensive minerals processing, contributes nearly 25 percent of GDP. However, the report *Towards a Ten Year Review* reveals that the international competitiveness of manufacturing suffers from a lack of skilled labour. This sector is protected mainly by tariffs, which average nearly 16 percent. Textiles, clothing and related items are also among the most tariff-protected products. Services are the largest employer, with over half of total employment, and account for nearly 60 percent of GDP.

However, in the last two years, large employers such as the textiles sector, machinery and equipment manufacturers, the motor vehicles sector and also iron and steel producers have recorded the most significant job losses, while the only manufacturing sectors that showed some increases in employment levels were the leather, wood, plastics and printing sectors which collectively only account for 12 percent of all manufacturing sector employment. There is growing concern about the effects of competition from Chinese imports, particularly in the clothing and textiles sector. Tables 11.2 and 11.3 illustrate the growth in exports and imports by sector.

Table 11.2: Growth in Exports, 1991-2001(1995 constant prices)							
Sector	Avg. 1 997-2001 (%)	Avg. 1991-1996 (%)	1991-1996 Rank	Avg share 1997-2001 (%)	1997-2001 Rank	Avg share 1991-1996 (%)	1991-1996 Rank
1 Business service	7.3	10.3	7	3.5	6	2.5	6
2 Manufacturing	6.9	15.5	1	53.3	1	41.2	2
3 Community service	6.9	5.3	8	0.3	7	0.3	7
4 Transport	5.8	11.7	4	6.1	3	5.2	3
5 Agriculture	5.3	13.6	3	4.3	5	3.9	5
6 Trade	3.5	10.6	6	5.5	4	4.5	4
7 Electricity	-0.1	14.3	2	0.1	8	0.1	8
8 Mining	-3.6	-3.7	9	26.9	2	42.3	1
9 Construction	-7.6	11.1	5	0.0	9	0.0	9
All industries	3.7	6.4	-	100.0	-	100.0	-
Source: TIPS, A Review of the Changing Composition of the South African Economy.							

Table 11.3: Growth in Imports, 1991-2001 (1995 constant prices)							
Sector	Avg. 1997-2001 (%)	Avg. 1991-1996 (%)	1991-1996 Rank	Avg share 1997-2001 (%)	1997-2001 Rank	Avg share 1991-1996 (%)	1991-1996 Rank
1 Mining	16.2	11.7	5	12.7	2	9.3	2
2 Transport	-1.5	5.7	6	4.0	3	5.3	3
3 Manufacturing	-1.7	12.8	3	77.8	1	77.1	1
4 Electricity	-4.1	22.0	1	0.0	9	0.0	9
5 Business serv	-5.8	2.7	8	1.4	5	2.2	5
6 Trade	-6.2	4.3	7	1.1	7	1.6	7
7 Construction	-6.2	20.3	2	0.1	8	0.1	8
8 Comm'ty serv	-6.8	1.5	9	1.1	6	2.1	6
9 Agriculture	-8.4	12.3	4	1.7	4	2.3	4
All industries	0.1	11.7		100.0		100.0%	
Source: TIPS, A Review of the Changing Composition of the South African Economy.							

Agricultural sector

In the agricultural sector, the government is promoting the deregulation of the marketing system, notably by reducing the number of control boards. Tariffs on agricultural products range from zero percent to 35 percent, with a simple average of 5.6 percent. Ceiling bound rates ranging up to almost 400 percent leave considerable margins for discretionary increases in applied tariffs.

In recent years, merchandise imports have grown faster than exports. South Africa's exports include: machinery, motor vehicles and fertilisers to African countries; and minerals and agricultural products to developed markets, mainly Germany, Italy, Japan, the UK and the US. South Africa's main suppliers of imports are Germany, Japan, the UK and the US.

According to the WTO, Trade Policy Review, SACU April 1998 Report, it notes that even though South Africa privatised or commercialised a number of public enterprises in the early 1990s, the process has since slowed down. Several state-owned enterprises (SOEs) hold monopolies or exercise majority control in various areas, including electricity, water, transport and communication, mining and quarrying. In the agricultural sector, there are still 14 marketing boards in operation. In the services sector, though the situation has improved with the restructuring of several state-owned service suppliers and an opening to foreign investment, the report notes that further liberalisation would help raise the competitiveness of South Africa's exports.

Job Sector

The Job Sector Summits which were created as a forum for negotiating industrial policy presented an opportunity for labour, government and business to thrash out the growth paths for specific sectors, including ways to prevent job losses and create employment in specific industries. Sector summits have so far occurred in the gold mining and clothing and textiles sectors and have been faced with serious problems.

While many unskilled workers are unemployed, there is still a shortage of suitably skilled workers which hinders expansion (Towards a Ten Year Review, 2004). Between 1995 and 2002, the number of employed people grew from 9,557,185 to 11,157,818, representing 1, 600,633 new jobs. However, during the same period, the number of unemployed people grew from 1,909,468 to 4,271,302, an increase of 2,361,834 leading to a negative net effect on job creation.

The first quarter of 2005 was also marked by a wave of retrenchments, in which tens of thousands of jobs were lost in various sectors of the economy such as mining and clothing and textiles prompting some groups like COSATU to call South Africa's unemployment crisis a national emergency. Of most concern is the fact that declining employment levels have occurred simultaneously with a decline in investment levels.

One of the major reasons for such a crisis, as often cited by some politicians, business people, economists and the media alike, dwell more on the failure by the government to reorganise the economy away from the distorted nature inherited from the past, in which it relied heavily on its primary sector (using cheap and unskilled labour) and the capital-intensive manufacturing industries designed to cater for white minority interests. This phenomenon is still alive and continues to manifest itself in different ways.

Small Business Sector

The Small Business Sector has made a significant contribution to the gross domestic product. SMMEs contribute about half of total employment and more than 30 percent of total GDP. SMMEs are now being seen as crucial to employment creation in South Africa although the most workers in this sector still remain vulnerable and unorganised.

Historically, unions have concentrated more on organising in big businesses and have ignored the small business sector. This is now changing. Globalisation and open market trade liberalisation or restructuring have resulted in massive full-time job losses, especially in big companies. The result has been a decline in union membership. Unions are being forced to come up with strategies to organise workers in the SMME sector.

The prevailing trend is that there is an increased level of consumerism among South Africans following the establishments of shopping Malls. In almost each and every black and coloured township in the Cape Metropole, for example, open land has been occupied by shopping malls. Prominent features of these malls are supermarkets, banks' automated teller machines (ATMs) and the lottery. The SMMES are not engaging in economic development projects that would significantly stimulate economic growth. "The malling strategy, brought about largely by open market liberalisation trade polices, is currently undermining local savings by encouraging consumerism and exacerbating poverty by effectively contributing to the destruction of family businesses such as spaza shops" (Simphiwe Dada, 2005).

11.7 Overview of the Trade Policy Process and Stakeholders

The Department of Trade and Industry (DTI) is the principal institution tasked with formulating and implementing South Africa's trade and industrial strategy. Within the department, the division on International Trade and Economic Development (ITED) is responsible for the trade negotiating agenda, and the division on Enterprise and Industry Development (EIDD) for industrial policy. While it is felt that the DTI's institutional structure, revised around 1999, is appropriate for managing these policy challenges, there is concern about capacity constraints at two levels: insufficient staff numbers; and insufficient institutional experience of trade negotiations compared to most of South Africa's negotiating partners.

The DTI is supported by the Council of Trade and Industry Institutions (COTII) that includes the Industrial Development Corporation (IDC), which funds industrial development projects; the newly established International Trade Administration Commission (ITAC), which administers trade policy; and Trade and Investment South Africa (TISA), which promotes exports and investment. In addition, the DTI co-chairs the Economics Cluster of government departments, which coordinates and integrates the initiatives and activities of those line departments that service and support the domestic economy. Instructively, given its cross-cutting policy interventions, the Microeconomic Reform Strategy is the cluster's flagship project. It will also monitor the implementation of ASGISA.

However, as the ambit and scope of the trade negotiating agenda extends well beyond the direct competence of the DTI and impinges upon the regulatory responsibilities and technical expertise of other departments, it is important that these departments directly participate in the preparation and execution of trade negotiations. For this reason, the South African Government has established an Interdepartmental Permanent Trade Forum (PTF). As a specialised forum, the PTF facilitates consultations and coordination *within* government in the formulation and implementation of trade policy, and in the preparation and execution of South Africa's trade negotiations. Departments will submit their key negotiating objectives, minimum outcomes, and concerns, and develop a negotiating strategy that sets out precise offensive and defensive negotiating positions. Anecdotal evidence suggests that the PTF has yet to be effectively operationalised.

The National Economic, Development and Labour Council (NEDLAC) institutionalises a culture of corporatist decision making in South Africa, and facilitates the crafting of consensus among the state and its social partners – that is, labour, business, and the community – on key economic and social policies. Within NEDLAC, discussions on industrial and trade policies reside with the Trade and Industry Chamber. The latter has established two substructures to assist in this regard: the Fund for Research into Industrial Development, Growth and Equity (FRIDGE) engages in research projects to enhance the competitiveness of industry; and the Technical Sectoral Liaison Committee (TESELICO) aims to enhance trade-related social dialogue, including the negotiation of trade agreements and interactions with the WTO. At this point, the community constituency – which largely represents civil society – is not included in TESELICO consultations, since it simply lacks the capacity to engage on technical trade matters. This underscores the need for capacity-building. In recent years, it is noteworthy that capital and labour increasingly share similar concerns about the deleterious effects of liberalisation on domestic industry and higher value-addition.

In addition to these domestic governance processes, South Africa's trade and industrial policies must also defer to supranational regional bodies, notably SACU. The new SACU Agreement provides for a more transparent and democratic decision-making procedure over tariffs and trade remedies, in contrast to the past when South Africa willy-nilly imposed its unilateral tariff preferences on its partners. The new SACU Agreement also mandates its member states to develop common policies and strategies with respect to industrial development. This is particularly important in light of the current exercise to develop a more robust and active industrial policy framework for South Africa. It remains to be seen how this policy project is reconciled with the common approach enjoined by the SACU Agreement.

There are a variety of civil society organisations (CSOs) active in the South African trade policy debate. These include the technically-minded Trade and Industrial Policy Strategies (TIPS), the South African Institute of International Affairs (SAIIA), the Trade Law Centre for Southern Africa (TRALAC), the Southern African Regional Poverty Network (SARPN), the Southern African Trust, and the Institute for Global Dialogue (IGD). The anti-globalisation platform is most noticeably occupied by the Alternative Information and Development Centre (AIDC) as well as a host of environmental, ecumenical and social justice groups.

Progressive voices on trade policy in South Africa have coalesced around the informal Trade Strategy Group (TSG), which was formed largely in response to an increasingly aloof and antagonistic regime (not only to civil society, but also to other African countries' interests) at the DTI during the tenure of Alec Erwin as Minister. The TSG blends reformist and radical responses to the neo-liberal disciplinary discourse, and encompasses a collection of progressive policy NGOs, trade unions, faith-based networks, women and environmental organisations that are broadly committed to the sustainable, equitable, and people-centred development of South Africa and the Southern African region. It includes such bodies as COSATU, the Southern and Eastern African

Trade, Information and Negotiations Institute (SEATINI), the Economic Justice Network (EJN), and the Gender and Trade in Africa Network (GENTA). The TSG has been especially active and vocal in opposing the proposed SACU-USA FTA, in supporting the COSATU campaign against non-agricultural market access (NAMA) reductions in the WTO, and in capacity-building for the NEDLAC community constituency.

11.8 Concluding Questions

In conclusion, this paper has attempted to provide a background note to the origins of South Africa's trade and industrial policy, reflecting on how it has evolved to this day. It also shows clearly how the government's macroeconomic strategies began to shift from RDP moving swiftly to GEAR following the end of apartheid. It also highlighted some limited success of these policies in post apartheid.

There is obviously a need to continue to re-looking at these macroeconomic strategies particularly to ensure that the Trade and Industrial policy is implemented with a mixture of well conceived, and mutually re-enforcing, incentives and penalties.
Some fundamental questions such as the following will continue to be asked:

- Considering that the prevailing logic of GEAR has serious limitations, the question then is what is the right macroeconomic framework for South Africa which will enhance poverty reduction or eradication?
- How much of policy space is allowed for ordinary people to question certain government policies and their impact on key sectors e.g. the problem of massive job losses in the manufacturing sector? and
- Before any new policies are implemented or adopted, how much of analysis and impact assessments are done to ensure that the policies are addressing the inequalities and poverty trap that most countries including South Africa find themselves in?

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Endnotes

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2 Speech delivered by Violet Seboni, 2nd Deputy President of COSATU to the SANGOCO workshop on non-agricultural market access (NAMA) on June 24, 2005.

12

CHAPTER

Trade and Poverty in Tanzania: *Missing Linkages?*

– Josaphat Kweka[1], George Kabelwa[2] and Justine Musa[3]

12.1 Introduction

The efficacy of trade (or trade policy) in poverty eradication has attracted increasing attention both to policy makers and analysts. In the context of the globalisation process, the principal reason underlying this interest is the significant position that trade policy has assumed in development policy debate in the last decade or so, which has also shaped the focus of policy reforms in most developing countries. Across the globe, and especially in developing countries, a change in trade policy is considered to have a significant impact on welfare.

Evidence on the impact of trade liberalisation in Tanzania is rather patchy. However, the policy debate especially in the last five years has been on whether trade has effectively helped reduce poverty. In response to this, the government has mainstreamed trade in the Poverty Reduction Strategies (PRSs) based on the assumed role of trade in enhancing growth and reducing poverty. A broader issue worth analysis is how trade links with development and poverty concerns. This issue is important given the argument that the impact of trade (or trade policy liberalisation) may differ not only across different countries but also across different groups of people within one country or different agents within the same sector along the supply chain. This paper provides background to the case study for Tanzania, one of the countries covered by the linkages between trade, development and poverty (TDP) project initiated by the Consumer Unit & Trust Society (CUTS), an India-based research and advocacy organisation.

The aim of the paper is twofold. First, it aims to examine the potential short-term impact of trade liberalisation on poverty and explains why the outcome of trade liberalisation has been mostly negative. One major hypothesis is that trade liberalisation has had limited impact on poverty because the link between trade and poverty is weak since the poor have no capacity to effectively participate in trade. Second, by examining trade policy and performance, the paper intends to identify two sectors and issues: one being a success story and the second a failure case of trade liberalisation for further detailed analysis in the form of case studies. Section 12.2 of the paper provides a review of macroeconomic policy performance in Tanzania by identifying key challenges on sustaining higher growth and employment for poverty reduction. Section 12.3 examines the performance of trade and hence its efficacy in sustaining growth and poverty reduction by discussing recent trade policy performance and institutional capacities. The discussion on the linkages between trade and poverty reduction and the identification of the key issues and sectors for the case studies are explained in Section 12.4, while Section 12.5 presents some concluding thoughts.

12.2 Macroeconomic Policy Environment and Performance

Background of the Tanzanian Economy

Like most other Sub-Saharan African (SSA) economies, the Tanzanian economy is characterised by a large, traditional rural sector and a small, modern urban sector and depends heavily on agriculture, which accounts for about half of gross domestic product (GDP), provides 85 percent of exports and employs 80 percent of the work force. Topography and climatic conditions, however, limit cultivated crops to only four percent of the land area. The manufacturing sector is still small, contributing less than 10 percent of GDP. Manufacturing traditionally featured the processing of agricultural products and light consumer goods. The World Bank, the International Monetary Fund (IMF) and other bilateral donors have provided funds to rehabilitate Tanzania's out-of-date economic infrastructure and to alleviate poverty.

Exports rely on a few cash crops, notably coffee, cotton and cashew nuts, but in the recent years tourism and mining have become the largest earners of foreign exchange. In the period 1991-2002, growth featured a pickup in industrial production and a substantial increase in the output of minerals, especially gold. Oil and gas exploration and development played an important role in this growth. Recent banking reforms have helped increase private sector growth and investment. The level of government spending as a proportion of GDP has been high, albeit growing at a slower rate in recent years. Donor financing has assumed greater importance (currently over 40 percent of the budget) after adoption of economic reforms in 1986. Continued donor assistance and solid macroeconomic policies supported real GDP growth of more than 5.2 percent in 2004. Servicing of foreign debt absorbs an increasing share of recurrent revenue, which relies heavily on indirect taxes.

Macroeconomic Policy Reforms and Performance

Starting from the mid-1990s Tanzania scaled up the pace of economic reforms that started in the mid-1980s with the removal of the public sector from commercial and business activities in favour of the private sector. At the core of Tanzania's stabilisation efforts is fiscal consolidation. In 1996-97, Tanzania adopted a cash budget system, under which expenditures are strictly limited to available resources from domestic revenue and foreign aid. This virtually eliminated net domestic borrowing. In parallel to regaining fiscal control, donor assistance in the form of grants and concessional lending increased substantially, which helped financed the increase in government expenditures from about 16 percent of GDP in 1997-98 to more than 22 percent in 2003-04.

Having achieved impressive results in macroeconomic stabilisation, macroeconomic policy reforms have placed emphasis on institutional reforms to better the business-operating environment, strengthen the regulatory role of the government and reform the legal and public service institutions.

A close examination of the post-reform economic performance in Tanzania shows three interesting phenomena. First, there is a significant improvement in economic growth. In recent years, the economy has been growing at about five percent per year (see Table 12.1). Second, there has been impressive macroeconomic stability illustrated by a significant reduction in the inflation rate to a single digit since 2000. Third, although the

Table 12.1: Tanzania Macroeconomic Indicators								
Indicators	**1995**	**1997**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**
Population (millions)	27.5	29.1	30.9	31.7	32.7	34.5	35.1	35.2
Per capita income ($)	176.9	236	240	270	280	281	281	282
GDP growth (%)	3.6	3.3	4.7	4.9	5.7	6.1	6.3	6.4
Gross domestic savings (as % of GDP)	9.1	7.7	5.3	11	11.2	13.9	13.9	14.2
Gross investment (as % of GDP)	19.7	14.7	15.5	17.6	16.1	19.3	19.5	19.8
Inflation (%)	27.4	16.1	7.8	6	5.2	4.9	4.4	4.6
Exchange rate (Tshs/$)	574.8	612	745	800	876	929	999	1,077
Exports (millions of $)	1,266	1,235	1,144	1,291	1,456	1,173	1,276	1,453
Imports (millions of $)	2,140	1,948	2,210	2,050	2,250	2,308	2,699	2,852
Current account balance	-589.9	-403	-830	-499	-480	-1,135	-1,423	-1,399
Balance of payments	-329.5	-200	-109	-35	17.5	7.3	440	244
Foreign reserves	270.9	623	776	974	1,157	1,184	1,670	1,952
External debt	8.4	3.8	4.2	5.7	6.2	6.5	5.8	5.3
Foreign Direct Investment	150	158	517	463	327	283.8	244	254

Source: Bank of Tanzania, Bureau of Statistics and Public Expenditure Review (various issues).

government has put in place an elaborate policy framework for poverty reduction, i.e. Poverty Reduction Strategy Papers (PRSPs), the macroeconomic achievements have not matched the expected level of poverty reduction.

The new type of aid, i.e. programme aid, encouraged structural policy reforms and many experts believe that the reforms have created a conducive environment for economic growth (Noni et al, 1999). In turn, improvement in the policy environment (after mid-1980s) has been a key factor in attracting more aid and foreign direct investment (FDI). On average, both savings and investments have remained low, i.e. at about 10 and 17 percent of GDP, respectively.

Although macroeconomic stability has improved notably, the balance of payments (BoP) has shown little improvement. However, foreign reserves have improved markedly – from about two months of imports in 1995 to over eight months of imports in 2004. External debt remained precarious during the review period despite Heavily Indebted Poor Countries (HIPC) debt relief. FDI inflows nearly doubled between 1995 and 2004.

At a microeconomic level, according to the World Bank (2005b), increase in total factor productivity explains most of the growth that occurred during the period 1995-2003 compared to labour and capital (physical and human) productivity. The increase in total factor productivity represents overall gains in the efficiency of the economy as a result of macro-economic stabilisation and structural reforms. These reforms have also fostered a focus of investments in activities with high return through the elimination of unproductive parastatal investment and the removal of low cost access to finance for the private sector.

Macroeconomic Challenges

Despite the impressive rate of economic growth and macroeconomic stability, many challenges abound for Tanzania: sustenance of the achieved macroeconomic performance, linking macroeconomic achievements to the broader objective of poverty reduction and reduction of dependence on external assistance and improvement of governance.

The first set of challenges, sustaining the macroeconomic achievements requires continuation of the monetary and fiscal policy stance (tight monetary and fiscal policy), strengthening financial sector reforms, higher domestic revenue mobilisation and further integration with regional and global trade through strategic trade reforms and effective development of the private sector.

The second set of challenges is how to effectively avail the benefits of growth for poverty reduction. The extent and trends of poverty and performance of poverty reduction goals are disappointing, as poverty is still a huge problem in Tanzania. It is not entirely clear – from either literature or policy documents – whether the low level of poverty reduction following reforms and macroeconomic achievement is due to lack or combination of trickle down, inappropriate growth or lack of irresponsiveness of the poor. Why has the implementation of economic liberalisation not generated widely shared improvements in economic and social well-being? This question is particularly vital in ensuring sustained commitment to reforms and growth strategies.

The third challenge is aid dependence. The extent of donor involvement both in terms of agenda setting and supply of human and financial resources for macroeconomic policy reforms is undoubtedly substantial, and has increased tremendously during the last decade reflecting donors' confidence with the government's commitment in pursuing reforms and opening up the economy. To ensure policy coherence and move the macroeconomic achievement faster into poverty reduction, ownership of development policy and effective capacity for implementation will be as important as the resource inflows. The fourth and final challenge and which relates to the preceding one is governance and accountability. Although formally it is considered that corruption has declined substantially, on the ground corruption is still pervasive, especially at lower levels.

12.3 Trade Policies and Performance

Review of Tanzania's Trade Policy

As part of the ongoing reforms that started in 1985 and heightened in early 1990s, the Government of Tanzania has embraced trade liberalisation by opening the economy to the external markets for trade, investment and (by limited extent) capital flows. More specifically the National Trade Policy (NTS) of 2003 recognises trade openness as a prerequisite for economic development (URT, 2003). Success can be seen in the form of reduced import restrictions, liberalised foreign exchange transactions, and simplified tariff structure, among others. Taxes on exports have been eliminated.[4] The financial, telecommunication and transport sectors have been liberalised. It is also clear that, with

Table 12.2: Openness Indicators for Tanzania (in percent)					
Indicator	**1985**	**1990**	**1995**	**2000**	**2004**
Export/Import Ratio	28	31	54	62	64
Balance of Trade	-18	-26	-19	-13	-19
Total exports	7	12	22	21	35
Total imports	25	38	42	35	54
Total Trade (export and imports)	32	50	64	56	89

Notes: Total export/import means export/imports of goods and (none-factor) services). Balance of trade is total exports minus total imports.

Source: Own Calculation using data from the Economic Survey.

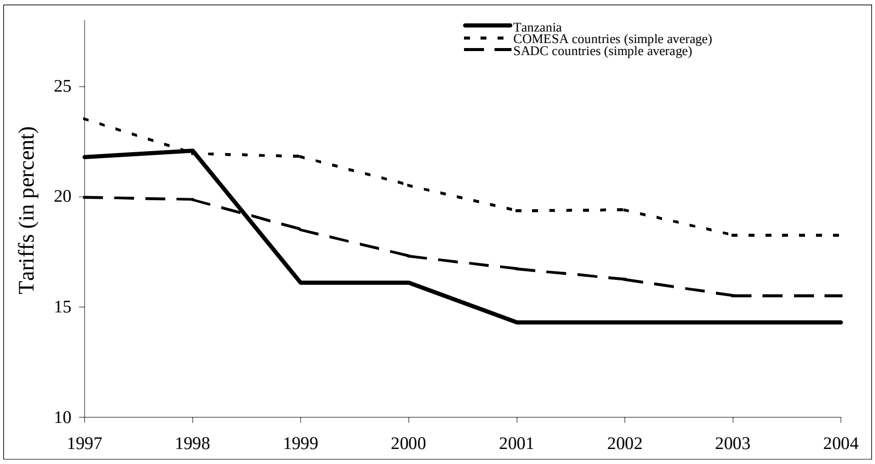
the significant trade liberalisation carried out by Tanzania, the economy has become more open but in favour of disproportionate increase in imports relative to exports; hence increased trade deficit (see Table 12.2).

The trade regime emanating from policy reforms discussed above has sought to promote domestic manufacturing. Under the current trade regime capital goods and unprocessed material imports enjoy zero tariffs while most unfinished products are subject to a maximum of 25 percent tariff (World Bank, 2005a). Furthermore, restrictions to imports exist in terms of licensing, minimum dutiable values and suspended duties among others. Despite the favourable policy regime, performance of the manufacturing sector in Tanzania has not been impressive. Part of the problem is a low level of competitiveness of the economy that renders the exportable less competitive as discussed below.

Another significant feature of the NTP 2003 is that its sound emphasis on regional integration and commitment to the Multilateral Trade System (MTS) has given the potential for regional integration to increase trade opportunities to member states rather than the global markets whose standards are often difficult to meet by a poor country (Kweka, 2005). Tanzania is a member of the East African Community (EAC) and South African Development Community (SADC) established in 1999 and 1992 respectively. The three partner states of EAC (Kenya, Tanzania and Uganda) have established a Customs Union (CU) whose protocol was signed on March 02, 2004, and became operational in January 2005 by eliminating internal tariffs for the next five years so that the CU is expected to be fully functioning by 2010.

With the establishment of the EAC CU in January 2005, Tanzania effectively changed its trade policy regime by adopting the Common External Tariff (CET). The previous 4-band escalatory tariff structure of 0, 10, 15 and 25 percent (on capital goods and unprocessed materials, semi-processed inputs, fully processed inputs, and final consumer goods, respectively) was replaced by a 3-band escalatory tariff structure of 0, 10 and 25 percent (on raw materials, capital goods, including meritorious goods) and finished goods, respectively). By adopting the CET, Tanzania lowered its average tariff from 13.8 to 12.3 percent. In fact, as shown in Figure 12.1, Tanzania has a lower average tariff than the average for both Common Market of Eastern and Southern Africa (COMESA) and Southern African Development Community (SADC).

Figure 12.1: Simple Average Tariff in Eastern and Southern Africa



Note: Membership in the COMESA and SADC overlaps.
Source: Adopted from World Bank, 2005a.

The SADC Trade protocols was signed by 11 of its 14 members including Tanzania in 1996 and entered into force in January 2000, which should result into a Free Trade Area (FTA) by 2008 and the complete liberalisation of all its products by 2012. Tanzania withdrew its membership from COMESA in 2000, although some stakeholders (especially the private sector) did not favour the withdrawal, but the government aimed to cut down cost and commitment to too many regional organisations by sticking to SADC and in EAC. Already these regional integration processes are bearing fruits in terms of increasing trade flows. According to Kweka and Mboya (2004), Tanzania's trade with regional members have intensified during the last decade – both in terms of volume of trade and scope of goods traded.

Regarding the multilateral trading system, Tanzania is a founding member of the World Trade Organisation (WTO) in which it is obliged to implement the WTO agreements. However, Tanzania's prospects in the MTS depend on the successful accomplishment of negotiations in the Doha Round. Evidence shows that since these negotiations started in 2001 there has been little progress in tackling the key developmental concerns of developing countries – especially on Special and Differential Treatment (S&DT) and implementation issues.

In pursuit of the Economic Partnership Agreement (EPA) negotiations that require an African, Caribbean and Pacific (ACP) country to conclude an EPA with the EU under a particular regional body, Tanzania has opted to negotiate an EPA under the SADC configuration. This indicates the country's intention to embrace SADC integration process parallel to that of EAC, despite the inherent challenges of overlapping memberships. With the EAC's agenda to fast-track possibility for federation, the challenge in providing sincere leadership for this issue is imperative. Tanzania is also eligible for multilateral trade preferences under the US Africa Growth and Opportunity Act (AGOA) and the EU's Everything But Arms (EBA) initiative. The government is undertaking efforts to build Tanzania's capacity to access global markets and increase exports, while conforming to trade rules, especially those of the WTO.

Trade Performance

Export Performance

Since the late 1990s there has been a significant growth in export, albeit the recorded export growth in Tanzania is modest by regional and global standards. The 1991-2004 trend growth in exports is estimated to be 8.6 percent in comparison with 12.9 percent for Uganda, and 9.4 percent for other developing countries. Tanzania's export structure has, however, changed as export composition shifted from such traditional products as coffee, cotton, sisal, tea and tobacco towards non-traditional products such as mining, fish and fish products, horticulture and tourism.

The modest growth of exports and low level of integration into the global economy is basically caused by low levels of export competitiveness. In turn, the low level of competitiveness is determined by various factors, including macroeconomic instability and an unfavourable business environment that raises transaction costs and limits entrepreneurship. In addition, constraints such as lack of export entrepreneurship and poor infrastructure including transport, energy and communications, and export-related services such as port handling, shipping, insurance and credit facilities etc., significantly limit the extent of exporting for a country such as Tanzania (GCA, 1997). Tanzania undertook structural reforms aimed at realigning its incentive structure towards the export sector, but the trends in the real effective exchange rate, using the definition adopted by the IMF (see IMF, 2004), shows that no significant improvement in the competitiveness has been achieved in the post-reform period.

Tanzania also faces high transaction costs that lead to high costs of inputs and materials, although there have been commendable efforts in lowering tariffs on imported capital goods and intermediate goods. Competition among new and private traders seems to have reduced the costs of exchanging many export crops, but the presence of multiple marketers have made completion of other exchanges in the marketing chains more costly (Winter-Nelson and Temu, 2003).

To date low production levels and limited delivery capacity characterised by lack of technology (hence lack of standards and low quality), inadequate human capital, and underdeveloped infrastructure have impeded Tanzania's participation and integration in the global economy. Another obstacle limiting Tanzania's global competitiveness is a low level of entrepreneurship. Entrepreneurs in Tanzania lag behind Eastern African counterparts in skills development, managerial acumen and business credentials (Kathleen, 2004). Entrepreneurs require greater access to land, education, finance and business development services (BDS) that will enhance their capacity to compete for export led growth. Tanzania also faces stringent conditions in accessing external markets. In fact, Tanzania faces high tariffs for some export products such as textile.

To enhance competitiveness, a number of trade facilitation issues also need to be addressed. These include, *inter alia*: inaccessible feeder roads from production sites to distribution centres to ports; lack of cold storage facilities and warehouses for perishable goods; limited direct air access to international markets; high cost of electricity and Information and Communication Technology (ICT) services; incidence of red tape, corruption and bureaucratic delays; and limited diversification of exportable products.

Overview on Trade Policy Stakeholders and Institutions

Since it is not easy to identify all stakeholders of trade liberalisation, and given the scope of this paper, we simply examine four broad groups of stakeholders, namely: the donors; the government; the private sector (enterprises); and the civil society organisations (CSOs), including NGOs and academic/research institutions. The purpose is to provide an overview of their respective roles (participation) in the formulation and implementation of trade policy. Our main sources of information include policy documents, available literature, especially the institutional review document (see URT, 2002) and knowledge.

***The Donors*:** Universally, donors are prioritising poverty reduction in their programmes based on the Millennium Development Goals (MDGs). Poverty alleviation was the explicitly stated motivating force driving multi-lateral, bilateral and some country/ institutional aid programmes. Countries are now encouraged to prepare PRSPs and for the HIPC, PRS processes are now the basis for World Bank and IMF concessional lending and for the conversion of debt into aid. Bilateral aid programmes are increasingly requiring a PRS as a precondition.

The Government: The Tanzanian Government has committed itself to a long-term strategy aimed at eradicating poverty by 2025 by increasing growth. In this recognition, the government has formulated an elaborate trade policy aimed at transforming Tanzanian economy to achieve high level of competitiveness important for sustained pro-poor trade performance.

The key institution mandated with the formulation of trade policy is the Ministry of Industry and Trade (MIT), which is responsible for domestic trade policy formulation and international trade policy development, regional trade integration, and multilateral trade negotiations. The main capacity constraints it faces include the lack of appropriate skills base and access to analytical techniques. The MIT staff still reflect the Ministry's old role of administrating parastatals, rather than developing policy. Therefore, it has no social or poverty analysis capability. Other key institutions involved in the trade policy include the Ministry of Foreign Affairs and International Cooperation; The Ministry of Finance; The Planning Commission; and Non-ministerial organisations such as Tanzania Bureau of Standards, Bank of Tanzania and the Tanzania Revenue Authority.

***The Private Sector**:* Like in other countries, the private sector in Tanzania is considered the engine of economic growth, which therefore has an important role in achieving poverty outcomes. However, one of the main concerns of the private sector is whether private sector development has been integrated in the poverty agenda. Furthermore, the private sector is concerned about the effectiveness of the government in implementing the Growth and Poverty Strategy given the existence of an unfavourable tax regime, high transaction costs and inefficient institutions – all of which add to the cost of doing business and compromise Tanzania's competitive position.

The private sector participants in trade policy process include Confederation of Tanzania Industries (CTI), Tanzania Chamber of Commerce, Industries and Agriculture (TCCIA), Tanzania Private Sector Foundation (TPSF) and other sector business associations. The role of the private sector is to advise the government in the formulation of trade policy and national positions on the issues under the trade negotiations. This is done during national consultations.

The Civil Society Organisations (CSOs): CSOs exist at a number of levels, including the grassroots, media, academia and international and local NGOs, each of which has different types of expertise and interests. In Tanzania, CSOs can be categorised into policy advocacy organisations; organisations supporting self-help groups (SHGs), including retailers; academic and research organisations; and business support providers and cooperatives. Some of them represent the interests of social groups, which are directly affected by poverty. These include among others, rural poor, urban poor, women, children, and orphans.

The main capacity constraints in public and private institutions and CSOs include the lack of analytical skills, legal expertise, strategic skills, negotiating skills and financial resources. It should also be noted that the PRSP, which is a medium term strategy determining budgetary allocations, is also is formulated through the same stakeholders. This is through consultation with the private sector, civil society and donors, including national and zonal workshops. The Vice Presidents' Office coordinates the PRSP, which is under an Inter-Ministerial Committee. The Poverty Monitoring System monitors and evaluates its impact, involving government, CSOs and donors.

12.4 Linking Trade, Development and Poverty

An important issue in the effect of trade on poverty for developing countries such as Tanzania is not only about the extent to which trade policy has impacted on poverty, but identifying the link through which trade can impact on poverty. In the context of Tanzania, our argument follows the discussion by Booth and Kweka (2004), that trade will impact on poverty reduction inasmuch as the following preconditions are fulfilled: (i) the poor are able to participate in the production of tradable goods and services; (ii) there are international opportunities for trade; and (iii) internal barriers to production and exchange of tradable goods are substantially reduced. However, before going into the discussion of the linkages between trade and poverty reduction, it is important to analyse the status of poverty in Tanzania. It should also be noted here that the first PRS was sector based, (priority sectors were identified in 2000-2003), and included some broad trade objectives under the agricultural heading, but the PRSP did not explicitly recognise trade as an instrument of poverty reduction. However, in its second phase the PRS has shifted from a sector-based to outcome-based approach in which broad outcomes are identified, and for which all sectors are supposed to identify strategies for meeting those outcomes. In this second PRS, trade is more explicitly covered and recognised as an important aspect of the strategy (see Section 4.4).

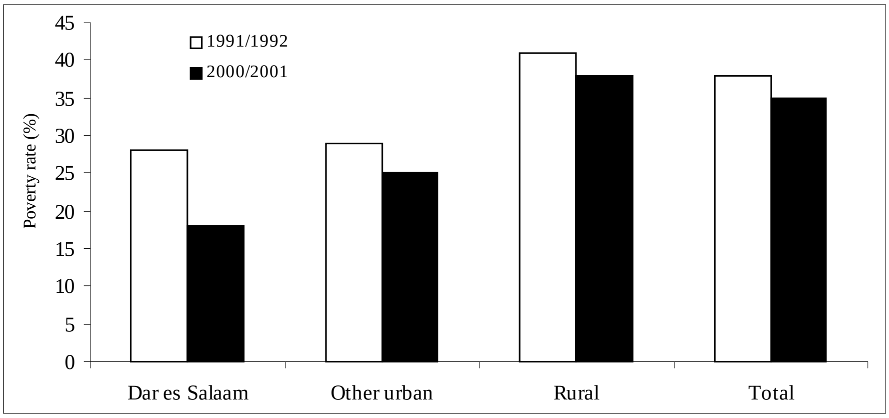
Trends in Poverty Status

According to the various PRS review reports, there has been little progress achieved in poverty reduction though the prospects for substantial decline in poverty are still considered pervasive. Currently, the government has reviewed its poverty reduction strategy to emphasise the growth and employment aspects. However, Tanzania will have to sustain high economic growth rates which it has attained in recent years or even have to surpass it if it is to achieve the poverty reduction target stipulated in the National Strategy for the Reduction of Poverty (NSGRP) of halving poverty by 2015.

According to the census and the results of the 2000-01 Household Budget Survey, around 11 million Tanzanians are below official poverty lines, indicating that they have insufficient income to meeting their basic human needs. This represents about 36 percent of the national population. The most important point to observe is that poverty remains an overwhelmingly rural phenomenon – as when the last comparable survey was undertaken, about 87 per cent of both the poor and the extremely poor live in rural areas. Less than three percent people live in Dar es Salaam (NBS, 2002: 81). The more challenging rural poverty stood at 39 percent (URT, 2003). Also, according to the Household Budget Survey 2000-01, basic poverty stood at 36 percent while food poverty stood at 19 percent. Figure 12.2 shows that poverty has declined in urban centres, especially in Dar es Salaam, from about 28 percent in 1991-92 to 18 percent in 2000-01. In rural areas, poverty shows no signs of abating, which remained above 35 percent between the two periods.

Another basic feature of the profile of poverty is captured by the occupation of the household head and the household's main source of cash income. About 40 percent of individuals in households whose head is in farming, livestock or fishing are poor, compared with 36 percent overall. And, because agricultural occupations are so common, 81 percent of the poor are in such households. Amongst households depending on agriculture, livestock or fishing, those whose principal source of income is livestock are most likely to be poor (59 percent) and those that rely principally on food crops come next (41 percent), followed by those whose principal source of cash income is cash crops (39 percent) in 1990-91.

Figure 12.2: Share of People below the Poverty Line in Urban and Rural Areas



Source: Based on Tanzania Household Budget Survey 1991-92 and 2000-01.

Conceptual Framework of the Linkage between Trade and Poverty Reduction

The starting point is rather conclusive that international trade is crucial for poverty reduction. Recent studies (see Conway, 2004; Winters, 2000) have simplified these links by focusing on three channels that trade and trade policy can directly impact on households, namely: through enterprise/sector (profits, wages and employment); distribution (border price and hence cheap imported products); and government – how government revenue from international trade affects pro-poor expenditures. We extend this framework first to emphasise the complementary conditions through which trade can impact on poverty, and secondly, to distinguish the impact of trade policy on *income* versus *non-income* poverty. We assume that the policy objective of trade policy is to increase income opportunities that are necessary in the fight against poverty.

However, this is only effective if the poor participate in the production and consumption of tradable goods and services. For the poor households that do not, trade policy can still impact on their welfare by affecting the price of the goods and services consumed, but also indirectly by the effect of trade policy on government revenue that is used to finance pro-poor expenditures (e.g. provision of public goods or intervention aimed at improving the living standards of the poor).

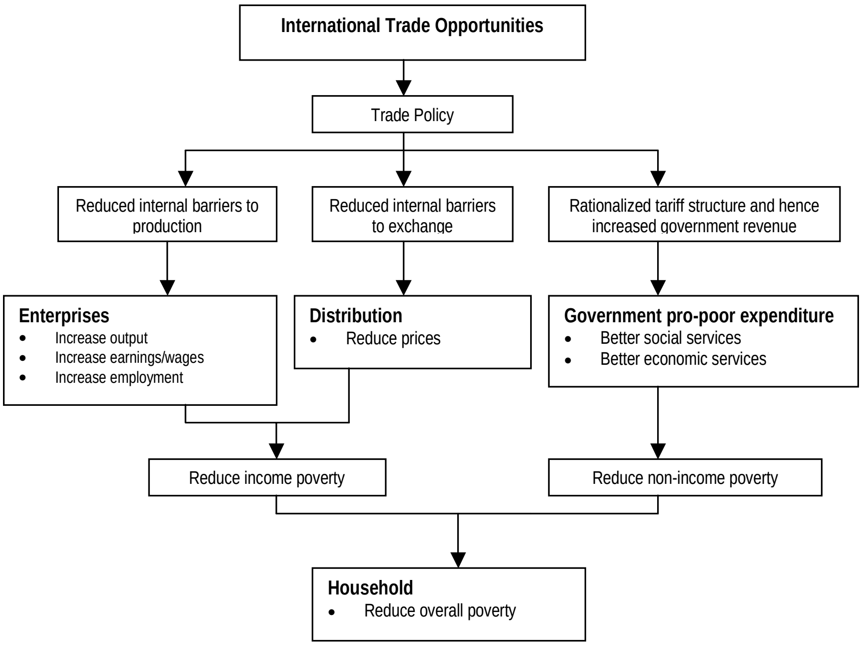
These links are shown in Figure 12.3, where arrows show flow of effect of trade policy to poverty reduction through three channels: firms (income from wage and profits: i.e. factor markets); distribution (price effect of traded goods); and government (pro-poor expenditure from tax revenue effects). These channels can affect poverty upon fulfilling several complementary conditions.

First, the international trade opportunities are assumed to impact the poor through the national trade policy, which effect distribution of such opportunities through its various (policy and non-policy) instruments, e.g. tariff, export promotion, non-tariff barriers (NTBs) and regulation of international trade. Second, the effectiveness of trade policy in delivering these opportunities will therefore depend on the extent to which internal barriers to production and exchange, e.g. infrastructure problems, competition policy, excessive taxation, tariff barriers and other supply constraints have been addressed. These barriers affect the way and extent to which firms will respond to market opportunities, the cost of distribution and consequently the government revenue.[5]

Finally, the three institutions will impact on poverty by responding to trade opportunity in different ways. As a result of increased export and import opportunities, enterprise will provide more jobs, but also recoup profits both of which will increase income of households therefore reducing income poverty. Efficiency in distribution of traded and non-traded goods and services (e.g. lower transaction costs and better trade facilitation services such as infrastructure) will reduce prices of such goods and services to the advantage of consumer thereby increasing welfare through consumer surplus. Low tariff and trade taxes will enhance tax compliance and increase demand thereby widening tax base that is assumed to generate more tax revenue than before liberalisation.

Increased tax revenue will raise to afford government's more pro-poor expenditure such as better social services, including health and education and provision of public goods and specific poverty reduction interventions all of which will benefit the poor especially

Figure 12.3: Conceptual Framework on the Linkage between Trade and Poverty Reduction



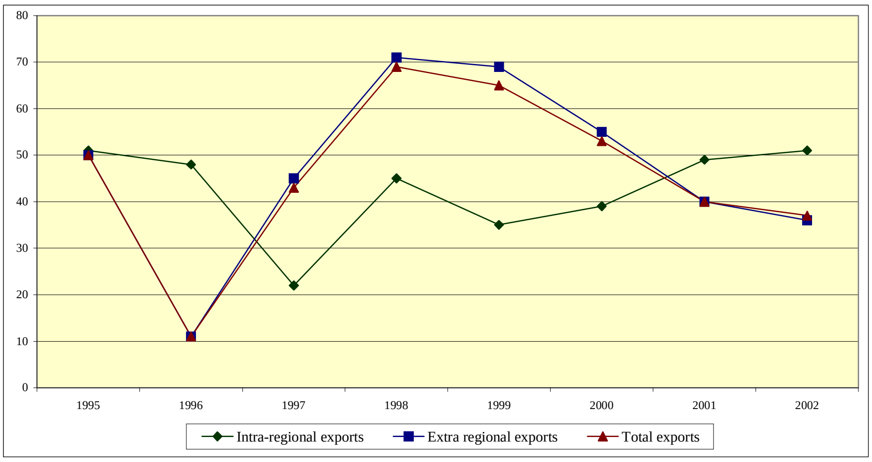
by increasing their quality of life and access to services. Description of the way each of the three channels applies on the Tanzanian economy follows.[6]

What Kind of Economic Growth Would Reduce Poverty in Tanzania?

Some types of economic growth reduce poverty much faster than others. If trade is important for growth, and growth is important for poverty reduction, it is logical that promotion of trade that is significantly linked to poverty is bonus, as it will increase growth and reduce poverty simultaneously. The concern of economic policy should be that the *structure* of growth is as important as the *rate*. In Tanzania, growth that is agriculture-based is far more likely to reduce poverty than growth that is not, so that promotion of agriculture trade becomes imperative (Amani, 2005). Also, based on the evidence from the DTIS (World Bank, 2005a), the country economic memorandum for Tanzania by the World Bank shows that households that are involved in export-oriented sectors (cash crops, tourism, fish ad mining) have lower poverty rates.

Tanzania's agricultural sector employs about 85 percent of the national labour force and accounts for about 48 percent of GDP during 1997-2001. It contributes about 64 percent of the income of the top 20 percent of the population, but as much as 90 percent for the poorest 20 percent. The rate of growth in agriculture is therefore not only a key determinant of overall growth in the economy, but critical for the poorest households in particular (IFAD, 2002: 4). World Bank country analysis for Tanzania agrees with this proposition, suggesting that, because of where the poor live, income growth in rural areas is approximately four times as efficient in reducing poverty incidence as growth in towns.

Figure 12.4: Share of Agriculture in the Value of Exports (1995-2002)



Source: Kweka and Mboya (2004).

For the same reason, growth in the capital is even less efficient as a factor in poverty reduction than growth in smaller towns (World Bank, 1996).

The greatest potential for agricultural growth lies in production for exports (World Bank, 2005b), not only the traditional exports but also food crops that have good market prospects in other countries of the region (Kweka and Mboya, 2004). However, production of foodstuffs for national consumption is constrained by the small size of the market and the slow growth of effective demand, whereas export markets are not limited in the same way. This does not exclude the expansion of internal trade as a source of growth and poverty reduction, but means that it would be unwise to rely only on this source. Tanzania's established export crops are widely grown by smallholder producers in many of the country's regions. However, the centrality of agricultural export growth to national development and poverty reduction is more important than these arguments suggest. Note that recent trends show that Tanzania's agricultural exports have been increasing in the regional markets relative to the non-regional market (see Figure 12.4), which also points out the role of regional integration on poverty reduction.

Another important argument arises from the evidence on the poverty-reducing multiplier effects from export agriculture. The World Bank/IFPRI study confirmed the finding of earlier research that export agriculture has major linkages to the non-farm sector – mainly because of the way it generates demand for consumption goods and services in the surrounding economy, and thus employment or income-generation opportunities for others. Spin-off benefits of this sort are 80 percent for export agriculture, compared with only 20 percent for urban light manufacturing. Even *urban* non-farm incomes benefit more from linkage effects from export agriculture than from increased income from manufacturing. The reason is probably that the first-round benefits are more widely shared in agriculture.

These are not the only kind of linkages that are important from the point of view of the development of an integrated national economy, and thus to poverty reduction, in the long run. Amongst services, tourism has been found to have stronger inter-sector linkages and multiplier effects than traditional sectors of agriculture and manufacturing. For instance, the growth of international tourism has significant effects on the food processing, and beverage and retail trade sub-sectors. In contrast, the low level of agricultural processing and the country's weak manufacturing base limit potential linkage effects in the traditional sectors (Kweka *et al*. 2003).

Why Has Not Growth or Trade Reduced Poverty in Tanzania?

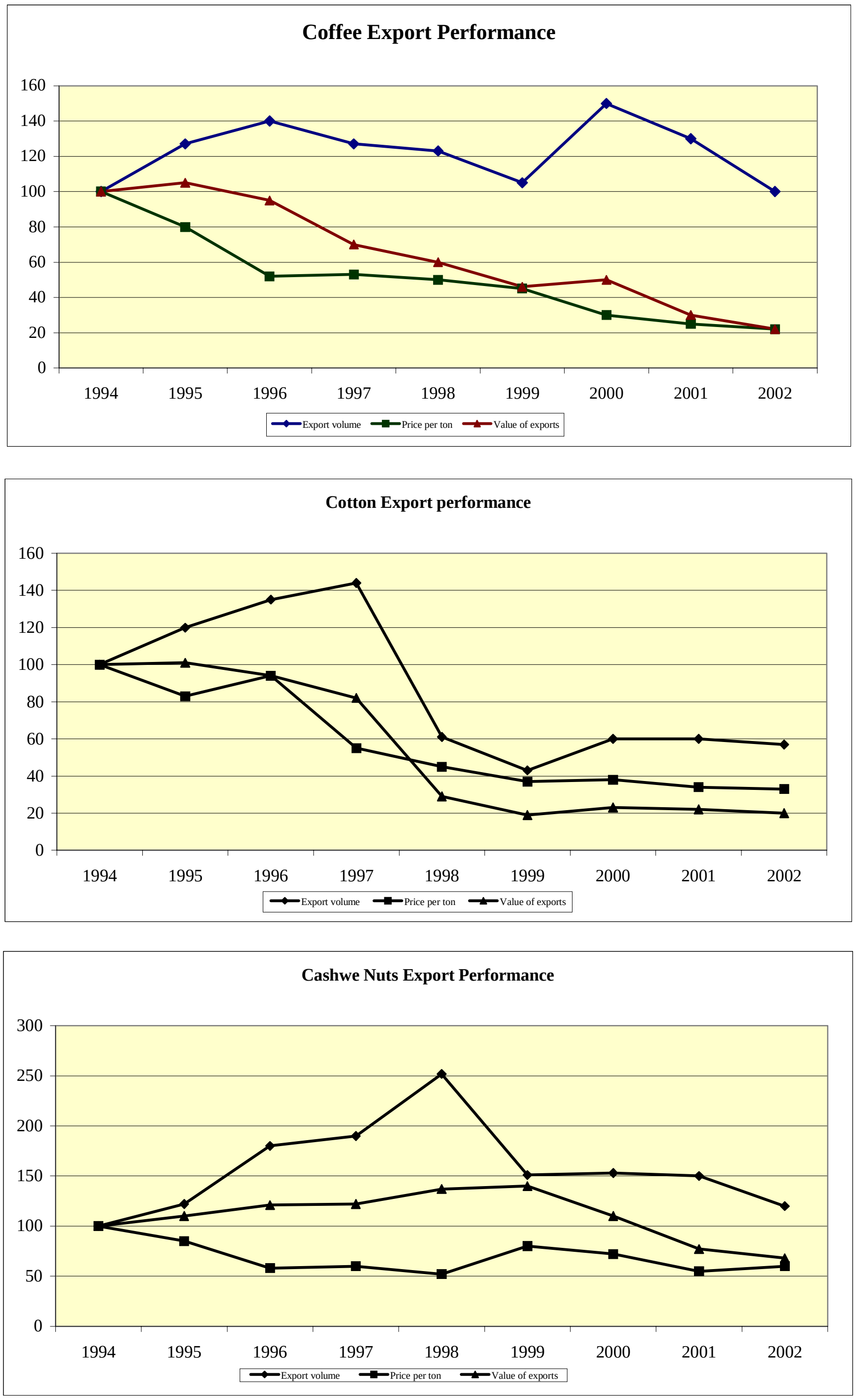
It does not appear from the best available data that income poverty has significantly reduced over the past decade. This is the central finding of the Poverty and Human Development Report (PHDR) 2002, produced by the Research and Analysis Working Group of the Poverty Monitoring System based on the 2000-01 household survey (URT, 2002; NBS, 2002). There are signs that income inequality has been growing, and indications that an earlier trend of improvement in infant and under-five mortality was reversed in the 1990s (URT, 2002: 7, 26).

The PHDR poses, as a central issue, the observation that changes in levels of poverty do not seem to reflect the country's good macro-economic performance in the 1990s. The authors argue that this raises questions about the macro-micro linkages for poverty reduction in Tanzania. The fact that higher GDP growth has been achieved is important. A further acceleration of overall growth will be necessary before substantial effects may reasonably be expected. However, in the context of Tanzania, it will be entirely wrong to attribute lack of substantial progress in poverty reduction to the reforms that have been implemented for nearly two decades now. On the contrary, these reforms set a necessary foundation for sustained growth, which in turn, will be better placed to reduce poverty than in the current initial phase.

At the same time, the structure of the recent growth is a crucial matter. The main driving forces behind the increased growth rate have been mining and services, not agriculture. Yet as we have just seen, it is in agriculture and closely related activities that the bulk of the poor earn their living, and where the poverty reducing linkages are strongest. The major agricultural crops have played a declining relative role, where both internal and external conditions have been unfavourable. For instance, as shown in Figure 12.5, the price per tonne of all major traditional export crops declined between 1995-2003 except for tea and tobacco that remained fairly flat. The decline in price was also associated with a decline in volume of production except for tea whose production has increased consistently, and tobacco that revived after a notable fall between 2000 and 2001.

As noted earlier, export of minerals surged to constitute nearly 40 percent of the value of goods exports in 2004. At the same time, total exports of goods declined relative to services, especially tourism, with services earnings reaching between 43 and 48 percent of total export earnings in recent years (Wuyts, 2003). Little is known about the distributional consequences of the kinds of investments in mining and tourism that have been booming in Tanzania. However, it seems likely that even though they may have other important benefits for national development, and thus for long-run poverty-reduction possibilities, neither have particularly strong poverty-reduction elasticities in

Figure 12.5: Export Performance for Major Crops (1994-2002) (1994=100)



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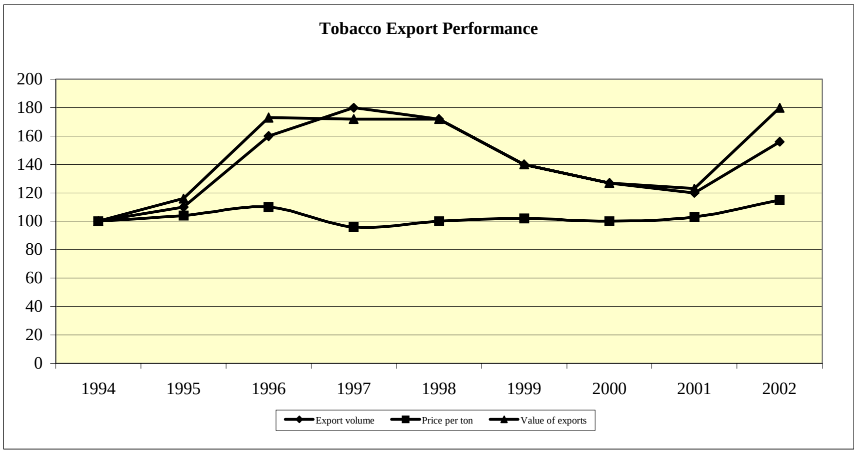

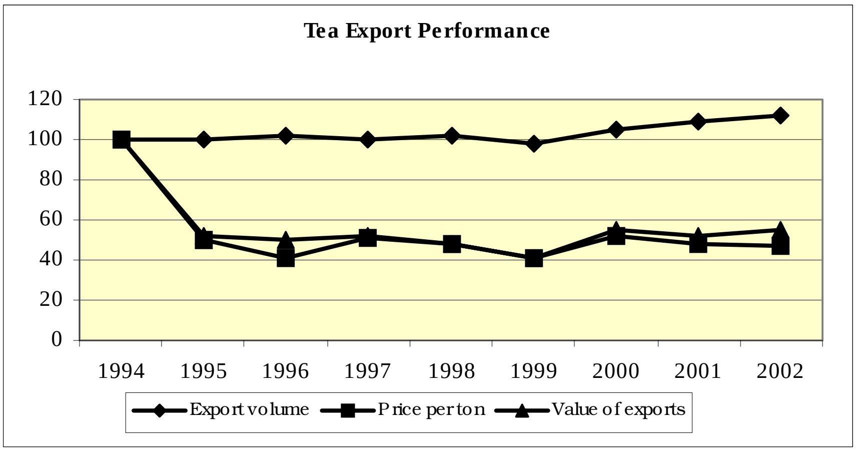

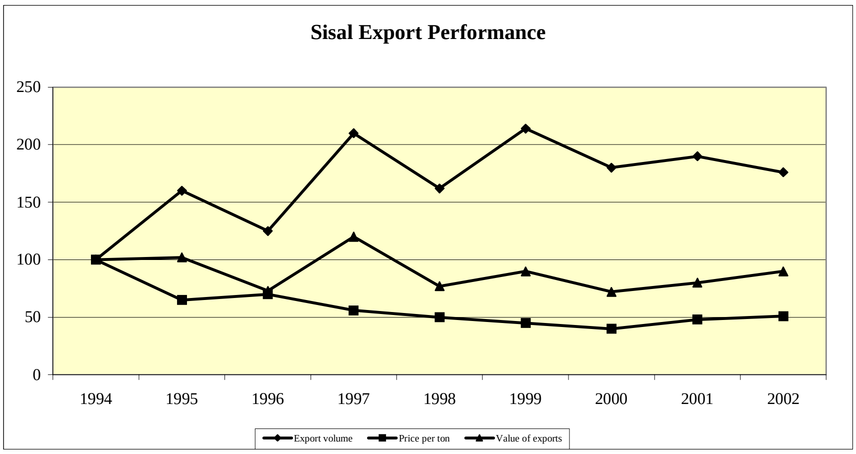

Source: Computed using Data from the Economic Survey (various years).

the short run owing to their susceptibility to capital flight and weak employment generation capacities.

Available studies agree that Tanzania's crop exports have done worse than expected and much worse than those of comparable national export economies such as those of Ethiopia, Kenya and Uganda. This suggests one of the reasons for the observed lack of change in poverty indicators over the period. More seriously, it suggests that substantial poverty reduction will continue to elude Tanzanians unless and until steps are taken to address the factors responsible.

Distribution Evidence – The Role of Infrastructure and Transaction Costs on Prices

Despite the fact that trade and specifically trade policy has enabled the reduction of border prices, Tanzanian consumers, particularly in the remote areas where poverty mostly prevails, have failed to benefit from the reduced prices because of high transport costs resulting from bad road network and inefficient ports. According to Kweka (2004), the larger share of transport costs in Tanzania is attributable to the international transport costs (72 percent). This implies that international trade can only benefit the poor Tanzanians given the reduction of these costs. Tanzania has made commendable efforts to address the transport cost problems. For example, investment in the transport infrastructure is considered one of the priority areas in the PRS1 and PRS2. As a result, the share of infrastructure expenditure (mostly donor-financed) has surged, partly explaining the construction boom. In addition, Tanzania is currently subsidising transportation of agricultural inputs (especially fertilisers) to the biggest grain producing regions in the southern part of Tanzania.

Findings from Booth and Kweka (2004) show that the poor can also benefit from trade liberalisation if the transaction costs are lowered. The rural poor in Tanzania are affected by trade policy whenever it changes the prices of the outputs they produce, relative to the prices of the goods and services they purchase as inputs or for consumption. They will benefit from trade liberalisation generally from: the removal of export taxes on their outputs; the lowering of foreign trade barriers; widely available quality certification services; and action against monopolies and cartels in agricultural distribution and processing within Tanzania. The urban poor may be differently placed. If employed in export industries they will be helped by trade liberalisation, but if employed in import-competing activities they could be hurt by it. All Tanzania's poor will benefit from low or zero tariffs on consumer goods of special interest to them.

Trade Tax Revenue and Government Pro-poor Expenditure Evidence

Akin to many developing countries, Tanzania has a high dependence on international trade taxes i.e., taxes on imports. For example, since in 2001 Tanzania's trade tax revenue contributed about 40 percent of total revenues excluding grants (World Bank, 2004). This implies that international trade tax revenue has a more or less similar impact on budget expenditure to that of donors' financial support (grants and concessional loans), on which the country heavily relies. The latter are expected to contribute about 41 percent of the total national budget in the year 2005-06.

On the export side, Tanzania has made great strides in rationalising export taxation by abolishing nearly all export taxes, except a few royalties that are associated with exploitation of natural resources or measures to discourage export of raw materials that can be used internally to generate higher export value. This includes an export tax of 15 percent on raw hides and skins to assist the struggling domestic tanning and leather industry; and the Fisheries Department that collects royalties on fish exports (rates of which are set at six percent of fob-value, but rather charged at US$0.20 per kg than on an *ad valorem* basis in an attempt to reduce evasion through under-invoicing). Finally, there is a royalty on the export of minerals charged at three percent of gross value for most of the minerals except diamonds which are charged at five percent. The major public concern in Tanzania is that the companies may be under-invoicing to avoid paying larger sums, and such complaints exacerbate the claim that mining has had less or no impact on poverty reduction.

On the expenditure side, a substantial share of the 2005-06 budget has been allocated for implementing the PRS2 (i.e., 'MKUKUTA') priorities under the three clusters: growth and reduction of income poverty; improved quality of life and social well-being; and good governance and accountability. Furthermore, relatively adequate resources have been allocated to economic and social services with a view to ring fencing the achievements of the first PRS. Leading sectors in terms of resource allocation included in the 2005-06 budget are: Works, Health, Education, Agriculture, and Water. According to Ulanga (2005), Tanzania has outstripped many African countries on the absolute amounts of resources expended for poverty reduction purposes.

If 23 African countries that have reached HIPC relief decision points in Africa are compared, it is only Ethiopia that has exceeded Tanzania on poverty reducing expenditure. Given the significant amount of international trade revenue, coupled with a significant amount of poverty reduction budget allocation, it is clear that trade is still an important factor for poverty reduction from the government revenue perspective.

Policy Response on Trade and Poverty

The foregoing discussion has indicated that in Tanzania there is huge potential for trade-led growth and reduction of poverty, but this potential is being under-utilised (Booth and Kweka, 2004). Clearly, two different but related issues are worth reiterating. First, trade performance, especially export response, has not lived up to the promises of the trade liberalisation. Second, the impact of trade policy on poverty reduction has been less significant than expected. Trade policy literature has mostly been pre-occupied with the former issue, where supply-side constraints have largely featured to explain low levels of export response in least developed countries (LDCs) despite the generous trade liberalisation implemented by these countries. Emphasis on the latter issue has occurred in the recent years but the debate is still unsettled.

In the Tanzanian context, we presume the main policy challenge is how to increase export response, which, according to the above outlined conceptual framework, can subsequently reduce income poverty through additional employment and income generated. For this to happen, the complementary conditions identified earlier need to be met. The government has been thriving in the last decade and continues to address these conditions with some successes in two respects. First, by continuing its pace of implementing reforms: establishment of the Business Environment Strengthening for

Tanzania (BEST) programme; formation of Private Sector Development Strategy; and privatisation of basic utilities and civil service reforms.

Secondly, as noted earlier, the government has formulated credible PRS, currently in its second phase (i.e. NSGRP or MKUKUTA). The NSGRP incorporates various strategies for fostering trade-led growth. Trade policy and trade development is incorporated in various cluster strategies; six specifically refer to trade and/or exports. These include the folloiwng policy statements:

- Make trade more inclusive through facilitating expansion of a wide range of enterprises, especially small and medium size enterprises (SMEs) in exporting activities;
- Promote trade and advocate for fair and inclusive globalisation, build capacity to provide trade services to tap into global production, outsourcing and marketing networks, and enhance export guarantee mechanisms;
- Build human capacity in trade negotiations, harmonise standards and improve customs procedures, and enhance on-going initiatives on increasing access for women to local, regional and global markets;
- Strive to reduce the deficit in the current account of the balance of payments (BoP), i.e. increase exports substantially in relation to imports with a view to reducing aid dependency and debt;
- Encourage public-private sector partnership to invest in business training, export and domestic marketing and provide training in quality assurance and establish modern quality-testing centres and laboratories; and
- Upgrade and develop new capabilities in order to maintain the growth of domestic markets and exports and promote specialisation in dynamic exports and encourage increased competitiveness.

The Ministry responsible for economic growth and planning plays the lead role in incorporating NSGRP priorities into the Medium-Term Plan and the Annual Budget. The Ministry of Finance has emphasised that spending ministries demonstrate the link between their in-house budget activities and NSGRP clusters as a condition for acceptable budget submission. This implies that trade development will attract fiscal resources to the extent that trade policy concerns are reflected in the NSGRP.

In the NSGRP, the section dealing with MIT indicates several activities relating to trade policy and development, with the majority of activities focusing on developing the SME sector. The Ministry of Finance is working on a matrix, i.e. the Performance Assessment Framework (PAF) linked to the multi-donor budget support facilities: Poverty Reduction Budget Support (PRBS) and the Poverty Reduction Strategy Credit (PRSC).

For these strategies to result in poverty reduction through trade, we recommend the government to focus interventions on those aspects that can both raise export response and at the same time boost the capacity of the poor to participate in poverty reduction. For instance, provision of extension services, training and input supply to facilitate entry into the production of quality, exportable farm produce; investment in infrastructure to enhance price competitiveness and efficiency in distribution; supporting the establishment of large scale commercial farming that will provide jobs to surplus unskilled labour; and promotion of export markets through an export guarantee scheme, support of market search and provision of incentive to SME exporters.

In conclusion, we emphasise that markets alone cannot deliver growth that will at the same time reduce poverty, hence a need to have PRS. Macro-economic performance and associated reforms can only provide a foundation but alone cannot address practical constraints at the grassroots level, i.e. micro-economic challenges. Similarly, trade and growth cannot address poverty automatically. Mechanisms and action need to be put in place to complement market forces in enhancing growth and poverty reduction.

Suggested Sectors and Issues of Case Studies

As noted in Section 12.1, one of the key outcomes of this paper is to identify sectors to be covered in two detailed case studies of sectors that have respectively benefited from trade liberalisation from those that have not. The case studies will examine, based on stakeholders' perceptions, what it takes to benefit (or not) from trade liberalisation. A key issue not addressed here is how such sectors for case studies are identified. This process is based on information from the analysis of export contribution and the performance of different export sectors to promote growth before and after the major economic reforms that were associated with significant trade liberalisation.

One general point is that the impacts of trade liberalisation in Tanzania, like in many developing countries, has been negative on import competing industries (mostly manufacturing), and positive in export industries, especially non-traditional exports. In this case, we suggest two industries: textiles and fisheries, which have been losers and winners respectively; fisheries because of its expansion in exports, and textiles because of the substantial decline in output, particularly in the mid-1990s, relative to high imports of textiles.

Textile Industries

With trade liberalisation, Tanzania succumbed to import surges and dumping of used or second-hand clothes and other goods of inferior quality. Consequently, 90 percent of Tanzania's textile mills that employed mostly women closed down as a result of liberalisation. Nevertheless, the textile sector displays strong export orientation in terms of the share of domestic output that is sold abroad but also it has high effective rates of protection. Export potential of the sector basically arises from the large share of export sales to industrialised country markets under preferential access conditions including AGOA (US market) and EBA (European market).

Textiles made up about one-fifth of all dutiable exports from Tanzania to the US in 2002–03. In addition, some types of textiles can be produced competitively using labour-intensive technologies, so that Tanzania could potentially have a comparative advantage. These include tanning and dying (batik) that has recently mushroomed in the country, and which have potential for exports in the regional (especially Kenya and Uganda) as well as the US markets.

Despite these potentials, the sector suffers from a number of constraints, including *inter alia*, lack of modernisation of technologies, diversification of products (integrated mills), and low levels of raw material quality. Other limitations include low levels of capitalisation of the plants and unfavourable competition resulting from import and the high cost of production.

Fisheries Industries

Fish and fish products are an important export for Tanzania. In 2003, fish exports made up 15 percent of the country's total merchandise exports, ranking it the second largest export after gold. The fisheries industry in Tanzania has been positively affected by liberalisation of the economy, which started way back in 1986. Between 1990 and 2003, fish exports rose 20 times, from US$8.1mn in 1990, to US$154mn in 2003. There is a strong world market for the two main Tanzanian fish exports – Nile Perch and shrimps – for which world demand continues to exceed world supply. The comparative advantage of Tanzania in fish comes from its very rich fish resources. The fisheries industry also plays an important role in poverty alleviation in the country given the participation of fisher folk whose catch accounts for around 99 percent of the nation's total fish catch.

The constraints faced by the sector include lack of reliable airfreight and lack of cold storage facility at Mwanza. In addition, escalating taxes are a major factor with respect to plans for extending the fish supply chain into new value-added areas. The industry has become subjected to cesses, fees and taxes imposed by several levels of government, thereby eroding the competitive advantage of Tanzania's fish processors *vis-à-vis* Kenya's.

12.5 Conclusion

One clear conclusion emerging from the best available data and literature is that trade liberalisation or trade performance has not led to significant poverty reduction in Tanzania. Several questions arise from this conclusion. First, is it that trade has not impacted on growth or it that growth has not impacted on poverty reduction? Second, is trade linked to poverty reduction? In other words, is Tanzanian trade poverty-reducing? Why or why not? This paper has attempted to shed some light on these questions using the best available secondary data and literature.

Available evidence and data show that Tanzania has implemented significant trade policy reforms: massive trade liberalisation (tariff reduction and rationalisation); abolishing export and related nuisance taxes; reducing NTBs; and improving or simplifying export and import procedures, including trade facilitation services. Tanzania has also implemented a wide range of policy reforms that are complementary to trade policy performance (e.g. macroeconomic stabilisation, restructuring and privatisation, institutional reforms and private sector development) A number of policies on several sectors have been formulated. As a result of these reforms, Tanzania has achieved impressive growth rates in the last decade and has attained credibility in the donor community.

However, the important issue for Tanzania is not so much about whether trade liberalisation has led to poverty reduction, but how Tanzania can increase its trade performance to sustain economic growth. Clearly, even where trade is closely linked to poverty reduction, low levels of competitiveness and productivity in the traded sector will undermine any poverty reducing trade strategy. Despite the significant trade policy reforms, increases in trade performance for Tanzania have only been modest much less diversified. It is high time that policy interventions were made to boost the competitiveness of Tanzania's trade and promote export orientation of the economy in parallel to the notable poverty reduction strategies.

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4 However, there are a couple of export royalties in fish, mining and hides/skins.

5 If tariff or taxes are exorbitant, firms will evade tax or will not grow, thus limiting tax base hence tax revenue.

6 This section draws heavily on the previous study on linking trade to poverty reduction in Tanzania, conducted by David Booth and Josaphat Kweka in 2004 as part of the Tanzania's Trade and Poverty Programme for the Government of Tanzania, as well as draft report on DTIS and CEM (see World Bank 2005a and 2005b, respectively).

13

CHAPTER

Trade Liberalisation and Its Impact on Poverty in Uganda

– ***Geoffey Bakunda***[1]

13.1 Introduction

Uganda has implemented significant economic reforms, including liberalisation of the trade regime since 1987. This has attracted foreign direct investment (FDI), mainly in manufacturing, and contributed to continued economic growth. Uganda's real gross domestic product (GDP) has grown at around six percent per annum on an average and is expected to continue growing at about seven percent per year in the medium term. Uganda views foreign trade as an important stimulus for economic growth and its trade policies aim to contribute to poverty reduction, promotion of employment and diversification and promotion of exports particularly of non-traditional products. These policy objects have been pursued through continuing liberalisation, deregulation, privatisation and participation in regional agreements, particularly the Common Market for Eastern and Southern Africa (COMESA) and the East African Cooperation (EAC). This paper explores the trade-poverty nexus in the context of the Ugandan economy.

13.2 Structure of the Ugandan Economy

Uganda's economy is primarily based on agriculture. The agriculture sector accounts for around 42 percent of real GDP and 80 percent of employment. Coffee is the major agricultural export product. The share of the industrial sector (including manufacturing, mining and quarrying, public utilities and construction in real GDP has increased from about 17 percent in 1996 to around 22 percent in 2004-05. Industrial production in Uganda consists mostly of agro processing. The agriculture sector accounts for five percent of employment. The share of services in real GDP has steadily increased from 38 percent in 1996 to 43.3 percent in 2004-05. The sector contributes 13 percent to employment.

Uganda faces significant economic challenges. Although it has undertaken a number of structural reforms, further trade reform is recognised as being necessary to continue on its path of economic progress. A fundamental weakness in Uganda's economy has been the lack of export growth. This is attributable to insufficient infrastructure, which continues to impair Uganda's economic progress particularly given its landlocked geographical location.

High production costs in Uganda, which are evident across all economic sectors, are the result of poor delivery of utility services, poor transportation, weaknesses and corruption in tax administration and commercial justice, the high costs of accessing capital, lack of skilled labour and low labour productivity. Non tariff barriers (NTBs) mainly technical requirements, e.g. sanitary and phyto-sanitary (SPS) measures in developed countries and emerging markets have also partly impeded the expansion of Ugandan exports.

In recent years, agricultural production in Uganda suffered from drought and coffee wilt disease which affected coffee production and exports. Uganda's economy has also suffered from security problems in the region and civil conflicts on its borders.

13.3 Recent Economic Developments

Uganda's economic reform dates back to 1987 when the government first undertook an Economic Recovery Programme (ERP). This was intended to address deficiencies in Uganda's export competitiveness, introduce market reforms into its agriculture policy, attract more foreign investment and improve the effectiveness of fiscal and monetary policies. Since 1995, Uganda has continued to work closely with the community of international organisations and international donors with the aim to fostering economic growth and poverty reduction.

Much of Uganda's economic success has been due to policies that promoted macro economic stability. Reforms carried out in the financial sector, marketing, taxation, restructuring of government ministries and parastatals, privatisation, decentralisation, rehabilitation of infrastructure and re-establishment of security of persons and property and the rule of law, have also played a significant role. Additionally, Uganda's national strategy for the eradication of poverty, the Uganda Poverty Eradication Action Plan (PEAP) of 2004, also provides a framework for formulating social economic policy. Under the plan, security, roads, agricultural research and extension, primary education and health care and water and sanitation are the highest priorities for medium term expenditures.

The rate of growth for the Ugandan economy has averaged about 5.1 percent since the fiscal year 1999-00, which has been lower than the medium term target of 7 percent. However, this growth rate has been higher than the average growth rate of 2.3 percent for the African continent. This lower than targeted rate of GDP growth in Uganda has been primarily attributed to drought conditions which affected all agricultural production including cash and food crops, with spillover effects on agro processing industries. The effect on coffee was worsened by the coffee wilt disease. Furthermore, increases in the world prices of oil and falls in commodity prices, particularly of coffee, have negatively affected Uganda's economy since 1999. Between 1999 and 2004, coffee export values have fallen by over US$100mn because of a 17 percent decline in output as well as a 25 percent reduction in coffee prices in the world market. As a result of reduced agricultural production, brought about by drought conditions, food prices rose sharply. However, non-agricultural sectors performed better, with the utilities, manufacturing, construction, and transport and communication all registered 8 percent or higher annual growth rates during 2001-2005.

In recent years, fiscal deficit, (including grants) is about 3 percent of GDP and inflation (measured by changes in consumer prices) has dropped from 32 percent in 1990-91 to less than 8 percent since 1994-95. Uganda's gross international reserves increased to cover about five months of prospective merchandise imports. Uganda's economic performance has made it eligible for the Heavily Indebted Poor Countries (HIPC) initiative.

However, because of the poor performance of exports and the delays in the realisation of savings from the enhanced IMF/World Banks' HIPC initiative the debt ratios have not improved since 1999. The ratio of debt service to domestic revenue increased from 17 percent in 1998-99 to 18.6 percent in 1999-00, and since then it has been stabilised at about the same level. The stock of Uganda's external debt is estimated at US$3.7bn as of June 2005.

13.4 Developments in Trade

Traditionally, Uganda has suffered from current account deficit resulting from deficits on trade and services accounts. Deterioration in the external terms of trade over the period contributed to a decline in export earnings from 11.2 percent of GDP in 1994-95 to 7.9 percent in 1999-00 and 9.5 percent in 2003-04. Imports, on the other hand, have been increasing in most years resulting in the widening of the trade balance.

Traditional exports from Uganda include coffee (the dominant export item), cotton, tea, and tobacco. As a result of export diversification efforts, the contribution of coffee to earnings from merchandised exports dropped from some 76 percent in 1999 to around 57 percent (including roasted coffee) in 2003. Diversification has contributed to an upward trend in the share of non-traditional exports such as floricultural products, fruits, vegetables, fish and fish products. Overall, agriculture still accounts for the bulk (90 percent) of Uganda's exports with an increasing share of non-coffee products. Uganda's main imports include machinery and transport equipment, food products, fuels, and chemicals. The upward trend in the share of fuels in total imports reflects the increases in world prices of these products in recent years while the trend in the share of chemicals is partly due to increased imports of medicaments.

The European Union (EU) is Uganda's main trading partner followed by COMESA (Government of Uganda, 2005). The EU is the destination for around 37 percent of total exports from Uganda, and accounts for about one quarter of total imports to Uganda. The sources of imports are more diversified than the destinations for exports. As a result of regional integration, Uganda's trade with the other countries in sub-Saharan Africa (SSA) has increased, and the share of the EU in Uganda's external trade (mainly total imports) to Uganda has declined. Kenya is the largest single supplier accounting for nearly one quarter of total merchandise imports to Uganda, followed by the UK at around 10 percent.

Within the EU, UK is the largest single destination for Uganda's exports. The other major destinations include the Netherlands, Spain, Germany, Italy and Switzerland. Uganda has also been trying to diversify her export markets. Since 1995, there has been a significant increase of exports to Asia and Africa. Although earnings from exports of services grew from US$64.1mn in 1994 to US$182.3mn in 1999 and to about US$500mn in 2003-04, Uganda remained a net importer of services. Total service imports in 2003-04 amounted to slightly over US$650mn widening the trade deficit to over US$100mn. High transportation costs mainly due to Uganda's landlocked situation largely contributed to deficits on the services account where payments for transportation services represented about 1/3 of total services imports in 2003-04.

13.5 Policy Outlook for Poverty Eradication and the PEAP

The proportion of the population living below the national poverty line in 2003 was 38.8 percent (excluding Pader district not on analysis due to insecurity there) corresponding to 9.8 million Ugandans. Income inequality too has risen since 2000 evidenced by the change in the Gini Coefficient index from 0.395 in the UNHS 1999-00 to 0.428 in the UNHS 2002-03. Uganda's Human Development Index (0.493) is 146th among the 177 reported countries with per capita income of US$300 or less in 2003 according to national authorities. Analysis of these statistics show that poverty has increased during the period 2000-05 from 39 percent to 49 percent among households especially those engaged in agriculture and for the proportion of those in crop agriculture whose numbers grew from 39 percent to 50 percent.

The government's medium and long-term focus remains the eradication of mass poverty. The recently revised Poverty Eradication Action Plan (PEAP) is a principle guide to all developmental activities of the central and local governments in the medium term. The PEAP 1997 and Vision 2025 set out the commitment of government to reduce the incidence of absolute poverty from 44 percent to 10 percent and relative poverty to 30 percent of the total population by 2017. While iterations of the PEAP have focused less significantly on trade as a component of poverty eradication, the current PEAP addresses more directly the need to integrate export competitiveness and trade liberalisation into a broad poverty alleviation effort.

Since 1997 the PEAP has endeavoured to address poverty and improved quality of life. However, it can be observed that there has been the over-focusing on agriculture which is traditionally a vulnerable and volatile sector. It is apparent that there is need to focus on other sectors such as the service sector, tourism, information and communication technology (ICT) and small scale enterprise development, energy sector and non-traditional exports such as fish to have meaningful impact on poverty. The other major shortcoming of the PEAP has been the lack of focus on urban poverty.

Uganda has placed great emphasis on private sector development as a major engine for economic growth. The Medium Term Competitive Strategy (MTCS) for the private sector from 2000 to 2005 was intended to target infrastructure development such as transportation and communications networks, regulatory and legal reform, and fiscal policy reforms with a view to creating an environment conducive to, and supportive of, private investment. The MTCS strategy is currently being revised and will be rolled forward.

The Government of Uganda has expanded its efforts to decentralise the services. These efforts have compounded challenges with respect to the strengthening of institutional capacity and developing government's abilities to implement policies particularly at the local government level. Capacity building initiatives are being undertaken in a variety of areas to improve fiscal policy particularly revenue collection as well as budget management. Although Uganda has continued to undertake measures intended to improve governance, transparency and accountability, there are still significant concerns about corruption. Because local governments are increasingly becoming providers of social services under Uganda's decentralisation initiatives, governance issues are becoming more apparent in Uganda. Rural areas lack sufficient human resources particularly in technical and professional areas. The absence of such resources further fuels concerns about the decentralised governments' ability to practice good governance.

In the area of trade policy the government is committed to continuing its efforts to liberalise, simplify, and streamline its trade regime. Existing discriminatory practices on selected imports will be phased out, consistent with a framework of trade liberalisation to be undertaken in the context of the EAC. The government has expressed desire for more technical assistance from donors which will facilitate a process of reaching decisions related to further trade liberalisation.

13.6 Uganda's Trade Policy Framework

Since 1995, Uganda's trade policies are defined in the context of its overall economic development strategy. The Government of Uganda adopted an Economic Recovery Programme (ERP) in 1987. The focus of the ERP shifted in the late 1980s and early 1990s from economic growth and macro economic stabilisation to structural reforms. Following a consultative conference organised by the government in 1994 to discuss the state of the economy, foreign trade has been viewed as an engine of economic growth. There has been intensification of export promotion efforts since 1995.

Uganda's trade policy has been aimed at poverty reduction, promoting employment, economic growth and export diversification and promotion (particularly non-traditional exports). Vertical diversification is to be achieved through further processing of primary export products. Incentive schemes (e.g. duty and tax concessions) were made available to producers and exporters to promote the competitiveness of local products. It was envisaged that trade among developing countries was to be promoted through regional integration (e.g. COMESA). There is government commitment to fully exploit preferential treatment to developing countries under *inter alia*, the US African Growth and Opportunity Act (AGOA) and the Everything But Arms (EBA) initiative.

Since 2000, the Government of Uganda has been committed to trade liberalisation, deregulation and removal of bureaucratic procedures. Trade policy has been aimed at creating a one-stop centre for trade promotion through merging the three trade promotion organisations (Uganda Export Promotion Board, Uganda Investment Authority, and Uganda Tourist Board) into one. However, this has not yet been done and trade promotion is still fragmented and the institutions are still weak.

13.7 Trade Liberalisation and Sectoral Performance

The Coffee Sub-sector

Coffee maintained its lead on exports compared to other agricultural exports in the last decade. However, in recent years, on an average the volume of coffee exports has been falling. For instance, while Uganda exported 3.16 million bags in 2001-02, this figure declined to 2.66 million bags in 2002-03 (UCDA Annual Report, 2004). This has been due in part to declining coffee demand globally as well as low prices.

The importance of coffee in the Ugandan economy and its impact on the livelihood of Ugandans cannot be overstated. Coffee provides employment to approximately five million Ugandans either directly or indirectly. Small holders produce 99 percent of total coffee production. Today, about 340,014 households in 48 districts are established coffee growing holdings. Uganda is the 2nd largest coffee producer in Africa after the Ivory Cost and ranks 9th in the World. Despite this, Uganda accounts for only three percent of world production and therefore has little impact on world pricing. At the same time, over 90 percent of the coffee is exported in raw form with the result that Uganda might benefit from value that could be added by moving up the processing chain. Furthermore, the value of coffee exports has been declining largely as a result of declining coffee prices.

Until 1990 the state owned Coffee Marketing Board (CMB) controlled all coffee marketing – both internal and external sales and prices were controlled at all levels. The CMB worked with a robust system of cooperative societies comprising of five cooperative unions each representing a major coffee growing region. The cooperative unions had member cooperative societies that spanned to the grassroots level. The cooperatives handled all coffee, including extension and support services to farmers up to the level of primary processing. The CMB handled the secondary processing and export of coffee.

During this period, the government through the CMB's price stabilisation fund ensured steady farm gate prices. Farmers were cushioned from wide price fluctuations in the world market and earned steady incomes. This also encouraged farmers to maintain good levels of production and quality. In 1991, the government began the process of liberalisation that is still an ongoing process. All matters pertaining to coffee have been divested by the government to the Ugandan Coffee Development Authority (UCDA), an independently operating parastatal, although the Ministry of Agriculture Animal Industry and Fisheries is charged with overall policy guidance. The minimum price system was abolished and the marketing of coffee and of inputs except planting materials was liberalised.

Prior to liberalisation, the cooperatives were active in boosting the performance of the sector. The creation of the UCDA heralded the full participation of the private investors in the coffee business. These were allowed to compete directly with the cooperative unions at all levels including export. The immediate benefits of increased competition were higher farm gate prices to farmers that rose up to 80 percent of export price and prompt payments. No deductions were made from their earnings. This resulted into positive improvement in farmers' welfare. Farmers were encouraged to plant more coffee. However, sooner than later, the quality of coffee beans started to decline that increased costs and losses in the coffee chain. By 2000, the cooperative system in Uganda had completely collapsed. Besides, farmer productivity started to decline due to absence of support and extension services from cooperatives societies. Government extension services in this sector remained non-existent.

Furthermore, the removal of the CMB monopoly in the export of coffee together with the collapse of the cooperatives attracted foreign investors alongside a few local firms into secondary processing and export. The participation of foreign investors allowed for transfer pricing as the majority were subsidiaries of foreign multinational companies (MNCs) in the coffee trade. The result was that export revenue from coffee did not reflect actual world market prices thus partly distorting national economic performance indicators.

In spite of the 17 percent reduction of coffee production since 1999-00, Uganda is said to have maintained a comparative advantage in coffee production. As a result, the government is continuing to focus efforts on coffee as one of the prime agricultural sub-sectors that can have a major impact on its poverty eradication efforts. Indeed coffee rejuvenation is an important part of Uganda's poverty eradication strategy (through the HIPC related poverty action fund). For its part, UCDA subsidises plantings, but not fertilisers or other chemicals. Since the year 2001-02, the government has procured seedlings for distribution to farmers which resulted in an additional 8,400 hectares of Arabic and Robusta coffee being planted. This was expected to produce an additional 16,800 tonnes of coffee beans from 2005.

The export of raw coffee ('green beans') pre-dominates the sector. The government, however, wants to add value in this industry and it is looking for investment although this may be difficult to attain since *inter alia*, the investment needed is heavy and the human resources required are rare. Imports of coffee and coffee products are subject to customs tariffs ranging from 10-25 percent to which is added with the two percent import licence commission and four percent withholding tax.

What emerges from the foregoing is that liberalisation of the coffee sector seems to have only created short term benefits to the poor. Farm gate prices increased for an initial period not exceeding five years. Afterwards, the coffee sector embarked on a steady downward trend in terms of farm gate prices, incomes at different levels in the value chain. While it is true that world market prices for coffee have been declining since 1997, the negative effects on the coffee sub-sector and the Ugandan economy in general seems to have been exacerbated by the involvement of multinational firms through their internal pricing practices. The collapse of the cooperative system in Uganda seems to have further weakened the sub-sector. Finally, like any agricultural sub-sector, the coffee sub-sector has been subject to vagaries of nature that have threatened to extinguish it completely in the absence of high scientific knowledge and capability as well as other resources to circumvent them. The coffee sub-sector is currently one of the most rapidly declining agricultural sub-sectors of Uganda's economy.

The Cotton Sub-sector

Cotton constitutes the second most important cash crop produced by Uganda. It is exported primarily in bales as raw cotton. Cotton has fluctuated since 1995 but the government is committed to efforts to revive the cotton industry both because it is a major source of revenue for many rural farmers who are not able to produce coffee and because Ugandan cotton is generally of high quality and enjoys a comparative advantage in the region. The industry (including textiles), employs up to 1.4 million people, including farmers, ginners, textile workers, middle men, oil millers, transporters and exporters, etc.

Until 1993, like all the major cash crops in Uganda, the cotton sub-sector was managed largely by the cooperative movement in the cotton growing regions. Four cooperative unions –Nyakatonzi, Bukedi, Lango, and Teso – managed over 90 percent of the farmers and the cotton product. The cooperatives not only supervised the farm activities but also purchased, transported and processed cotton ready for export. Over 90 percent of the cotton ginneries were owned by the cooperatives. The cooperative unions had member cooperative societies that spanned to the grassroots level. The cooperatives handled all cotton including extension and support services to farmers, up to the level of primary processing. Private companies handled subsequent stages of processing. However, these were few with limited capacity and handled only a small portion of the cotton output. This left the larger portion of lint cotton for export. During this period, the cooperative societies through their export marketing agency UNEX maintained a price stabilisation fund that ensured steady farm gate prices. Farmers were cushioned from wide price fluctuations in the world market and earned steady incomes. This also encouraged farmers to maintain good levels of production and quality

Like their counterparts in the coffee growing regions, by 1999, the cooperative societies in the cotton growing regions had collapsed and cotton marketing left to private operators. Although the cotton sub-sector was a major culprit of the political instability in Uganda in the 1970s and 1980s, the collapse of cooperatives due to private sector competition seems to have had a major brunt. Output has remained far below the 1970 level when the country had larger acreage under cotton and also registered high levels of farm level productivity. This is partly attributed to the under functioning of the government extension services. In addition to the absence of support from cooperatives, farm gate prices did not significantly improve with liberalisation. In part, this has been due to the decline in international prices which fluctuate widely. Although it was widely anticipated that liberalising would substantially attract private sector investment at different levels of the cotton value chain, minimal vertical integration has occurred. Exports of cotton lint have continued while the few textile and garment manufacturing firms continue to import yarn and textiles.

Since 1994, the regulatory, development and commercial responsibilities for the cotton sub-sector has been residing with the Cotton Development Organisation (CDO), a parastatal institution. The CDO is active in setting standard for cotton seed and lint, producing, processing and distributing cotton seed, and announcing cotton prices at the beginning and end of the cotton growing season. The CDO's role is currently under review by the Ministry responsible for Agriculture, which is assessing what changes, if any, should be undertaken with respect to the CDO's activities in a more liberalised economy. Customs tariffs on cotton and cotton products range from 10 percent to 25 percent and average 22.5 percent. Like other products, imports of cotton and cotton products are subject to the two percent licence commission and four percent withholding tax.

What seems to emerge is that a major factor that affected the cotton sub-sector has been the political instability and insecurity experienced for a long time in the cotton growing regions. However, when the sector was liberalised, private sector competition in the purchase and primary processing of cotton accelerated the demise of the cotton cooperatives that had for long supported farm level production and productivity. Consequently, the increase in cotton production has failed to match the 1960s and 1970s levels. Similarly, because the expected vertical integration of the sector through substantial private sector investment has not occurred, the effect of liberalisation on the sector in the last decade seems to have been more negative than positive.

Other Agricultural Sub-sectors

Tea has been a significant contributor of export earnings for Uganda although like coffee it has suffered similar difficulties, such as lower prices and reduced production. Some 22,100 tonnes of tea were exported in 1999 down from 23,355 tonnes 1998. This reflects a 6.4 percent fall in production, from 26,400 tonnes in 1998 to 24,700 tonnes in 1999. This was in contrast to the increase in acreage, which rose by six percent in the same period. The lower production was due to the severe drought that affected the south western and central regions in Uganda. About 5000 households are well established tea farm holdings in the districts of Kyenjojo, Kanungu, Kibaale, Hoima, Bushenyi, and Kabarole. In 2003-04 18 million plantlets were ready for off-loading. Under research, rehabilitation of the gene bank (149) was accomplished and a nursery shed for 30,000 plantlets was erected. However, challenges include the delayed off-loading of the seedlings from the nursery owing to limited funds which push up the cost of maintaining the seedling in the nursery.

Tobacco production is of increasing importance to Uganda, as 80 percent has been targeted for the export market. In 2001-02, the government raised excise duties on cigarettes from 122 percent to 130 percent, and the duties remained at the level of 130 percent by 2005. Commercial floriculture is still a relatively new sub-sector that was started in 1993. This sub-sector has expanded from one farm in 1993 to 20 farms with 75 hectares in 1997-98. The rapid expansion has included shipment of roses and other flowers to the Netherlands from where Ugandan flowers compete successfully in 10 different markets. Uganda earned US$30mn from flower exports during the 2000-01 season and this steadily increased to over US$70mn by 2003-04.

A variety of fruit and vegetables is commercially produced but their exports have been limited, accounting for approximately US$2mn in 1998. The primary market for these goods has been the UK, Belgium and Sweden. The volume of exports has been expanding with an annual growth rate of 48 percent between 1994 and 1998. Bananas are the mostly cultivated food crop in Uganda. Annual production is estimated at 8.5 million tonnes, accounting for 15 percent of world production. However, banana production has been primarily meant for domestic production, with per capita consumption the highest in the world. In addition to providing food, bananas ensure income to farmers throughout the year, play a key role in import substitution, provides soil surface cover, prevent soil erosion and serve as feed for livestock. A 15 percent customs tariff applies to imports of edible vegetables, certain roots and tubers, edible fruit and nuts, and peel of citrus fruit and melons.

The livestock sub-sector currently contributes an average of 17 percent to 19 percent of the agricultural GDP, and 7 to 9 percent of the national GDP. It has expanded steadily since 1995, growing at an estimated 2.2 percent per annum. The diary industry is estimated to contribute 40-50 percent of the livestock GDP. It is estimated that mixed farming smallholders and pastoralists together own over 90 percent of the national cattle herd. From an economic point of view, cattle are the most important of all the livestock, although goats and to a lesser extent sheep, pigs and poultry make significant contributions to the economy and the diet. The milk export earnings were estimated at US$3mn in 2003-04, although this is expected to drop because of restrictions in the Kenya and Rwanda markets.

The dairy sector was liberalised in the early 1990s allowing private sector participation in the sector. The government owned Dairy Corporation, which enjoyed monopoly in the buying, processing and marketing of milk, owned milk centres in all the milk producing areas of the country and a milk processing factory in the capital city, Kampala. The Dairy Corporation controlled milk prices and paid farmers on a monthly basis. In 2000, the government fully liberalised the sector and created the Dairy Development Authority (DDA) to regulate and promote the development of the sector. Currently, the sector comprises of farmers, traders, processors and consumers.

Since liberalisation of the sector in 1991, a number of private operators were attracted into the sector – both as commercial farmers as well as processors. The participation of private processors created impetus for small dairy farmers to increase milk production. Unfortunately, most of the processing firms have since closed shop because of unpaid loans and general lack of competitiveness. There is also a limited domestic market for milk and milk exports that has not grown much.

The Manufacturing Sector

The manufacturing sector in Uganda is characterised by small scale processors of agricultural commodities (food processing), and production of basic consumer goods, beverages, tobacco, textiles and apparel, leather and leather products, wood products, metallic products, clay products, cement and chemicals. Capital goods industries are still few in number. Industrial output has grown by about 10 percent since 1999. The increase in output is primarily attributed to improvements in the sugar, electricity and soap industries.

Capacity utilisation has been very low at less than 20 percent for most industries. Many industries are dependent on imported inputs (i.e. steel 9 percent, plastics 94 percent, paper 94 percent). As most industries are high cost producers this affects the international competitiveness of Uganda's manufactured products. In general terms, Uganda imports most of its manufactured goods and local production remains insufficient to meet her needs. A recent study by United Nations Industrial Development Organisation (UNIDO) identified eight key challenges facing Uganda's manufacturing sector: (i) lack of competitiveness as a result of high costs due to low productivity and quality; (ii) outdated technologies; (iii) few agro-food processing industries; (iv) poor product quality; (v) poor technical/ business information; (vi) inadequate institutional support especially for SMEs; (vii) scarcity of investments; and (viii) poor industrial infrastructure facilities.

A recent survey conducted by the Uganda Investment Authority (UIA), established that transport costs are much higher in Uganda than in neighbouring countries. Other infrastructure costs such as power, water and telecommunications are also relatively inefficient, which contribute to the difficulties industries in Uganda encounter. These high costs along with Taxes on inputs are areas in which the government has to take action. During the period 1991-98, total investments in Uganda amounted to US$1.43bn of which manufacturing projects accounted for about US$677.7mn (47 percent). In 1998, the UIA licenced 2,021 projects, of which 1,051 were in the manufacturing sector (52 percent). Employment generated by total investment is estimated at 81,972 of which 42,012 jobs were ear-marked for the manufacturing sector, constituting 48 percent of total jobs created. Within the manufacturing category, agro processing accounted for about 58 percent of the total.

The simple average rate of customs tariffs in the manufacturing sector has been 8.9 percent. The maximum rate of 15 percent has applied to imports of consumer gods. With the establishment of the East African Customs Union in 2005, the average tariff rates are zero percent for capital goods, 10 percent for intermediate products and 25 percent for final consumer goods.

What seems to emerge from the foregoing is that although the index of industrial production has fluctuated widely, in overall terms, Uganda's industrial sector seems to have benefited from liberalisation policies since the early 1990s. The sector has benefited from substantial investment (mainly FDI) which has averaged approximately 50 percent of total investment into Uganda since 1991 in terms of number of projects and investment value as well as jobs created. However, liberalisation seems not to have positively impacted on the cost of manufacturing. The cost of most utilities such as electricity, fuel, and telephones has remained relatively high keeping the overall costs of manufacturing higher than most neighbouring countries. Partly, this has been a result of high taxes maintained by the government in a bid to raise sufficient revenue.

The Services Sector

The services sector in Uganda is made up of traded and non-traded sub sectors. The services sector represents a promising sector which contributes 42 percent of GDP. Growth in the service sector has nevertheless lagged behind but it remains a sector that has more potential than any other including the main agricultural sector. In 1999-00, services grew by 6.2 percent compared to agriculture's 1.6 percent. Growth in the services sector is now projected to be highest in transportation and communications (9 percent) followed by construction (8.5 percent) and electricity and water supply (7 percent). The growth in transport and communication services has come mainly from increased access to telecommunication services, which expanded by 35 percent. In addition, Uganda has a track record of being one of the best providers of high quality social services in East Africa particularly education. Other service sectors with great potential include tourism, air transport and ICT.

Until recently, Uganda has not had an overall policy objective for the services sector. During 2004-05, a national services export strategy was prepared for the first time. However, trade promotion activities have targeted eight service sub-sectors: education services; medical services; ICT; printing and publishing; financial services; and air cargo logistics and an inland port. However, from the perspective of Uganda's participation in the multilateral trading system, the main service sectors include banking and financial services, tourism, transport and communication services. Uganda has already made certain commitments in tourism and telecommunication services to the WTO and preparations are also in advanced stages to try to make commitments in other services within the frame work of Uganda's requests and offers.

The Education Sub-sector

Government policy on education has been to encourage private investment in the sector to supplement government efforts. However, since 1996, the government has focused on provision of free primary education. The dramatic increase in private sector participation in education started in 1993 with the admission of the first cohort of private students at Makerere University, then the only university in the country. Since then, all levels of education have been opened up to private sector investment. Today, there are 16 universities only 4 of which are public universities. The rest are private. In addition, private investment has been highest at secondary level. Today, out of 980 secondary schools, 400 are public while 580 are private. About 60 percent of secondary schools therefore, are private. With regard to primary education, the government introduced Universal Primary Education (UPE) in 1996. All primary school going children now have access to education. Primary school enrollment increased from 2.5 million to 8.7 million by 2004 (Government of Uganda, 2005). The introduction of UPE has enabled millions of children from poor families particularly in the rural areas to access primary education. However, there is increased private investment at this level especially in the urban areas which has created competition from private schools.

In general, the involvement of the private sector in primary and secondary education has had several effects. Firstly, standards of education in government schools have tended to be poorer (also on a steady decline) than in private schools. Apart from the fact that the best teachers are attracted to private schools where they are offered better salary packages, the student-teacher ratios in government schools have tended to be very high (well beyond the standard of 40:1). Secondly, as a result of relatively poor standards in government schools, some parents increasingly prefer to send their children to private schools so that they could acquire better education, which increases the cost of education to poor households.

At tertiary level, liberalisation has had several consequences. Firstly, the level of tuition charges has steadily risen. Private entrepreneurs have to recover their costs of investment. Secondly, the best teachers have crossed over to teach in private schools which, overall, offer better salaries than government supported schools. Thirdly, apart from a few historically good government supported schools in and around Kampala City, general facilities and infrastructure in government owned schools are below those in private schools and are declining.

Currently, there is an improved primary education curriculum that emphasises problem solving skills to improve the capacity of pupils to integrate into the Uganda's workforce. There are investment incentives availed to encourage the development of secondary schools, facilities and infrastructure, advances in ICT along with the required personnel and training equipment. There is increased potential for exporting education services within the market of the regional organisations to which Uganda belongs including the EAC and COMESA. The use of English as a common language of instruction at all levels of education and training offers the education sector in Uganda the needed competitive edge over the sector within the region.

The sector is however still faced with certain constraints that include:

- A lack of a well defined regulatory framework for the education sector and delays in adapting the national curriculum to international standards;
- Inadequate infrastructure, lack of a coherent strategy for attracting foreign students at institutional and sectoral levels; and

- Perhaps more importantly the higher cost of acquiring Information Technology connectivity.

The education sector in Uganda presents great potential for export of educational services and this has been vindicated by the growing number of foreign students hosted by Uganda from most English speaking countries of Africa. This has occurred at all levels of education although students from Western Europe, Asia, the Middle East and North America are registered in various educational institutions in Uganda.

The Communications Sub-sector

Telecommunications

In 1996, the government decided to implement broad utility sector reforms including the telecommunications sector. The reforms included separating the former Uganda Posts and Telecommunications (UPTC) into the Uganda Postal Ltd. 100 percent government owned and Uganda Telecom Ltd in which government owned 49 percent and detecon – the core investor has the majority share of 51 percent. The Uganda Communications Commission (UCC) was created in 1998 as an independent regulator of the communication sector in addition to being an advisor to government on communication policy. A second national operator MTN Uganda was licenced and started operation in October 1998.

As an incentive, the two national telecommunications operators were offered a duopoly exclusivity of five years for voice, fax and leased lines up to 2005 after which these services will be open to full competition. As a result, this has created and still has a potential to create a wide range of investment opportunities in this sector. For example, during the exclusivity period, it is permissible for the major licence holders to offer services in the exclusive category in partnership. Otherwise sub-sectors like internet paging and courier and public payphones (using lines from major operators) are fully open for competition.

Currently, there is one national postal operator, three mobile phone operators, 20 internet service providers, 100 private FM stations and over 20 courier service firms. The two national telecommunication operators are permitted to provide basic telephone services using any technology available to them provided that acceptable quality standards are met. For purposes of data transmission, the market has to use the services of those companies alongside 20 minor operators all of whom are engaged mainly in the production and issue of postage stamps, pre-stamped envelopes, aerograms and international reply coupons, the renting and leasing of postal office boxes and the delivery of letters.

The communication sector is growing in relative strength especially given the substantial investments designed to provide adequate quantities and improved efficiency in the sub-sector. Additional benefits that have also accrued to the sub sector following its liberalisation include competition and the growing availability of skilled and experienced human resources. Weaknesses however still remain and among others include high rental and construction services, high tax and advertising costs.

Air Transport

The Civil Aviation Authority (CAA) regulates the air transport sector. The CAA is a corporate established under the CAA Statute No.3 of 1994 (although it was *de facto* operational from 1991). The cardinal objective of the CAA is to promote the safe, regular, secure and efficient use and development of civil aviation inside and outside Uganda. As of 2001, Uganda had concluded bilateral air service agreement (ASA) with 12 countries although this had increased to 20 in 2002. Eleven international airlines have scheduled operations to and from Entebbe International Airport serving 11 destinations. Assessments of a few indicators regarding the performance of the sub-sector indicate that:

- Passengers through Entebbe international airport grew at an average of 9.6 percent per annum during the period 1991 to 2004.
- Domestic passenger flow at Entebbe international airport in the period 1991 to 2004 grew at 24.42 percent per annum.
- Cargo traffic statistics in the same period indicate that there was a growth of 22.79 percent. However, between 1998 and 1999, the volume of cargo declined by 17 percent largely on account of the ban of fish exports, the deterioration in the terms of trade that depreciated the exchange rate. The fall in air freighted imports was unfortunately not fully offset by an increase in exports largely on account of the decline in air freighted cargo including fish and others.

The above indicators show an improvement in the air transport sector that could be attributed to the liberalisation and regulation of the sector. Spurred by government supportive policies, a positive expectation has been on the horizon.

The Financial Sector

In May 1987, the government of Uganda embarked on the Economic Recovery Programme in order to address the weaknesses in the economy and the financial sector in particular. The programme was supported by credits from World Bank, International Monetary Fund (IMF) and other donors in line with the World Bank Country Assistance Strategy (CAS). The main focus of the programme was on macro economic stability, liberalisation of foreign exchange trade, price and marketing systems. The Government of Uganda also put in place conditions to improve the incentive structure and business climate so as to promote savings mobilisation and investment as well as the rehabilitation of the country's economic social and institutional infrastructure. By 1992, the Government of Uganda had recorded considerable progress and real GDP was growing at an annual average of 5.9 percent between 1987 and 1992. Inflation reduced from 240 percent to 30 percent. The exchange and interest rate regimes were fully liberalised by 1994 and price controls were eliminated. In spite of these achievements, the financial sector remained weak.

In 1993, the Government of Uganda sought more financing from the World Bank and IMF under the Financial Sector Adjustment Credit (FSAC) programme. Under FSAC programme, the legal and regulatory framework was strengthened with five statutes enacted. These include Bank of Uganda Statute 1993, Financial Institutions Statute 1993, Non Performing Assets Recovery Trust 1994, the Capital Markets Statute of 1996, and the Insurance Statute of 1996.

In general, the financial sector in Uganda is currently faced with a number of challenges. The turbulence in the financial world placed supervision of financial institutions at the macro economic centre management. To this extent therefore, building of an effective financial system through the application of on sight and off sight inspections of financial institutions and reduction of regulatory discretion and forbearance in the area of the intervention framework has been the top agenda of the central bank. The financial outreach is still low and the need to take advantage of the most recent technological advances can not be under-estimated. Gaps also exist in the area of medium to long term financing and the requirement of small and rural borrowers and savers is yet to be satisfied. The disparity between the deposit and lending rates remain wide and continue to reflect the structural problems within the banking system.

Tourism and Travel

The tourism and travel services sector is one of the fastest growing services sectors in Uganda and indeed one of the two service sectors that Uganda has already made commitments on at the WTO. Available data shows that the sector has been growing at an average annual rate of 23 percent during the period 1992 to 2004. The sector remains highly dependent on international visitor arrivals with very limited growth in domestic tourism activity, and continues to benefit from official government recognition for its importance to the economy and the image of the country internationally. Consequently, the sector has attracted some government promotion. In 2000, for instance, the tourism industry contributed nearly 30 percent of total planned investment in Uganda. Investment in tourism has been directed to expanding capacity to meet the growing tourist influx into the country over the years. Between 1998 and 2000, the sector benefited from about 26 investment projects with total planned investment of more than US$400mn although this figure has declined substantially in 2004. Average annual investments have remained at less than US$50mn in 2004 most of which has gone into hotel and accommodation services.

Consistent with the relevant General Agreement on Trade in Services (GATS) classification, the tourism and travel sector in Uganda has basically four broad categories of firms or services. These are hotel and accommodation services, tour and travel operators, international and regional conference services, and other auxiliary services. The size of the industry is relatively small by international standards dominated mainly by the accommodation services sub-sector. Despite the growing importance of the tourist sector in Uganda, the sector itself still faces major challenges. One of the challenges concerns leakages in tourist industry incomes that are effectively not realised and retained within Uganda. Although Uganda has experienced strong growth in the industry as exemplified by the growth in arrivals by 123 percent between 1992 and 1999, the performance of the industry only resulted in a 16 percent growth in tourist expenditures or incomes to Ugandan tourist service providers over the same period. Clearly, this represents a disparity which highlights the impact of leakages on and the uneven distribution of tourist incomes.

Beyond the common tourism services, it has been argued that GATS classification of tourism services may not adequately cover Uganda's tourism export interests such as environmental issues, cultural values and heritage, community interests, crafts, and the entire curio industry. Air transport still remains largely excluded from the GATS and yet it is one of the services sectors that afford Uganda access to its tourist market. Given the current framework of air transport remaining under the existing bilateral negotiated form, air transport therefore will continue to remain as a bastion for uncompetitive practices for which continued leakages will continue to occur and to deny mainly developing countries to benefit from the more liberal tourist market.

13.8 Emerging Issues

Economic Growth and Stability under Liberalisation

Although there was a steady increase in economic growth during the period of liberalisation averaging 5-6 percent during 1995-2005, this was not accompanied with reduced income inequality, i.e. income inequality seems to have widened. The period experienced wide fluctuation in poverty levels ranging from 56 percent to 38 percent. While there was a steady reduction in poverty levels during the period 1995-2001, this seems to have reversed and increased to the level of 49 percent in 2005.

Regarding productivity, agricultural productivity seems to have suffered during the period of liberaliaation largely due to a breakdown in agricultural support systems. Although productivity in the service sector seems to have improved due to increased competition and improvements in the regulatory frameworks, minimal improvements in manufacturing productivity seem to have been registered due to increased competition from imports. In the case of economic stability, this has been maintained under liberalisation. Inflation has been contained at levels between 5 percent and 11 percent during the period under review while government reserves increased from about US$300mn in 1994 to US$1bn by 2003.

Households and Markets under Liberalisation

The importance of trade liberalisation in Uganda has been that it has allowed freedom of economic activity. But this freedom has constrained the out-competed participants, especially rural poor farming households. These households have been still living in poverty because of constrained gains from the sale of their output. Because the role of the state was minimised under liberalisation, the relatively bigger private producers and buyers usurped the economic profits from the poor. This was exacerbated by the collapse of the co-operative unions and the privatisation of government companies that were involved in agricultural produce processing and marketing.

Regarding border price shocks, fluctuations in international commodity prices got directly transmitted to poor households. This has been experienced particularly in the traditional cash crop sectors of coffee, cotton, tea, and others like hides and skins. Similarly, the liberalisation of petroleum products has made the economy increasingly vulnerable to fluctuations in international petroleum prices. Coupled with the high tax on fuel, this has made the cost of transport relatively more expensive. In the case of tourism, it has been affected mainly by insecurity in major tourist areas.

Some markets were created while some were destroyed. Examples include the foreign exchange market that was created and the domestic commodity market chain that was destroyed. In the manufacturing sector, the emergence of counterfeit goods has been a key phenomenon. Trade liberalisation seems to have been faster than the ability of domestic regulatory institutions to regulate markets effectively. In the majority of the sectors, households responded poorly to domestic market liberalisation. Because over 70 percent of households are rural and largely semi-illiterate, response to market signals is usually less than adequate. No spillovers seem to have been witnessed in any particular sector.

Overall, trade liberalisation has increased vulnerability of the poor in Uganda. Not only are the poor fully exposed to external price shocks, both as producers and consumers, nut also they have lost a large proportion of production and market support hitherto enjoyed before liberalisation. The cooperative movement and system has virtually collapsed and the farming households currently have no source of backstopping support.

Markets under Liberalisation

Price fluctuations are a perennial feature of agricultural prices world wide. Uganda has been no exception. Since liberalisation, price fluctuation has been the norm and, also, prices have been declining in overall terms. This has correspondingly negatively affected household incomes because only modest increases in production have been witnessed over the period. Most rural farming households, unless assisted have little ability to effectively respond to market signals. While the prices of most of the traditional commodities have generally been on the decline, this was not accompanied by crop diversification. The absence of crop diversification to more market driven food crops like rice and wheat meant that household incomes have correspondingly gone down in tandem with international commodity prices.

The most notable effect of liberalisation and deregulation has been the collapse of the cooperative movement and system. Before liberalisation, over 70 percent of agricultural production was organised under the cooperative system. The collapse of the cooperative system meant that nearly all existing price stabilisation mechanisms either collapsed or are not functioning. This has occurred amidst rising costs of production and marketing since most production inputs including marketing facilities and equipment are not produced locally. Liberalisation seems to have resulted in what can be termed as an 'economic orphanage' situation among communities that relied on cooperatives for support. The net affect has been continuing decline in agricultural productivity.

Additionally, although a greater proportion of market prices appear to have been transmitted to the farming households, this seems not to have been felt. For instance, in the coffee sub-sector, liberalisation resulted into active participation of subsidiary companies of MNCs in coffee buying, processing and export. This allowed for transfer pricing that meant that quoted export prices were much less than market prices. In the case of coffee for instance, although the proportion of farm gate prices reached (and has remained) over 65 percent of export prices, there has been minimal impact on the incomes of coffee farming households. The positive effects of liberalisation seem to have been watered down by overall decline in commodity prices.

Wages and Employment under Liberalisation

While real wages have been going up in the formal sector, the increase has been minimal. Unemployment is on the increase because employable labour has grown faster than growth in jobs. Although there has been growth in microfinance institutions providing micro credit facilities to the informal sector, this sector has not been able to attract the educated labour force partly because the cost of micro credit which is very high and (interest rates have ranged between 2.5 and 3 percent per month) cannot result in any meaningful investments. Besides, though microfinance credit has continued to support thousands who are in the informal sector as a form of employment, its real impact is yet to be assessed.

Liberalisation of education particularly higher education, including the introduction of cost-sharing schemes in public higher education institutions has led to the high cost of education. As a result, children from poor families find it increasingly difficult to access higher education as well as formal employment. Currently, children from poor households are less likely to obtain formal jobs than children from rich families.

Impact on Government Revenue and Spending

Government revenue has steadily increased since 1987. Although partly a result of improved tax administration, the role of increased trade (particularly import trade) and expansion of private sector investment in widening the tax base is beyond question. Currently, trade taxes (mainly import duty) still account for over 60 percent of government tax revenue. Value-added tax is charged on imports as well as domestically traded goods. This underlines the important role a liberalised trade regime has had on government revenue.

Although the increase in government revenue over the last decade has not enabled the Government of Uganda to balance the budget, it has enabled the government to meet a bigger percentage of its recurrent expenditure. Real wages have increased over time, though modestly, for all public servants compared to the 1990 levels. The main benefit of the increase in government revenue in the last decade has been the introduction of Universal Primary Education since 1996.

13.9 Conclusions

Uganda's liberalisation experience seems to have had mixed results. Firstly, while tremendous gains have been achieved in the areas of economic growth and stability as well as government revenue, it is also quite clear that liberalisation of the economy has achieved marginally in terms of the international competitiveness of domestic production, especially in agriculture. Secondly, although domestic markets appear to be working, the poor households seem to have benefited little in terms of income growth and better prices. Thirdly, rapid liberalisation has greatly increased the overall exposure of the economy to global markets. Consequently, the vulnerability of the poor households, particularly farming households has greatly increased. Fourthly, it appears primary that any future additional liberalisation measures should consider the existing domestic capacity of a sector to effectively engage international market forces.

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14

CHAPTER

Linkages between Trade, Development and Poverty Reduction in Zambia: *An Overview*

– ***Venkatesh Seshamani***[1]

14.1 Introduction

Up until 1990, for two decades, Zambia was characterised by a highly centralised and controlled economic regime. The consequences of this regime were, on the whole, highly disastrous because of lack of growth, economic stagnation, hyperinflation running into triple digit figures, an unsustainable level of external debt and poverty engulfing 70 percent of the population.

Zambia witnessed a transition to a multi-party democracy in 1991, which also marked the beginning of serious policy reforms with the objectives of reviving economic growth, containing inflation and reducing poverty. Major macroeconomic, financial and institutional reforms were introduced at a rapid pace within a space of 4-5 years. Trade liberalisation was one of the major reforms included in the overall package of reforms.

Prior to 1992, the country did have a brief phase of liberalisation during the 1980s. Beginning with partial decontrol of some commodity prices in 1982, the country reached a high phase of liberalisation during the period 1985-87. But the political costs of the reforms that included a food riot at the end of 1986, were more than what the then government had expected and so a regime of controls was re-instituted around mid-1987 with a blueprint for a New Economic Recovery Programme (NERP) based on the theme of 'growth from own resources'. It was realised that the NERP with little external support and alienation from the International Monetary Fund (IMF) and the World Bank, could not be sustained for long and an inexorable move towards liberalisation under the guise of 'controlled flexibility' was made in 1988. This move, however, could only proceed in fits and starts owing to the political turbulence that eventually led to the dire consequences described above.

This paper analyses the trade reforms that occurred mainly in the second phase of liberalisation during the 1990s and its economic and developmental impacts. It must nevertheless be appreciated that it is not easy to sift the impact of trade liberalisation *per se* from other liberalisation measures since they were all implemented almost simultaneously and one measure could have acted either as a catalyst or as an impediment to another. For example, in the wake of trade liberalisation there was an improvement in Zambia's trade performance but some analysts would attribute this outcome not wholly to trade liberalisation but also to the depreciation of the Zambian kwacha that was considerably over-valued during the pre-liberalisation period. By the same token then, one cannot attribute the adverse consequences such as increase in formal unemployment to trade liberalisation alone since, for example, major privatisation of over-manned public sector companies and a Public Sector Reform Programme (PSRP) were also carried out alongside.

A further caveat that needs to be made is that it is difficult to discuss the impact of trade on say poverty reduction bypassing the intermediate chains of economic growth and distribution or without consideration of trade's multi-collinear relationship with investment, debt and aid. Furthermore, it is seldom possible for a country like Zambia to have a truly independent negotiation on trade with the World Trade Organisation (WTO) that can be different in ideological character from the kind of negotiations that are conducted with the IMF and the World Bank, since all these institutions are ultimately birds of the same ideological (neo-liberal) feather.

14.2 Structure of the Zambian Economy

Although some changes in the country's economic structure have occurred since 1980, the changes have not been very dramatic, as can be seen from Table 14.1. The contribution of agriculture to gross domestic product (GDP) has hardly changed between 1980 and 2003. Although the mining sector's contribution has come down from the 1980 level, the decline took place mainly during the 1980s and since 1991, the GDP contribution of the sector has remained the same. But the contribution of manufacturing has declined significantly while that of the services has increased.

On the face of it, the policy of import substitution industrialisation in the early years following independence in 1964 helped develop a diversified manufacturing sector with products ranging from food, beverages, and tobacco to textiles, chemicals and metal and metal products. In effect, it was a combined policy of tariffs, quantitative restrictions (QRs) and exchange rate management that served to shield the manufacturing sector from external competition and make it profitable despite the high costs of production and inefficiency. Besides, the resources from the mining sector generated by copper sales in particular were used to give a fillip to the manufacturing sector.

The manufacturing sector hardly produced any products for exports but on the other hand was heavily dependent on imports. Hence, when the mining sector began to decline with the collapse of the copper price in 1975, the prevailing trend in industrialisation could not be sustained since there were not enough resources to

Table 14.1: Sectoral Contribution to GDP (%)

Sector	1980	1981-1990	1991-2000	2001-2002	2002
Agriculture	14.2	15.8	16.4	16.1	14.9
Mining	16.4	25.0	7.9	7.1	7.9
Manufacturing	18.5	15.5	20.0	10.7	10.7
Services	50.9	43.6	55.7	66.2	66.5
Total	100	100	100	100	100

Source: Central Statistical Office.

finance imports. And the reforms of the 1990s leading to the opening up of markets and to the exposure of domestic firms to international competition proved to be the last straws that broke the back of an artificially propped up manufacturing sector.

The mining sector, notably the copper mining sub-sector, has been the main lifeline of the Zambian economy. The mono-nuclear concentration of production on copper is well-known. Copper contributed to 90 percent of the country's export earnings and, although diversification away from copper has been an avowed objective for a long time, little was done to achieve this objective. With the institution of trade reforms having an accent on export promotion and diversification, the role of copper has been coming down with the share of non-copper exports in foreign exchange earnings on the increase. But copper's declining contribution until recently was also the result of falling prices, undercapitalisation of the mines and the withdrawal of Anglo-American Corporation from the mining sector.

Copper, however, still dominates exports with a contribution of nearly 70 percent. And with the huge surge in copper prices to more than double the previous values and improvements in copper production in the post-privatisation phase resulting from new investments and discovery of new copper reserves, copper has currently regained its paramount status in the economy. However, it has to be recognised that a collapse in copper prices could make history repeat itself for Zambia and thus export diversification away from copper should continue to receive due attention.

As can be noted from Table 14.1, the services sector is steadily growing in importance. It has great potential to contribute to GDP and employment generation. Improved services provision such as transport, energy and telecommunications can serve to enhance the efficiency, cost-effectiveness and hence competitiveness of domestically produced goods. Mudenda and Ndulo (2005) point out that there should be an effort to link service sector reform especially to domestically produced goods that the country may want to export and that trade liberalisation in the absence of such reform could result in negative effective rates of protection for these goods.

14.3 Potential Impacts of Trade Liberalisation

There can be no gainsaying the fact that trade can be one of the vital drivers of growth and poverty reduction in the Zambian economy. Before getting into the specific discussion of the potential and actual impacts of trade reforms in Zambia, we shall briefly discuss some of the prevailing hypotheses regarding the linkage between trade and poverty reduction and development. UNDP's *Human Development Report 2005* provides some significant comments in this respect. The following are some of them:

- The idea that participation enhances human welfare is as old as modern economics. Adam Smith, David Ricardo, John Stuart Mill and Karl Marx all argued that specialisation through trade would increase productivity, economic growth and living standards. Many of their insights remain valid. But the pathways between trade and human development are complex – and there are no simple blueprints for successful integration into global markets (pp.119).
- The idea that openness to trade is inherently good for both growth and human development now enjoys almost universal support (pp.119).

- The evidence to support the proposition that import liberalisation is automatically good for growth is weak – almost as weak as the opposite proposition that protectionism is good for growth (pp.119).
- At a household level, exports can provide an important source of income and employment for poor people (pp.120).
- Beyond the household some of the important benefits from trade derive from imports of capital goods that are cheaper than those that are available domestically (pp.120).
- Participation in trade can produce losers as well as winners (pp.120).
- Participation in trade can exacerbate inequality as poor people absorb the adjustment costs of increased competition from imports, while people with assets and market power take advantage of opportunities provided by exports (pp.123).

The above statements from the UNDP report suggest that the link between trade and poverty reduction is more tenuous in practice than what is often more regularly advocated. The fact that reform in trade policies can produce both winners and losers and that the poor are more vulnerable to the adverse impact of trade reform suggest that trade policy can lead to poverty reduction only if it is treated as an integral part of poverty reduction strategies. That this has not been always the case is shown by the mixed results of trade reform witnessed in several countries of sub-Saharan Africa (SSA) including Zambia. In Zambia's Poverty Reduction Strategy Paper (PRSP) 2002-04, there was virtually no mention of trade or trade-related policies either in its macroeconomic section or elsewhere in the document.

It is useful even at this fact illustrate the UNDP assertion that the pathways between trade and poverty reduction are complex. Not only trade liberalisation may produce winners and losers, the same group of people (e.g. the poor) may win in some ways and lose in some ways and the net results are not readily obvious. Zambia itself provides one such illustration.

It is now a well-known story that soon after the implementation of trade liberalisation, the textile and clothing sector in Zambia became a major casualty. The formally registered companies in this sector that had long flourished in a relatively protected environment suddenly found themselves facing stiff competition from two fronts: one, the importation of 'seconds' clothing known popularly as *salaula*; two, the import of cheap goods from countries like China and India. Unable to face this competition, most companies closed down. How did this situation affect the poor? The following were the results:

- The closure of companies contributed to significant loss of jobs and thereby adversely affected the welfare of the poor;
- The closure of the companies meant significantly reduced tax revenues to the government and hence reduced ability of the government to provide social services to the poor;
- But *salaula* and cheap imported goods meant that the poor could now have easier access to decent clothing than was the case before. Also, *saluala* expanded into an industry in itself, creating employment and providing livelihoods to thousands of poor Zambians even in the rural areas through such transmission mechanisms as transportation, trading, distribution, laundry and restyling to mention a few.[2] But since all these activities are informal, it is unlikely that the government would have earned any tax revenue.

Box 14.1 The Economics and Politics of *Salaula* Trade in Zambia

The economic and political dimensions of *salaula* have been brought out in the book by Hansen (2000).The *economics* in question is the fact that liberalised trade patterns, i.e. one of the consequences of the IMF and World Bank Structural Adjustment Programme (SAP) opened up Zambia and many other developing countries to an influx of cheap imports. This, in turn, had a negative impact on local industries which could not compete with the imports. None of the 72 clothing manufacturing businesses operating in Zambia at the beginning of the 1990s is open today. Thousands of Zambians pushed out of formal sector employment by the economic reform programme are busy in the informal sector, buying bales of secondhand clothes, opening shops on the streets of towns and villages, and eking out a survival by providing cheap but attractive wear to their fellow citizens.

The *politics* of *salaula* are the result of four competing pressures that the government of Zambia must try to balance. First, the IMF and the World Bank insist that trade barriers should not be imposed. Second, textile and clothing manufacturers demand protection from all the imported products. Third, sellers of *salaula* are willing to fight any restrictions on their trade. Fourth, the public at large claim that *salaula* is necessary for their well-being. Hansen notes that these conflicting political pressures came to the surface when the 1998 budget proposed an increased tariff on bales of *salaula*. After months of bitter wrangling, the then Republican President intervened and suspended the proposed tariff.

Source: Hansen (2000); Henriot (2002).

Again, winners and losers also depend on the entrepreneurial skills of company managements. Not all Zambian companies in the textile sector went under as a result of the liberalising policies. Some of them, realising that competition was inevitable, launched into product diversification and product improvement through replacement of outmoded machinery and equipment and have been able to continue in business.[3]

14.4 Trade Reforms and Economic Impacts

As has already been stated, Zambia began with a strategy of import substitution industrialisation (ISI) which helped develop a diversified industrial structure. But ISI by its very definition was biased against exports. Thus, until trade liberalisation began to take root, the country exported a very limited range of products besides copper. These included goods like cement, men's wear, sugar, crushed stone, lime and explosives. In 1980, the contribution of these non-copper exports was only 0.7 percent.

With the collapse of copper prices, there were no longer enough resources to sustain the industrial structure created by ISI. Clearly, there was a felt need to change the industrial strategy from ISI to export-oriented industrialisation (EOI) to diversify the export base and sustain foreign exchange earnings. But this shift in the strategy would inevitably expose the manufacturing industries to external competition which they were not geared to face. The trade reforms of 1985 and those during the 1990s did produce this anticipated effect with consequent drastic impacts on manufacturing output and employment and a significant shrinkage of the sector.

Until 1975, high tariffs going up from zero percent to as much as 150 percent were the principal instrument of protection. There were also import bans on some goods. But with the huge decline in copper earnings, tariffs were subsequently supplemented by QRs and rationing of foreign exchange in order to ensure that the existing manufacturing industries continued to enjoy the high levels of protection. Soon, QRs became more pervasive and important than tariffs.[4]

The liberalisation in 1985 wrought several changes: an auction system of foreign exchange replaced administrative allocations; tariff rates were revised so that they ranged between 10 percent and 100 percent; there was freer access to import licences; and most QRs on imports were removed. But, as already stated, this phase of liberalisation was short-lived since the country went back to controls in 1987. During the second phase of liberalisation in the 1990s, there was a progressive reduction in the nominal tariff rates. By 1996, the rates were brought down to 0, 5, 15 and 25 percent, a reduction from the previously obtaining 11 tariff lines to just four tariff lines. The changes in the volumes of exports and imports are shown in Table 14.2.

Three things that worth noting from Table 14.2 are: (i) there has been some decline in the value of exports from US$1.5bn in 1980 to US$1.1b in 2003; (ii) prior to 1990 (before the second phase of liberalisation), exports exceeded imports but after 1990, imports have overtaken exports; and (iii) the total value of trade has remained more or less unchanged around US$2.5bn between 1980 and 2003, although the contribution of trade to GDP has fallen by about 10 percent.

Table 14.2: Volume of Trade in Goods

	Exports in million $ (% of GDP)	Imports in million $ (% of GDP)	Total Trade in million $ (% of GDP)
1980	1,457.0 (37.5)	1,114.0 (28.7)	2,571.0 (66.2)
1981-1990	1,134.0 (36.4)	915.0 (29.4)	2,049.0 (65.9)
1991-2000	998.0 (29.8)	1,020.0 (30.5)	2,018.0 (60.3)
2001-2003	951.0 (24.5)	1,281.0 (33.0)	2,232.0 (57.6)
2003	1,051.0 (24.4)	1,387.0 (32.3)	2,438.0 (56.7)

Source: International Financial Statistics, Bank of Zambia; cited in Mudenda and Ndulo (2005).

Economic and Development Scenarios Following Trade Liberalisation

Economic growth which was close to nil on average until the end of the last millennium has been consistently positive over the past 5-6 years averaging about 4.5 percent. While this is a positive development, the growth rate is not robust enough to produce

Table 14.3: Trends in Poverty in Zambia, 1991-2003					
	1991	**1993**	**1996**	**1998**	**2003**
Poverty incidence (%)	69.7	73.8	69.2	72.9	66.5
Extreme poverty incidence (%)	58.2	60.6	53.2	57.9	46.0
Poverty gap (%)	62.2	58.3	51.3	40.1	27.1
Poverty depth (%)	46.6	40.5	32.3	26.7	13.9

Source: Central Statistical Office: Social Dimensions of Adjustment Survey 1991 and 1993, Living Conditions Monitoring Survey 1996, 1998, 2003.

a significant impact on poverty reduction and human progress in Zambia. Poverty and inequality levels are high in Zambia and consequently the poverty elasticity of growth is quite low. The results of the latest Living Conditions Monitoring Survey of 2003 reveal that more than two-third of the population lives below a money-metric poverty line and nearly 50 percent are in extreme poverty (see Table 14.3).

The high degree of inequality can be seen from the value of the Gini Coefficient lying between 0.5 and 0.6. In such a situation, a growth rate of 4-5 percent would not be enough to bring down poverty significantly. An IMF-World Bank Joint Evaluation of progress in Zambia's PRSP performance states that even a subset of the Millennium Development Goals (MDGs) including reducing extreme poverty by half can be attained in Zambia by 2015 only if two conditions are met: (1) achievement of average annual growth rates in excess of eight percent; and (2) better prioritisation, scaling up and stronger effectiveness of poverty reduction programmes (see IMF, 2005).

While total trade, as already stated, has not significantly expanded since trade liberalisation, the positive development is in the growing shift of exports from copper to non-traditional exports. The share of non-traditional exports in foreign exchange earnings rose from 8 percent in 1990 to 39 percent in 2002 (from US$90mn to US$360mn in absolute terms). There has been a significant increase in government revenues from trade taxes from US$8mn in 1990 to US$990mn in 2002. However, in percentage terms there has hardly been any change during this period (in fact, there has been a decrease from 36 percent in 1990 to 34 percent in 2002).

One of the most adverse impacts in the post-liberalisation phase has been a drastic decline in formal employment. The decline was from 23.3 percent of the labour force in 1980 to 8.1 percent in 2003. However, this consequence cannot be attributed to trade liberalisation alone. The retrenchments that came about under the Public Service Reform Programme and in the post-privatisation phase in the privatised companies have also played a significant part. A *Post Privatisation Impact Assessment Study* conducted by the Zambia Privatisation Agency (ZPA) in 2005 showed that while privatisation led to an improvement in the operational efficiency and capacity utilisation of firms, it also led to soaring formal unemployment. The unemployment was the result of most companies trimming their labour force to more efficient levels and in some cases switching to labour-saving technologies. The loss of formal jobs has also led to a huge expansion of the informal sector.

As can be noted from Table 14.3, poverty continues to remain the greatest challenge to policy makers in Zambia. Besides the money-metric indicators of poverty (see Table 14.3), human poverty indicators also do not present a flattering picture. According to UNICEF's *State of the World's Children 2006* Report, between 1990 and 2004, the Under-5 Mortality Rate has risen from 180 to 182 deaths per 1000 live births and the Infant Mortality Rate from 101 to 102 deaths per 1000 live births. Average life expectancy at birth has fallen drastically from nearly 53 years in 1980 to 38 years in 2004. Much of this decline has been on account of the prevalence of HIV/AIDS.

14.5 Linkages between Trade and Poverty Reduction in Zambia

The Potential for Linkages

The Diagnostic Trade Integration Study (DTIS) (2005) for Zambia analyses the potential linkages that could be secured between trade and poverty reduction. The DTIS looks at the impact of trade on households both as consumers and producers or income earners. As income earners, households are affected when trade changes wages and agricultural income. As consumers, households are affected when trade changes the prices of goods consumed by the family.

According to the study, in rural areas, there are two main channels through which new trade opportunities can affect household income: (a) households can switch from subsistence farming to cash crop farming; (b) household members may earn a wage in other farms. To provide some quantification of the gains that can be expected from these two new opportunities generated by international trade, the study uses two models: the unconstrained household model (where the household can plant an additional hectare cash crop without giving up subsistence farming); and the constrained household model (where the household switches to a cash crop by giving up subsistence farming). In the case of the unconstrained household model there would be no foregone income by expanding household activities to a cash crop.

In the constrained model, growing cotton (instead of subsistence farming) leads to increases in income of around 20 to 24 percent in the case of (a) and (b) above. In the unconstrained model, instead, the gains are equivalent to around 56 and 68 percent. If the household switches to tobacco, the gains would be 71 and 104 percent in the constrained model, and 88 and 130 percent in the unconstrained model. Therefore, growing tobacco seems to be an important vehicle for poverty alleviation. In the cases of vegetables and groundnuts, two activities often mentioned as good prospects for non-traditional exports, there are no gains in income in the constrained model, but gains of 37 and 20 percent, respectively, in the unconstrained model.

One key crop in Zambia is maize, which is grown by the vast majority of households. Farmers grow local varieties and hybrid maize. While local maize is devoted to own-consumption, hybrid maize can potentially be produced for the market. The study finds gains ranging from 55.7 percent in the constrained model to roughly 100 percent in the unconstrained model. These are important results because they support the claim that income gains can be achieved through the production and sale of hybrid maize. In addition, since most Zambian farmers across the whole country grow (or grew) maize, there is a presumption that they are able to produce it efficiently and that some of the constraints faced in other crops may not be present. Know-how and fertiliser use are examples. In those regions in which cotton and tobacco, major exportable crops, are not suitable agricultural activities (due to weather or soil conditions), the production of hybrid maize appears as a valid alternative. Switching from local to hybrid maize requires significant increase in government extension services and other support to maize producers.

If larger market access is achieved, rural labour markets may expand and workers may become employed and earn a wage. By comparing the average income in subsistence and in rural wage employment in agriculture, DTIS estimates gains associated with rural employment ranging from 104.2 to 128.3 percent of the total expenditure of the average poor household in rural areas. Rural employment in commercial farms could be good instruments for poverty alleviation.

In urban areas, key vehicles for poverty alleviation through trade involve employment opportunities and higher wages. Zambia's main opportunities for export diversification and employment creation are in the areas of light manufacturing. These include textiles (cotton yarn, loom state fabric, acrylic yarn, and toweling), processed foods (sugar, molasses, honey and bees wax) and engineering products (copper rods, cables, wire, billets and brass ingots). The light-manufacturing sector is the key to poverty reduction because it is low and unskilled labour intensive. Households benefit from the wage incomes, which are generally higher than incomes coming from their next best alternative such as farming their own plots. In addition, incomes from employment in factories are generally less variable than farm incomes, which are very dependent on rain and other exogenous factors.

A healthy and growing manufacturing sector can decrease poverty partly because of its ability to create jobs through direct employment generation and equally importantly, because of the backward linkages it fosters through the sourcing of raw materials (agricultural goods) and intermediate goods (button and thread producers, packers, etc.), capital goods, and through forward linkages (advertising, marketing, distribution, etc.). In Zambia, a healthy manufacturing sector also contributes to a more profitable agricultural and primary commodity sector. The employment opportunities generated decreases the households' dependence on farm incomes, and increases formal sector employment. Hence, employment and wages are not the only benefits that accrue to these workers and to the economy as a whole. In addition, workers in these factories are also likely to be exposed to good production practices, management techniques, quality control practices, etc. In other words, there is significant potential for Total Factor Productivity (TFP) growth, which in turn, tends to have a lasting impact on productivity and hence, economic growth.

The largest impacts of trade policies on the consumption side will be caused by changes in the prices of food items. There is an important additional role for trade as an instrument to reduce the cost of living. Among several foodstuffs, maize is the main food item consumed in Zambia. There are four main types of maize consumption: home produced maize, mugaiwa, roller maize and breakfast meal. Maize consumption was heavily subsidised until liberalisation in the early 1990s. After the elimination of these subsidies, consumers substituted away from industrial maize and towards cheaper mugaiwa maize.

This substitution cushioned some of the negative effects on the elimination of the subsidies. However, this substitution was only possible after the liberalisation of the small milling industry. Importantly, liberalised access to imported maize – to be grinded by small local mills – is essential if poor farmers are to benefit from cheaper mugaiwa.

Realising the Potential

The DTIS points to the potential of trade to reduce poverty through export diversification and enhancement. But to what extent can the higher volume and composition of exports be realised? While in principle, the potential may be there; in practice, a host of barriers may prevent the realisation of the potential.

The Zambian Government after 1991 took steps to remove barriers to trade by opening up its markets and participating in a number of trade arrangements. These include multilateral arrangements like WTO, EU-ACP Cotonou Agreement and the Economic Partnership Agreement (EPA). Regionally, Zambia is a member of the Common Market for Eastern and Southern Africa (COMESA) and Southern African Development Community (SADC) and participates in preferential arrangements like Africa Growth Opportunity Act (AGOA), Everything But Arms (EBA) and the Canadian Initiative.

The underlying premise of the above approach to trade is that by integrating into the global market, it will help enhance Zambia's growth which in turn will help reduce poverty. Zambia's exports are, however, mostly primary and semi processed commodities such as copper, cobalt, cotton, tobacco, fresh flowers, copper wires and textiles. While the Zambian Government has taken all the above-mentioned steps, the country's integration into the global market is restricted by what other governments do. For example, a system of escalating duties and tariffs discourages value addition and confines the country to the export of unprocessed raw materials.[5] This entails a long-term opportunity cost in terms of diversification, job creation and higher growth. It also restricts Zambia's ability to avail of arrangements such as AGOA and EU-ACP. These, in any case, do not address the issue of tariff escalation.

Heavy subsidisation by developed countries of their agricultural products again has a potential negative impact on diversification. Although Zambia does not export agricultural products in a significant way and hence does not bear any direct impact of the subsidies, it is discouraged from venturing into agricultural goods in whose production it may have a latent comparative advantage. Mudenda (2005) explains several non-tariff barriers (NTBs) to trade with the EU and the US even though Zambia is supposed to have free market access to these regions. Some of these are:

- **Sanitary and Phyto-sanitary (SPS) Measures:** Although every country has a set of food safety and animal plant standards, the EU goes beyond what is perceived as necessary for health protection and use SPS measures to shield domestic producers from economic competition.

- **Minimum Residual Level (MRL):** Standards of MRL of chemicals/pesticides are set at a very high level. The EU has a list of 33 active ingredients of pesticides. Zambian soils have too many pests which make it inevitable to make use of such chemicals and this reduces the products that qualify for the EU market.

- **Market Standards:** The market standards set by the EU countries regarding how each product should grow, its size, shape, smell, packaging, etc., are based on their own climatic conditions and this makes it difficult for Zambian products to penetrate their markets.

- **Pest Risk Assessment (PRA):** Some pests like leaf mining Lirimyza, tobacco whitefly, caterpillars are not allowed in the EU. PRA involves additional costs to exporters since Zambia does not have sufficient pest control at production stage.

- **Restrictive Rules of Origin:** The rules of origin that govern the use of the Cotonou Agreement makes it difficult for potential Zambian exporters to source imports from a cheaper source that does not qualify under the EU. The producers are allowed to source inputs only from other GSP eligible countries.

- **Child Labour:** In Zambia, most exports like cotton and vegetables are grown by small-scale farmers who rely on family labour that includes child labour. The underlying premise here is that children doing light safe work off school times supplement family incomes without compromising their future.

- **Information Flow:** The flow of information regarding changes in the export markets pertaining to policies, quality requirements, and certification and export procedures does not get to suppliers in good time and this holds up goods at the port of entry.

14.6 Conclusion

Trade undoubtedly has the potential to impact favourably on poverty reduction and human development in Zambia. Even accounting for other factors, trade liberalisation has served to stimulate sustained growth, promote competition and efficiency, veer production activities in the direction of areas where the country has a comparative advantage and diversify the structure of trade by boosting non-traditional exports.

But this linkage between trade, development and poverty reduction cannot be taken for granted. One needs to take a number of conscious steps to forge that linkage. Some of them are:

- Foremost at the national level, the paramountcy of poverty reduction and human development as the overarching fundamental objective should not be allowed to give way to lesser instrumental objectives.
- Trade needs to be mainstreamed into the National Development Plan that is currently under finalisation. As was pointed out, trade did not even receive an honourable mention in the previous development document, the PRSP.[6]
- Efforts should be made not only to enhance trade but also to attract additional inflows of aid. Although we have not discussed aid in this paper, it must be mentioned that, given the significant financial requirements for the country to address the poverty issue as represented by the MDG targets, both trade and aid are required for Zambia at this stage. They are both complements rather than substitutes at this stage.
- There is need for a significant enhancement of investments, both domestic and foreign. If trade liberalisation can attract foreign direct investment (FDI), it can act as a cheaper source of capital than debt.
- The numerous non-tariff and technical barriers in the export markets that were spelt out in the previous section need to be addressed.[7]

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Endnotes

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2 *Salaula* has also spurred the business instinct of small entrepreneurs to engage in similar activities in other areas as well. For instance, people access several types of goods from wholesale shops and repack them for resale in small shops famously known as "*tembas*". This has enabled them to sustain big families including those who are employed as a result.

3 A major textile company in one of the Zambian towns has also been able to generate several small-scale business activities involving the use of its by-products to produce furniture, mattresses, door mats, mops, etc. thus creating secondary employment and income. The risk, however, is that, if for any reason, the company closes down, the entire township will be affected.

4 In 1988, Zambia introduced a duty drawback scheme to provide some incentive to genuine exporters especially of non-traditional (i.e. non-copper) exports. The idea is that if a company has paid duty on import of raw materials and intermediate good that are used in export production, they can obtain a refund of the duty. However, the operation of this scheme left much to be desired: cumbersome procedures, delays in obtaining refunds and high claim costs for the firms have dissuaded most of the exporting companies from availing of the scheme. Clearly, this is a policy that is very desirable in principle but beset with practical problems. Around the same time, the basis for tariffs was shifted from fob to cif, and domestic and import sales tax rates were unified.

5 Indeed, tariff peaks and tariff escalations occur in respect of those very products in which Zambia has a comparative advantage, namely, food, beverages, tobacco, textiles, leather, wood and wood products.

6 When the current government took over in 2001, it decided to revive national planning that had been abandoned in 1991. So when the first PRSP implementation ended in 2004, it was decided to have not another PRSP but a more comprehensive National Development Plan for the period 2006 – 2010. This plan is to be finalised soon.

7 While international trade is open in principle, these barriers limit the ability of Zambia to benefit from the openness. In other words, what is open in principle remains largely closed in practice.