A Comparison between Aid and Trade as a Means of Reducing Global Poverty

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Abstract

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As the international community works to eradicate extreme poverty, it is important to consider which vehicle -- aid or trade -- allows the developed world to most efficiently share its resources with those trapped in poverty. Whereas aid simply transfers resources from developed nations to those still developing, trade agreements provide poor, low-skilled workers with greater bargaining power over their own resources. Trade, therefore, is a more effective means of reducing poverty in the long term.

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Introduction

In in his book *The End of Poverty*, economist Jeffrey Sachs spends a section discussing the rise and fall of China. Around the beginning of the sixteenth century, China was the world's technological superpower, responsible for inventing gunpowder, the compass, and the printing press. By the end of the sixteenth century, China had been conquered by Europe. What happened? What made China fall from its position of power so quickly? Sachs explains it comes down to a decision made in 1434. "In that year," says Sachs, "the Ming emperor effectively closed China to international trade, dismantling the world's largest and most advanced fleet of ocean vessels" (150). And when China disconnected itself from the world, it could not maintain its technological or economic edge, and its power relative to the rest of the world began to decline. Sachs points out that Adam Smith himself addressed China's isolation in his masterwork *The Wealth of Nations*, where he writes, "A country which neglects or despises foreign commerce, and which admits the vessels of foreign nations into one or two of its ports only, cannot transact the same quantity of business which it might do with different laws or institutions" (151). The rise and fall of nations depends on the extent to which they embrace foreign markets or isolate themselves from them.

And when it comes to extreme global poverty, the question of market access becomes even more important. Poverty, of course, is a problem of resources, and surrounding the effort to reduce poverty is a debate over how developed nations most efficiently share their resources with those who need them the most. This paper will compare two methods of expanding resources to those in extreme poverty: aid and trade.

Aid involves the direct transfer of resources, whereas trade allows resources to be exchanged in global markets, and certainly, both are both necessary tools in the reduction of global poverty, but between the two, this paper argues, trade is more effective because of its capacity to promote positive political reform and long-term economic growth. Ultimately trade is more effective than aid because it, rather than simply transferring resources to the poor, gives the poor greater bargaining power over their own resources.

Chapter 1

Aid and trade

There are two general ways in which developed nations can reduce poverty in the developing world. The first is to share resources with the developing world. This is done principally through foreign aid. In the United States, the agency responsible for administering foreign aid to the developing world is the United States Agency for International Development (USAID). According to the organization's mission statement, USAID is working toward "two complementary and intrinsically linked goals: ending extreme poverty and promoting the development of resilient, democratic societies that are able to realize their potential" (USAID). USAID works in over 100 countries (USAID).

The second way the developed world can assist the developing world is by expanding markets to include poorer nations. This is done primarily through the expansion of trade, often through Free Trade agreements. The part of US Code that determines how other countries export there products to the U.S. is the Harmonized Tariff Schedule of the United States. To get an idea of how this section of law impacts foreign economies, consider a report from NPR's Jacob Goldstein. He ordered two batches of identical T-shirts. One batch came from Columbia. The other came from Bangladesh. The shirts imported from Bangladesh were taxed at a rate of 16.5 percent, whereas the shirts imported from Columbia were taxed at zero percent, thanks to a free trade agreement we have with that country (Goldstein). That an individual can purchase identical products from separate countries and the products be treated so differently indicates inefficient trade policy. And this is why trade reform is such an important topic. By eliminating barriers to trade, countries can increase efficiency and spur economic growth. And economic growth means, in the long run, lower poverty.

Growth

There has been considerable progress toward the reduction of poverty over the past couple decades. In 2000, the governments of 147 countries agreed to eight Millennium Development goals, the first of which was to cut extreme poverty in half by 2015. The global community accomplished that goal five years early and has since turned its attention toward the complete elimination of extreme poverty by 2030 (Economist). Accomplishing this new goal will require lifting 1 billion people out of poverty (Ravallion 2).

It is worth noting that the primary consideration of programs designed to eliminate poverty is their ability to generate growth. "Around two-thirds of poverty reduction within a country comes from growth," according to the Economist (Economist). There are some who argue that economic growth is not a viable means of reducing global poverty because the poor are excluded from potential gains. Research from the World Bank shows this is not the case. In a report titled "Growth is Good for the Poor," researchers David Dollar and Aart Kraay examined four decades of data from 92 countries and found "Average incomes of the poorest fifth of society rise proportionately with average incomes" (Dollar and Kraay). They go onto explain "several determinants of growth -- such as good rule of law, openness to international trade, and developed financial markets -- have little systematic effect on the share of income that accrues to the bottom quintile. Consequently these factors benefit the poorest fifth of society as much as everyone else" (Dollar and Kraay). In other words, good governmental policy produces efficiency, and this efficiency generates growth, and this type of growth does not exclude the poor. Rather, it spreads gains to the poor proportional to their share of the population.

And understanding the important role economic growth plays in the reduction of poverty is key to understanding the relative impacts of aid and trade on developing countries.

Poverty

Any thorough discussion of poverty requires a precise definition of the word. There are, in fact, two ways to define poverty. The first method is to define poverty according to an absolute standard. The second is to define poverty according to a relative standard. Under an absolute standard of poverty, any individual or family with an income level below a defined amount is considered to be impoverished. Under the relative standard, poverty is determined based on an individual or family's wealth compared to that of other individuals or families. For example, if a nation established that anyone who made less than 25 dollars a day was impoverished, then that nation would be using an absolute standard to measure poverty. If the nation determined that poverty included any family or individual making less than 25 percent of median income, then it would be utilizing a relative standard to measure poverty.

In this paper, we will use an absolute standard of poverty for three reasons. The first is that an absolute standard of poverty will allow us to more easily compare the relative impacts of aid and trade across international boundaries. The second is that an absolute definition of poverty shows the amount of income necessary to access basic needs such as food and water. Access to these necessities should be the chief consideration of a program designed to reduce global poverty. In this paper we will be asking whether aid or trade more efficiently provides the world's poorest people with access to those needs. The third reason is that the relevant aid organizations discussed in the paper use an absolute standard. In particular, the World Bank sets the poverty rate at

$1.25/day (Economist). We will accept this definition of extreme poverty for the purposes of this paper.

Chapter 2

The Effect of Trade on Developing Political Environments

The obvious difficulty in analyzing aid programs is that there are so many of them and so many various types that it would be impossible to say whether aid programs in general have been effective or ineffective. But this paper isn't concerned with overall aid effectiveness. It is only concerned with aid's effect relative to that of trade. And the first major consideration of both is whether they, in general, encourage positive policy reform or simply embolden bad governments.

It is certainly true that trade agreements have been misused to bolster bad political systems. A World Bank study analyzed the effect of trade liberalization in 30 African countries between 1981 and 2000 and found that trade did indeed reduce poverty -- but only when three conditions were met. The nations involved needed deep financial sectors, good education, and strong governance. In nations where those three conditions were not met, "greater openness to trade could be associated with higher levels of poverty" (Singh).

But as the World Trade Organization points out on its website, trade agreements do at least provide some mechanism for dealing with foreign government corruption: "The rules include commitments not to backslide into unwise policies" (WTO). Trade agreements have the effect of integrating developed and developing markets. In doing so, trade agreements bring developing economies onto the developed playing field, requiring them to reduce corruption. In fact, one of the biggest barriers to improving governance in the developing world is trade protectionism. Protectionism reduces the bargaining power of the poor and insulates corrupt political systems. The WTO

continues: “Particular types of trade barriers cause additional damage because they provide opportunities for corruption and other forms of bad government. One kind of trade barrier that the WTO’s rules try to tackle is the quota, for example restricting imports or exports to no more than a specific amount each year. Because quotas limit supply, they artificially raise prices, creating abnormally large profits (economists talk about “quota rent”). That profit can be used to influence policies because more money is available for lobbying” (WTO).

And this theory, that trade agreements reduce corruption, is backed by empirical data. Research published in the Journal of Economic Integration found that increased trade between the European Union and 34 African nations between 1984 and 2009 “reduced the level of corruption” in those African nations (Gokcekus and Suzuki).

The Effect of Aid on Developing Political Environments

Foreign aid does not integrate foreign markets with our own as trade does. Aid strengthens the allegiance of a foreign government to our own, but if the foreign government is corrupt, the aid will likely strengthen the corruption. Iqbal Z. Quadir, founder and director of MIT's Legatum Center for Development and Entrepreneurship, points out that Pakistan is one of those nations that has received substantial amounts of aid from the United States. “Pakistan has been one of the key recipients of U.S. aid over the last six decades, but there has been no real progress as a result. Pakistan is riddled with problems that are rooted in the disproportionate power of the state. Aid has only boosted that power,” he writes. But Malaysia, he continues, has benefited from trade rather than aid, and it has experienced economic growth twice that of Pakistan (Quadir). The reason for the disparity is quite simple. If a poor government is rewarded by foreign

aid, the government has less incentive to reform, and the people will be worse off. But if trade opens up the markets of a poor nation, the people of that nation will gain bargaining power in international markets, and the actors in the international markets will place greater pressure on the corrupt government to change.

Mr. Quadir's specific conclusions about Pakistan and Malaysia are backed by researchers from the National Bureau of Economic Research who found, in general "no evidence that less corrupt governments receive more foreign aid. On the contrary, according to some measures of corruption, more corrupt governments receive more aid" (Alesina and Weder 2). There are some who will suggest that more corrupt governments should be receiving more foreign aid because the aid will encourage positive policy reform, however the researchers found this was not the case: "we could not find any evidence that an increase in foreign aid reduces corruption" (Alesina and Weder 2).

We can think of it in this way. With foreign aid, we give resources to a foreign government. That government, if it uses the resources correctly, will reduce poverty. But with free trade agreements, the poor gain bargaining power over their own resources. Furthermore, the developing nation's market becomes more closely integrated with our own, producing an environment that will hopefully, in the long run, lead to positive governmental reforms.

Chapter 3

The Impact of Foreign Aid on Economic Growth

Aid is not only limited in its capacity to promote political reform. It has little capacity to promote long term economic growth, according to research. Take the example of Africa. Former Goldman Sachs economist Dambisa Moyo points out in an article for the Wall Street Journal titled "Why Aid is Hurting Africa" that African nations receive $50 billion in economic assistance each year, yet the aid has not translated into economic growth. "Over the past 60 years at least $1 trillion of development-related aid has been transferred from rich countries to Africa. Yet real per-capita income today is lower than it was in the 1970s, and more than 50% of the population -- over 350 million people -- live on less than a dollar a day, a figure that has nearly doubled in two decades," he writes. And the aid has not only been ineffective. In many ways, it has been harmful. First of all, the aid is not free. African nations must repay $20 billion in debt each year (Moyo). This debt burden diverts resources from programs that could be beneficial to the continent's economies. Furthermore, the African Union, Africa's regional body, found in a 2002 report that corruption costs the continent $150 billion a year (Blunt), and foreign aid, in many ways, makes that corruption possible . Northwestern Univerity Professor Jeffrey Winters delivered testimony before the Senate Foreign Relations Committee in which he claimed the World Bank "participated mostly passively in the corruption of roughly $100 billion of its loan funds intended for development" (Bhargava and Bolongaita 5).

And the failure of aid to promote long term growth is not limited to Africa. A 2005 study by researchers at the International Monetary Fund found, in general " little

robust evidence of a positive (or negative) relationship between aid inflows into a country and its economic growth. We also find no evidence that aid works better in better policy or geographical environments, or that certain forms of aid work better than others" (Rajan and Subramanian). This raises an obvious question. If the data shows aid to have no effect on a country's economic growth, then what is it good for?

Perceived vs. Actual effects of Foreign Aid on Developing Economies

It is clear there is a disconnect between the perceived impact of foreign aid and the actual one. When politicians go on TV and explain that people in poor countries do not have access to good education systems or paved roads, the natural response is to demand that the planet's wealthiest hand over a portion of their resources so that the impoverished might climb out of poverty, but this thinking is a product of distorted view of poor countries. We have made the mistake of thinking of poor countries as "inherently poor." We consider them to be in positions of despair, thus we discuss them as if there condition is hopeless. Rather than applying our energy to the promotion of programs that would expand poor economies, we look for band-aids. The results have been disappointing.

This does not mean that aid is inherently bad. If a poor nation experiences a natural disaster, it should certainly receive aid from the developed world. If the people of an impoverished country require aid to avoid starvation or dehydration or illness, they should receive aid. But is imperative we recognize aid can only function as a temporary band-aid and that the efforts to use foreign aid as a tool of economic expansion have been ineffective at best and counterproductive at worst. It is sent to help the people, but it provides only a barrier to necessary governmental reforms. It acts as a shield for

corruption. As Mr. Moyo puts it: “It is no wonder that across Africa, over 70% of the public purse comes from foreign aid. In Ethiopia, where aid constitutes more than 90% of the government budget, a mere 2% of the country's population has access to mobile phones” (Moyo).

Chapter 4

Trade Theory

Trade has been largely successful in promoting economic expansion in the developing world. I will support this claim in two ways. First, I will explain the virtue of trade as poverty-fighting tool using trade theory. Then, I will provide case studies where trade has been successful in alleviate poverty. It is worth noting, however, that trade is not a perfect method of reducing poverty. In general, trade barriers are constructed to benefit certain industries. When trade barriers are removed, the economy in general will likely grow, but the members of those groups previously supported by protectionism will likely be worse off, at least in the short-run. If a considerable portion of the nation's poor belong to those industries, then it is conceivable that a trade agreement could make the problem of poverty worse. This is why it is important to remember that neither aid nor trade can reduce poverty in isolation. The approaches must be used in tandem along with a whole host of other policies for a anti-poverty program to be truly effective.

That being said, trade offers a uniquely valuable approach to global poverty reduction given its unique capacity to produce long-term economic growth, and to understand this idea, we must look to trade theory. Without getting into the separate branches of trade theory (Neoclassical, New Trade Theory, and such), let's examine the idea upon which most economists agree: comparative advantage. The discussion of comparative advantage is especially necessary given the most frequent criticism of trade agreements, that they expose poor workers to international competition, making it harder for them to thrive. The basics of trade theory indicate the opposite is true. If a trade agreement is proposed between a relatively rich nation and one that is relatively poor, the

agreement will allow greater degrees of specialization in each nation and their combined output will increase such that the people in both nations are better off. Perhaps the rich nation will choose to devote fewer resources to manufacturing. They will instead develop a more robust financial sector or entertainment industry. The poorer nation will devote its resources to manufacturing. It easy to see how impoverished workers in the relatively poor nation will be better off. They are not being put off business due to the trade agreement. The opposite has happened. Their market has expanded drastically. This heightened degree of specialization resulting in a mutually beneficial trading arrangement is due to comparative advantage. A nation has a comparative advantage over another when it can produce a good at a lower opportunity cost. And opportunity cost is precisely the concept that explains why trade is such a powerful tool in the reduction of poverty. A rich nation like the United States has a finite number of resources and a finite number of laborers. The extent to which the United States can rely on relatively poorer nations produce cheap goods, it can dedicate its limited resources to the expansion of its service industry, the production of high-end products, etc. And to the extent the United States can specialize in the production of these types of products, relatively poorer nations will gain the opportunity to specialize as well, and both nations will be better off.

Thus, it is no wonder that a considerable amount of research exists that shows trade agreements, in the long run, have the effect of reducing poverty in the planet's poorest nations.

Case Studies

The nation of India, for example, began liberalizing trade in the early 1990s, but its various regions did not open up to trade equally. An analysis conducted by researchers

with Columbia University's Program on Indian Economic Policies found "faster poverty reduction in states and regions experiencing greater increases in exposure to trade" (Cain, Hasan, and Mitra).

A separate analysis, conducted by researchers for UN Millennium Project's Task Force on Trade, looked at the potential impacts of trade reform in Bolivia. These researchers found that trade reform could potentially expand the labor market by 50,000 jobs, which "could yield average gains of 7% on household income" (Lara and Soloaga). To understand why trade reform benefits Bolivia in this way, it is helpful to remember that, because of comparative advantage, trade reform usually benefits those sectors in an economy that are most robust. If a nation has a large agricultural industry, for example, then it likely has a large amount of agricultural resources. If this nation signs a trade agreement, it will likely enjoy a comparative advantage in agriculture (because its opportunity cost of producing agriculture will be relatively low). Thus, under a trade agreement, the nation's agricultural sector will likely expand. Similarly, poor countries often enjoy an abundance of low-skilled labor, thus they often enjoy a comparative advantage in the production of goods requiring low-skilled workers. These poor laborers, rather than losing work due to increased competition, gain work because they can now access foreign markets. This serves to boost exports and increase the nation's income. As the Columbia University's Program on Indian Economic Policies study points out: "Most poor countries are actually relatively abundant in unskilled labor. This fact should lead us to expect that unskilled workers will benefit from trade liberalization in such countries" (Cain, Hasan, and Mitra). These researchers point out that the effects of trade

reform are not always this simple. But as a general rule, trade reform will assist the poor -- not exploit them.

In Zambia, a separate group of researchers for the UN Millennium Project's Task Force on Trade analyzed the potential impact of ambitious trade reforms including domestic tariff liberalization and concluded the outcome would be twofold. First, there would be a small decline in employment. This is to be expected. If domestic tariffs were in place to support domestic workers, then it stands to reason those workers would "lose" in as scenario where that protection was removed. But the second impact of an ambitious trade reform would be lower prices for key consumption goods for all households. "At the end," reads the report, "the consumption gains associated with lower prices dominate the losses from job destruction so that Zambia stands to gains from the ambitious scenario" (Balat, Brambilla, and Porto 2). It is worth noting that, according to the study, Zambia would only realize a net-benefit from trade under ambitious trade reforms including domestic tariff liberalization subsidy elimination. Again, trade agreements are not a silver bullet. They require complementary measures in order to be effective in the reduction of global poverty.

A study organized by the World Bank found similar results in Cambodia. Under ambitious trade reform, "the changes in international prices coupled with the elimination of all Cambodian tariffs would produce gains of about 7.5 percent of per capita consumption on average" (Soloaga). According to the study, this increase in consumption would be expected "to produce a positive average impact on households' income of about 3.7%" (Soloaga). As with the Zambia case above, these gains are only realized under an ambitious trade reform scenario where the host country agrees to

reduce domestic tariffs. The researchers note that trade reform, rather than exploiting the poor, provides the poor with potential access to better technology and lower transaction costs. We see in Cambodia, once more, that trade can be an effective tool in empowering poor workers.

Alessandro Nicita of the World Bank Development Research conducted a study similar to those described above. His study looked at Madagascar. He examined two trade reform scenarios. The first scenario was a limited "business as usual" multilateral trade liberalization. The second scenario was an ambitious trade liberalization. The ambitious scenario, he concluded, would benefit the nation's poor: "the results indicate that the households that benefit most are those living in poverty, with increases in real income ranging from 2 to almost 3 percent" (Nicita). The "business as usual" trade liberalization would be less effective: "A similar distribution of gains, but of much lower magnitude, is found for the *business as usual* scenario" (Nicita). The limited liberalization is less effective because of Madagascar's weak infrastructure and its economy's slow response to changes in international prices. The researchers point out that many of the nation's poorest workers live in rural areas that will not be affected by changes in trade policy if the changes are not substantial. This is yet another example of the limitations developed nations face in reducing global poverty. There task is not simply to give impoverished people access to resources -- they must provide impoverished people with access to resources while overcoming the limitations of a weak and possibly corrupt host country.

In some countries, such as Ethiopia, governance is sufficiently weak to make the potential positive impact of trade reform negligible. Nicita, in a separate study for the

World Bank, found that Ethiopia, "Under the most optimistic scenario, when an *ambitious* liberalization is paired with domestic policies, the effects are estimated to be less than a one percent increase in real income for most households" (Nicita). Trade is ineffective in Ethiopia because domestic markets are undeveloped. "In particular, low price transmission, a pervasive subsistence economy, weak infrastructure and the overall low supply response of the Ethiopian economy severely thwart the possible benefits of" trade liberalization (Nicita).

Conclusion

There is no program or agreement that can alleviate poverty in isolation. Good foreign policy is like a good diet: the key is moderation. And in a good foreign policy, there is certainly room for aid as a well as trade, but it is helpful to remember the limitations of both. When it comes to long-term poverty reduction through economic growth, it is clear trade is the more effective. It provides a mechanism for reducing foreign corruption, whereas foreign aid emboldens bad governance. Whereas the evidence shows little support for aid as a tool of promoting economic growth, there is considerable research suggesting trade can be an effective means of promoting long-term growth and reducing poverty. Ultimately trade is more effective than aid because it, rather than simply transferring resources to the poor, gives the poor greater bargaining power over their own resources by expanding access to foreign markets.

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