Liberalisation and Poverty: Is there a virtuous circle for India?

Countries liberalise their trade and investment regimes because they believe that this will lead to more rapid growth through a more efficient allocation of resources.

A government on the verge of implementing a package of policies ushering liberalisation has to answer two important questions: (1) whether liberalisation, in general, generate faster growth only at the cost of higher inequality? (2) whether it is possible for outcomes flowing from the liberalisation of trade and investment regimes to have a favourable impact on poverty alleviation.

It is evident that reforms will not deliver the required results in isolation. Which means that one needs to identify a set of conditions, which, if satisfied, would establish a positive connection between trade & investment liberalisation and poverty alleviation.

This Briefing Paper analyses macroeconomic and industry specific data to help identify such set of conditions in the context of the ongoing Indian reform process.

Defining Liberalisation

There is a reasonable degree of agreement on what 'liberalisation' means. The basic component of liberalisation package consists of tariff reduction, devaluation, policies promoting foreign direct investment and industrial de-licensing (See Box 1).

The analytical framework

The impact of liberalisation on poverty has to be understood as a combined outcome of three different forces:

1. *The structural effect* which is expected to influence the domestic structure of production to move towards the economy's comparative advantage.

2. *The labour demand effect* that is expected to be a result of the

Box 1: Components of Liberalisation

Trade Liberalisation

- A significant devaluation of the currency, along with the removal of restrictions on current account transactions.
- A move from quantitative restrictions to (relatively high) tariffs in the early phase, and across the board reduction in tariffs in later phases.

Investment Liberalisation

- Removal of restrictions on investment decisions by domestic entrepreneurs with regard to product choice, scale and location.
- Easing of restrictions on foreign firms with respect to the above decisions.

Financial Sector Liberalisation

- Movement towards market determined interest rates.
- Easing the Access of domestic firms to foreign funds, through debt and equity instruments.
- Easing the access of foreign investors to domestic financial instruments.

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structural effect. Studying this effect would entail finding out whether the structural effect has been able to create necessary opportunities for labour to be employed.

3. *The labour supply effect* which would help us know whether there are efforts to achieve a complementarity between the skills required by the market as a result of liberalisation and those possessed by upwardly mobile workers.

It is well known that these effects cannot be studied in isolation. They need to be studied in context of policies adopted and measures promulgated by governments at the national and state level, in the area of trade, enterprise, labour welfare *et al.* This would help us understand whether policies are responding to demands of industry and labour as they prepare themselves to face a competitive climate.

The Indian reform process needs to be studied in the context of this framework. Comparison of the behaviour of certain macroeconomic and industry level variables (e.g. exports, value added by the organised as well as the unorganised sector, output, employment, earnings, whole sale price indices etc.) during the pre and post liberalisation period help us capture the labour demand and supply effect to a certain extent. More so, they provide us indicators pertaining to industrial employment and earnings. Recent measures of the incidence of poverty across states provide us with some explanation about factors that have differentiated states on the basis of their poverty alleviation performance.

The findings emerging from the analysis above help us to identify the set of conditions that would help us attain our objective of facilitating a climate that would create positive link between trade & investment liberalisation and poverty alleviation.

The Reform Process in India

At the outset, it should be pointed out that although we tend to see 1991 as a major turning point in Indian economic policy regimes, limited steps towards industrial deregulation and lowering trade and foreign investment barriers were undertaken in the decade of the eighties.

1991 saw a very significant widening of the reform process. The initiatives combined macro level changes, of which a sharp devaluation was particularly significant, with micro level changes that lowered entry barriers for both domestic and foreign producers. There are several issues relating to the process of liberalisation in India, and how it might impact on poverty.

First, there were several other types of reforms going on simultaneously, which have some bearing on the overall outcome of the policy.

The second point to be noted is that the gradual unfolding of the process of liberalisation has been compounded by the lags in decision-making that businesses usually face when confronted with changing environments. Under these circumstances, it has been rather difficult, over a relatively short period of time, to isolate the effects of liberalisation on industrial structure and performance from various other forces.

The third point is that in the process of implementing reforms, a certain level of imbalance has crept in. While entry for both foreign and domestic producers has been made relatively free, exit, for the typical producer in the organised sector, still remains difficult.

The most important facet of the Indian reform process has been that the thrust of the reforms has been on non-agricultural sectors. Even though there have been some steps taken to reform agriculture, motivated by short-term compulsions, there has been a tendency to reverse them when circumstances changed. Which compels us to establish a positive link between trade & investment liberalisation and poverty alleviation with a strong emphasis on the industrial sector.

Major Findings

Comparison of the behaviour of certain macroeconomic and industry level variables during the period 1987-88 to 1994-95 reveals the following:

- Despite relatively rapid growth in exports, the share of exports in total output has been declining over a period straddling 1991. This indicates that growth in domestic demand has had a larger role to play in the allocation of resources.
- Unorganised sector has been contributing to a smaller share to the output of industrial sectors over this period. Besides, there have not been much structural changes in the organised industrial sector during this period.
- Labour productivity has shown some acceleration, but real earnings have not risen at the same rate.
- Employment in the organised manufacturing sector has grown more rapidly in the three years after 1991 that in the three years before.
- Labour intensive sectors have shown an increasing degree of formalisation. More so there has been a tendency to formalise manufacturing activity in general since the early 1990s.

Analysis of the recent measures of the incidence of poverty and employment figures across states for the period 1987-88 to 1993-94 shows that:

- There exist quite significant differences in poverty alleviation across states. Some have done better in reducing rural poverty, while others have had more success with urban poverty.
- Manufacturing employment has increased the fastest in the southern states and slowest in the eastern states. Southern states have also been able to generate more jobs in these sectors.
- Rural employment in the unorganised manufacturing sector has declined in virtually all states.

Correlation analysis between the poverty reduction performance across states and the state level variables viz. state gross domestic product, industrial employment in 1987-88 and 1993-94, real earnings in 1987-88 and 1993-94, social sector expenditures, and change in unorganised sector manufacturing employment, show that:

- Overall poverty reduction results from rural poverty reduction.
- Average social sector expenditure shows a relatively strong favourable impact on both rural and urban poverty.
- Larger declines in unorganised rural sector employment are seen to be associated with larger absolute declines in poverty.
- States having a higher proportion of their labour force in labour intensive industries have been able to reduce overall poverty to a greater extent.
- An individual employed in the organised sector, not just at the average wage, but even at the lowest wage, has been able to earn enough to keep a household at an expenditure above the poverty line. An individual working in the unorganised manufacturing sector, even if s/he has been paid her/his upper bound wage, has not been able to do so, in several states.

Conclusions

The compelling justification, both moral and political, for doing whatever could be done to accelerate the growth rate in India has been the high burden of poverty. India's record with poverty alleviation over the first four decades of independence has made it very clear that redistribution *per se*, by whatever means, does not provide the solution. Growth is crucial.

The new economic environment with its microeconomic policy packages is expected to make it more attractive for domestic producers to go into labour-intensive goods and services. As the structure of domestic production shifts in favour of labour-intensive activities, more jobs would be created per every rupee of investment in fixed assets. Simultaneously, intensifying competition would force improvements in productivity, which would eventually drive up wages.

In short, the argument is that trade and investment liberalisation will reduce poverty by creating more jobs and pushing earnings up. However, even if this were a valid description, one needs to consider the net effect. The re-allocation of resources across sectors implies that jobs and incomes in some sectors will decline, even as they go up in others. Policy makers can't afford to be complacent assuming that liberalisation would eventually benefit a greater number of people than it would hurt. In fact they must ensure that tangible benefits flowing out of the reform process accrue to a large number of people so as to generate the necessary political support to sustain the momentum.

What is India's record on this score? In the first few years after 1991, investment and export activity boomed. This contributed to a tremendous acceleration of growth for a three-year stretch. However, for a variety of reasons, this pace could not be sustained, and growth rates came back to more 'normal' levels, woefully inadequate from the poverty alleviation point of view. Why has this happened? Is liberalisation of trade and investment not what it was touted to be? Has India not gone about it the right way? Is there something outside India's control that prevents her from realising the potential benefits?

The answer to the first question is that liberalisation cannot be seen as an unconditional success. Its benefits depend entirely on the conditions in which it is carried out. Mainly, these relate to the efficient functioning of markets–for goods, capital and labour–which allow for the relatively smooth re-allocation of resources across sectors. How well do markets work in India? The appropriate answer to this is: only as well as they are allowed to.

There are many situations in which the market mechanism is not allowed to work. Lets provide one domestic constraint and one external constraint, both of which are crucial to the ability of liberalisation to favourably impact on poverty.

Markets enhance efficiency when they are competitive. Competition is a process of churning. New producers are constantly entering the marketplace, hoping to outperform the existing ones. Inefficient producers are simply driven out of business by efficient ones. It is a cruel, brutal process, but it does what no other system can do; it gets the best out of available resources. For competition to work, inefficiently used resources–labour, capital, management, entrepreneurship-*must* be allowed to leave their current activity and seek more efficient uses.

The logical framework within which liberalisation can be expected to have its beneficial effects depends on the equal freedom of resources to enter and exit. India's policy changes have certainly enhanced the freedom to enter, but they are far from granting the freedom to exit. If resources cannot move out of inefficient uses, it is not clear at all that liberalisation will generate the kind of virtuous employment-earnings-poverty reduction circle that is expected from it.

On the external front, the logic of trade and investment liberalisation, viewed in terms of the same virtuous circle requires that developing countries, who typically specialise in the production of labour-intensive goods and services must be able to sell these goods and services in the global marketplace. The natural markets for these products are countries where labour is scarce, and producing them is expensive. Yet, the way in which the world trading order is evolving, these are the very countries that are making it more and more difficult for the developing world to export their products. However legitimate these concerns may be in and of themselves, health, environment, social and other standards are being used to make exports from the developing world more difficult and less competitive.

In the area of complementary policies, one finds that policies that promote stable growth in the economy of a state are positively associated with poverty alleviation. This of course includes the stable growth of agricultural sector within the state. More so maintenance of a stable magnitude of social expenditure by the state government has a positive impact on the poverty alleviation.

It is in this context that this paper has thrown up a set of conditions, which if satisfied would set in motion a virtuous cycle between liberalisation and poverty alleviation for India.

Recommendations

Macroeconomic and External Environment

- **To maintain an exchange rate, which does not discriminate against exports and in favour of domestic sales.**
- **To maintain the inflation rate in line with the rates of major trading partners.**
- **To highlight the contradiction between the goal of removing poverty in the developing world and the protective tendencies consolidating in the developed world at the time of trade negotiations.**
- **To take into account the adverse impacts that standards may have on poverty in the developing world.**

Facilitating Structural Change

- **To facilitate exit for resources to move into labour-intensive sectors.**
- **To create a National Renewal Fund (NRF) for promoting the equitable sharing of costs of exit, and the NRF must be funded by contributions from all involved parties: government, employers and workers.**

Labour Demand and Supply

- **To strengthen the capabilities of employer and employee associations so as to be able to undertake collaborative activities with respect to training.**
- **To adopt a fiscal mechanism for resolving potential conflicts arising from the freedom of movements of workers in search of jobs.**

Complementary Policies

- **To promote policies that ensure stable growth of the economy, which is positively associated with poverty alleviation.**
- **To maintain a stable magnitude of social expenditure.**

This Briefing Paper is an abridged version highlighting the Indian component of a research project, "Conditions Necessary for the Liberalisation of Trade and Investment to Reduce Poverty," which was carried out by the CUTS Centre for International Trade, Economics & Environment, Bhaskar Marg, Bani Park, Jaipur 302 016, India. Ph: 91.141.20 2940/20 5802, Fx: 91.141.20 2968, Email: cutsjpr@jp1.dot.net.in, cuts.jpr@cuts-india.org, Website: www.cuts-india.org, in association with the Indira Gandhi Institute for Development Research, Mumbai, the Sustainable Development Policy Institute, Islamabad, Pakistan and the Centre for Policy Dialogue, Dhaka, Bangladesh in 1999, and printed by Jaipur Printers (P) Ltd., M I Road, Jaipur 302 001.

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