Growth and Prosperity: Still the Best Ways of Reducing Poverty

Sandy Cuthbertson

Paper prepared for presentation at the "Prosper or Perish: Asian Poverty and the Australian Economy" conference conducted by the Crawford Fund for International Agricultural Research, Parliament House, Canberra, Australia, June 28, 2001

Growth and Prosperity: Still the Best Ways of Reducing Poverty

AUSTRALIAN ADDRESS

SANDY CUTHBERTSON

Although the title of this conference is 'Prosper or Perish', I intend to discuss prosperity - why it is to be preferred and what can be done do to make it happen.

The way many of us think about most issues is conditioned by how we grew up. As our childhood fashions the spectacles we use to look at the rest of our lives, I want to tell you a little bit about my childhood and how that affects my view of the issue at hand.

I grew up on a dairy farm at Miner's Rest, just outside Ballarat. It was a cold, windswept place, ill suited to dairying. The folklore was that a 10-year-old cow would grow 2 inches if taken 100 miles away from Miner's Rest in any direction.

We had a couple of neighbours. One was a prosperous farmer with a large well-run property. With him the boundary fences were excellent, the stock well-bred, well-fed and well-behaved. There were no rabbits, foxes, Paterson's curse or gorse hedge. The other neighbour was not prosperous. His farm was a mess, with weed-infested pastures, poor fences and ill-bred stock.

More importantly, the prosperous neighbour and my parents cooperated constructively on many things - from attending field days together to sharing ideas, farm equipment, roads and fences - the relationship was harmonious and constructive. In contrast, with the poor neighbour there was little prospect for mutually beneficial activities - there was nothing much to trade. Thus I have always taken the benefits of having prosperous neighbours for granted.

SANDY CUTHBERTSON is Managing Director of the Centre for International Economics (CIE), Canberra, which he along with Andrew Stoeckel established in 1986. His extensive overseas experience includes long-term assignments in Sri Lanka and Washington. For the last five years he has been part of CIE teams which have prepared an annual review of Vietnam's trade policies. Sandy grew up on a dairy farm near Ballarat in Victoria and studied agricultural economics at the University of New England and North Carolina State University.

Prosperous neighbours are to be preferred

The organisers of the conference want me to be the dry and detached economist establishing beyond doubt that prosperous neighbours are to be preferred. I am happy enough to do this, but to me it's almost a 'no-brainer'. Apart from the impressions formed as a young fellow, my logic is simple.

- With open trade the consumption possibilities available to citizens of participating countries depend on their collective production capacity - put simply there are no opportunities to gain from trade with a neighbour that produces next to nothing.
- As the productive capacity of any one particular country expands (i.e. it becomes more prosperous) the consumption opportunities open to the people in all participating countries expand.

Thus, Australia's merchandise exports with ASEAN have grown by an average 12% per annum over the past 12 years, despite falls in both 1998 and 1999 in the aftermath of the Asian financial crisis. Merchandise imports have grown by an average 16% per annum over the past 12 years. ASEAN investment in Australia grew rapidly through the 1990s until 1997 and is generally about double Australian investment in ASEAN countries.

As a boring economist, I am supposed to consider only hard and measurable things. But in fact when we are prosperous and our neighbours are prosperous, our circle of friends expands infinitely. So all our lives become richer as we are able to visit, talk over the telephone and exchange emails with more and different people. Even a Luddite like me has regular exchanges of emails, including jokes, with friends in Vietnam, Thailand and Sri Lanka. Some of these exchanges refer to work and projects but many are about fun and enhancing the quality of each other's lives.

Prosperity comes from private firms in an open competitive environment

If you look about you today one obvious thought comes to mind. In terms of development policy this audience is the A list. In fact, just for a little bit of research we downloaded everybody's CVs and list of publications. I took all those careers articles, reports, books and so forth and derived a few quite astounding statistics. Consider the following.

- In this room today there is a total of 5499 person years equivalents of development policy activity (and by the end of the day we will clock up 5500).
- The overseas travel activities would have supported:
  - one airline;
  - three hotel chains;
  - one Pajero assembly plant.
- If the total output by page was laid end to end, there would be sufficient paper to lay an unbroken trail around the world 7 times, and that is not counting charts and double-sided copying.

I have to say my own humble contributions sufficed for the leg from Singapore to Colombo. You will be delighted to know that this spectacular productivity, no matter how it is measured, shows no sign of slackening off. Despite the absolutely enormous contributions indicated by my calculations, I am now going to argue that there are bigger and more sustainable contributions to development that are made by people who are probably not here today.

These people include the business people, the sales people, the adventurers who set up factories, shops, bars and trading houses in small towns and back streets. Most of us here today are not familiar with such people. Some of us might even find them a bit sharp. They have to be to survive. In Sri Lanka last week I met Australians who had established factories to make garments, others who were making sailboards and others again who were exporting specialty beers from Sri Lanka. Sometimes these investors are footloose, they work out of suitcases and you meet them in hotel lounges because they have no office. In other cases they are big respectable firms. Whatever the case, people like me must take care never to kid ourselves that we are at the front end of development.

But important as these investors and traders are relative to most of us, they too are relatively unimportant in the scheme of things. Development in the end is something that starts and is achieved by the citizens of the countries involved. We would all like to see them become prosperous, but the driving force for development is that so would they.

Recent years have seen substantial changes in the nature of foreign direct investment in developing countries. For many years it was resource-based sectors that attracted most of it, but through the 1990s private infrastructure schemes have come to be increasingly important.

Following the early efforts of Chile and the United Kingdom, Michael Klein of the World Bank private sector advisory services department says that over 140 countries have been trying out private participation in infrastructure (Klein 2001[7]. This is involving extensive effort in developing the regulatory arrangements that help these markets work effectively. The World Bank's 2001 Global Prospects contain a study of electronic commerce in developing countries. According to this report the big impediment to electronic commerce is telephone access and call charges. The report observes that the best chances for increased telephone penetration lie in the use of competition and the harnessing of private investment and ideas.

Why should anyone doubt that prosperous neighbours are to be preferred?

To me the real riddle is to be found in the question as to why on earth anyone would not wish their neighbours to be prosperous? To be sure there are people capable of envy and jealousy but not many, and there are certainly none here today, so I doubt that this is an explanation worth pursuing.

But other possible explanations might be:

- People are concerned that prosperity in other countries comes at the expense of poor people;
- People see other countries as competitors and increasingly prosperous countries as tougher competitors;
- People like prosperity well enough but they are uncomfortable about what it takes to achieve it.

Concern that prosperity comes at the expense of poor people

A recent report which CIE staff helped DFAT prepare describes large reductions in the incidence of poverty in several East Asian countries. The absolute number and proportion of people living on less than the World Bank's uniform poverty line of US$1 a day fell sharply in East Asian APEC economies between 1985 and 1995 (see Chart 1). The number of people living in poverty fell by about a third (around 165 million people). In Indonesia and China, the proportion of the population living in poverty fell by 65% and 41% respectively (CIE 2000[8]).

Vietnam has also achieved considerable success, according to this criterion, in reducing the incidence of poverty over the past decade. The measure shows, of course, changes in only one dimension of poverty. But the success of these APEC economies in improving a broader range of social indicators confirms a positive story about the wellbeing of the poor, which has been affected, but far from reversed, by the increase in people living below the poverty line as result of the financial crisis (World Bank 2000[9]).

Most of this reduction in poverty is attributed to the strong growth of these economies. Chart 2 shows that economic growth has been the overwhelming force behind poverty reduction in many East Asian

[7]*Private Sector Development; Entrepreneurship, Markets and Development.* Klein, M. World Bank Private Sector Development Strategy, 7 May 2001.

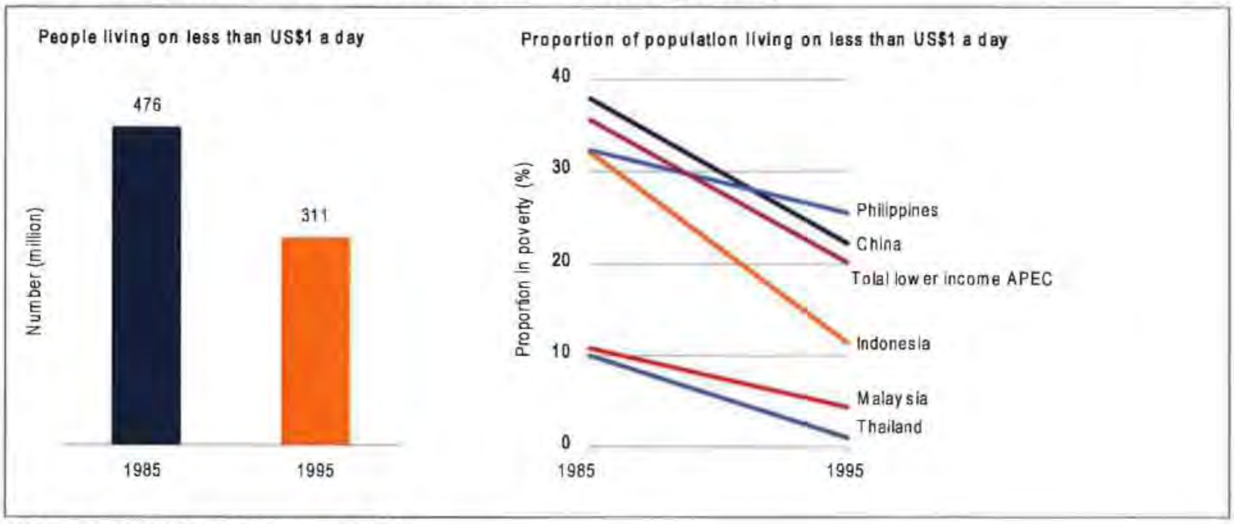
[8]*APEC's Decade of Progress: Open Economies Delivering to People.* CIE. APEC Economic Leaders' Meeting in Brunei Darussalam, 2000.

[9]*World Development Report: Attacking Poverty.* 2000. World Bank, Washington, DC.

APEC economies. This confirms recent research which shows that, contrary to some widely held views, growth is good for the poor.

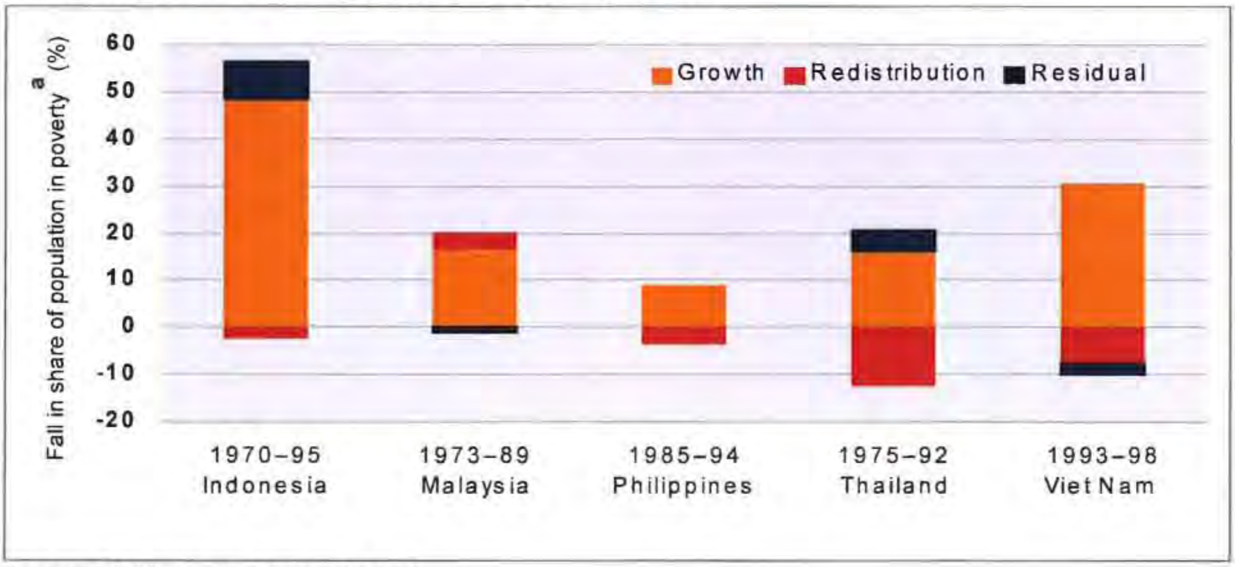
This research shows that, on average, every percentage point increase in average household consumption reduces the proportion of people living on less than US$2 a day by about 2% (World Bank 2000). In other words, the benefits of overall economic growth are felt quite strongly by the poorer parts of society. Economic growth has consistently led to rising consumption in the poorest fifth of the population in developing economies. World Bank analysis of growth and contraction experiences in 65 developing economies shows that, on average, growth in consumption by the poorest fifth tracked overall economic growth one-for-one in the 1980s and 1990s (World Bank 2000).

Chart 1. **East Asian APEC members have been alleviating poverty**



Data source: APEC's Decade of Progress, CIE 2000

Chart 2. **Growth is the driving force behind poverty reduction**



Data source: APEC's Decade of Progress, CIE 2000

Income improvements for the poor are one thing- but what if the rich are getting richer faster?

I am pleased to be at a conference about prosperity. To me it is a very positive and upbeat approach which sits well with economic growth. I have recently had to adjust my thinking as the focus of international agencies has shifted from economic growth to poverty reduction. So over the past nine months I have worked in Kyrgyzstan, Nepal and Sri Lanka. In all these places there are World Bank, ADB, UNDP and Government resources working on poverty reduction strategies.

In most cases the change is one of emphasis rather than direction. These strategies still begin with the presumption that poverty reduction requires growth. And in some cases the revised emphasis has helped people recognise that the obstacles to many pro-growth measures are created by the enfranchised and relatively wealthy to impede policy reforms which would erode some of their preferred positions. It has been healthy to recognise the tendency for much official development assistance to slosh around in capital cities. And it has also been constructive to shift attention onto the investments that help people out of poverty through education, health and labour market reform. As yet it does not seem to have resulted in an increased emphasis on agriculture and rural development. We will come back to this later but for now note that:

- The countryside is where the people are and it is where most of the poor people are; and
- It was the green revolution of the 1960s that triggered significant growth of many Asian economies.

While shifts in the balance of effort are generally positive. I worry about getting to the point where it is not considered sound to advocate economic growth and prosperity, and that it is only acceptable to say we are all on about poverty reduction.

This emphasis on poverty reduction seems to originate in the widely held belief that economic growth as it has occurred in recent years has led to ever-widening global inequality. While I have lacked the wit and energy to challenge these statistics, I have not been comfortable with them.

- Most developing countries grow faster than developed countries because by taking advantage of the technological discoveries made in developed countries they are able to 'leap frog' or 'catch up'. The missions of both ACIAR and the Crawford Fund are to facilitate this 'catch-up'.
- When I go to Sri Lanka, where I have been working for 20 years, or Vietnam, where I have been working for ten years, certainly most of the people I see are much better off.
- The fact that some countries (mainly Asian) are growing faster than other countries (mainly African) could mean that a global assessment of inequality could find that it is increasing. But that is not a 'growth' outcome, it is a 'no growth' (in Africa) outcome.
- Studies so far find no systematic relationship between growth and distribution.
- Direct measurement of poverty typically understates even poor people's incomes. When surveyors go into homes in Vietnam for example, they frequently find evidence of consumption - TVs, motor cycles etc, which do not reflect reported income. Poor people have a strong incentive to not disclose information to officials.

So I was interested to read last week that the former head of Australian Bureau of Statistics, Ian Castles, does not agree with the conventional wisdom that there is growing inequality and considers that the evidence shows that the relative gap between rich and poor is in fact narrowing (Castles 2001[10]).

According to Castles, these statements of widening inequality are based on calculations which convert GDP into a common currency and grossly understate the contributions of developing countries to

[10] Castles, I. *Australian Financial Review*, 14 June 2001

global output. These views are comforting to me, as for most of my career the model I worked with involved development of policies which would promote economic growth. Over the years, I and people like me could well be accused of taking it for granted that without economic growth, there was little chance of people moving out of poverty, and with it there was a pretty good chance. I am relieved to find these possibly lazy presumptions of ours are not wide of the mark.

Having said that, in recent years such presumptions have been modified as we have come to recognize the importance of institutions and governance for both achieving sustainable growth and providing opportunities for everyone to have a go at getting some of it.

These issues are important. If there is a belief that economic growth - and the only policies that will deliver economic growth: open trade, domestic competition and market-supportive institutions - has delivered inequitable results, that might lead to dissatisfaction with the only real option for improving the lot of poor people.

Even worse it might lead to policies which actually hurt poor and rich alike. These include reverting back to protection, job guarantee schemes, unfair dismissal laws and attempts to apply draconian taxation of the wealthy that end up taxing the middle class.

The tendency to see other countries as competitors

I was in Sri Lanka last week. Some of my friends there were worried about a trade agreement Sri Lanka has formed with a large and reasonably rapidly growing India. They seemed to think that selected Indian products would flood into Sri Lanka and wipe out some Sri Lankan producers. This might be a problem for the Sri Lankans who produce those products, though the evidence is that the positive growth effects of increased trade opportunities invariably make adjustment much easier than most people expect. Expanded trade opportunities make consumers better off. It makes exporting more attractive and generally stimulates rather than depresses economic activity. Consumers will eventually need to generate foreign exchange to buy the imported goods, so eventually enhanced access to good-value Indian products will be equivalent to a boost in demand for exports.

This tendency to see the economic output of the world as fixed is not helped by language which has it that the people of the developed world are rich because they 'control' most of the world's GDP. As Ian Castles points out, wealth is generated by production, not by control. He notes the fallacy of seeing world output as a fixed pie from which poor countries necessarily must get less if rich countries prosper - or one where the increasing prosperity of developing countries means less for us (Castles 2001).

The 'it's not so much that people are against prosperity, it's more that they are against what has to be done to achieve it' explanation

Perhaps I might preface my remarks here with a comment of the well-known American trade policy economist, Michael Finger. He says 'If your favourite tool is a hammer, all of your problems will look like nails.' My favourite tools are open trade, competition and institutions to support both. I am happy enough to admit to this, but there is convincing evidence that I am on the right track.

A substantial number of countries have been able to double average per capita income in about 10 years - e.g. Botswana, Chile, China, Ireland, Japan, Korea, Thailand - by adopting and adapting technical and organisational advances already invented elsewhere. Openness and competition - including easy entry and exit - are needed for this kind of leap-frogging to happen, and they provide the best bet for poverty reduction. Openness and market competition, particularly in testing export markets, underpinned much of the growth of East Asian economies. All the evidence is that the poor benefit from growth in the same proportion as do others. Connecting the poor to markets by giving them choice by providing entrepreneurial opportunity, by building roads and communication systems - all these things support the most powerful mechanism for escaping poverty, namely the ability to adopt and adapt improved practices.

The way forward

Michael Klein believes competitive markets are one of the reasons why we can even think about international development targets of halving poverty by 2015 (Klein 2001), yet open trade and competitive markets are widely seen as 'bads' by people with a keen and sincere interest in development. A large number of people seem to see prosperity built on such foundations as a conspiracy of the elite and the establishment.

Thus we have seen violent demonstrations over the last few years whenever the agencies promoting openness and competition meet. How can this state of affairs be reconciled? Consider the following explanations:

- When people stress the virtues of openness and competition they do not mean 'nature red in tooth and claw'; they mean and should stress the importance of institutions to support market transactions that are voluntary exchanges between citizens;
- Some of the underlying principles of the WTO have been undermined so the WTO rules now tend to obscure the case for free trade; and
- There is a tendency to forget the people in rural areas.

The importance of institutions

Some 15 years ago a World Development Report tackled the charge that some of its policies were of a kind that 'so long as the price was right' it would rain. This is a bit simplistic, but it is fair enough to say that there was a tendency to believe the 'market' would do it. With the experience of transition economies through the 1990s has come a realisation that there are many market-supporting institutional arrangements which cannot be taken for granted. Hermando De Soto's extensive work over the last few years has concluded (*The Mystery of Capital*[11]) that many poor people could tap into considerable wealth under institutional arrangements which clarified title of land, created reliable conditions for them to save and borrow, and removed barriers to entry and exit into entrepreneurial activity. The recent shift to finding the evolving role of government and the law which will promote effective market transactions - such as accounting standards, property rights, enforcable contracts, dispute resolution methods - seems a potentially much more constructive thing to do than to fight openness and competition at every turn. This same consideration explains why some countries that have followed the open trade market route have not prospered.

The tendency to confuse the arguments for open trade

A second reason why people might protest against the WTO and the World Bank is the unfortunate perception that these organisations are urging developing country governments to adopt measures which are against their best interests and are in the interests of the developed countries only. In the case of the WTO this perception has been nurtured by the so called 'concessions' approach which has it that any reductions in trade barriers a country makes are concessions or favours made in order to get trading partners to reduce their trade barriers. In fact, the primary reason why countries should reduce trade barriers are entirely domestic.

While the WTO is inclined to get the credit (or the blame depending on your point of view) for the extensive reductions in barriers to trade of the last few years, in practice most trade reforms are made by countries for sound domestic reasons and have nothing to do with the WTO. Over the last 20 years I have worked in many countries which have taken substantial trade openings. In each case the reforms were introduced in recognition of the need to do so to ensure improved economic performance at

[11] *The Mystery of Capital: Why capitalism triumphs in the West and fails everywhere else.* De Soto, H. Bantam Books, London. 2000. 243 pp.

home. This was the case in New Zealand in 1986, in Australia in 1987, in Sri Lanka in 1977 and in Samoa in 1998. It is also the case in non-WTO member countries, China and Vietnam.

A few years ago Vietnam embarked upon a vigorous structural adjustment program called *doi moi* or economic renovation. It involved:

- Establishment of property rights for farmers;
- Dismantling of some state-owned enterprises;
- Achievement of fiscal balance; and
- A substantial dismantling of trade barriers.

These significant reforms were not part of any Structural Adjustment Loan and had no international agency conditionality. They were introduced in 1989 as Vietnam faced a crisis following prolonged drought and the break-up of the Soviet Union. They were introduced because economic renovation was seen to be Vietnam's best if not only economic policy option. Finally and most importantly, they worked. From a situation where food security was a dominant concern, Vietnam is now the third, and sometimes second, largest exporter of rice in the world.

The tendency to forget people in the bush

A famous and chronic New York bank robber, when asked why he persisted in robbing banks replied - 'because that's where the money is.' In the same way, if the Crawford Fund was asked why it worked on agriculture, one answer might be 'because that is where the people are'.

That it is where the people are is one reason for focussing on agriculture. Another is that all the evidence is that across Asia rapid improvements in incomes and agricultural production have contributed to rapid reduction in poverty - this despite increasing population pressures. It is well known that all the transforming economies in Asia (except of course Hong Kong and Singapore) enjoyed successful agricultural revolutions before their modernisation.

A technology-driven transformation of the agricultural sector appears to be a necessary condition for good economic growth; rapid agricultural growth contributes to economic transformation in several ways:

- It supplies basic foods, raw materials for agricultural industry and exports;
- It releases labour and capital (in the form of rural savings and taxes to the non-farm sector); and
- It generates purchasing power among the rural population for non-farm consumer goods and services.

Jim Ryan has recently drawn attention to the diminished interest in agriculture by the international development community. I understand that the share of the World Bank's loan portfolio for agriculture and rural development is some 7%, down from 30% some 25 years ago. On average agriculture takes up about 10% of OECD countries development assistance, and in Australia it is 3% or 4% (Ryan 2001[12]).

This diminishing interest in agriculture might reflect reduced concerns about food security stemming from past technological successes and reductions in trade barriers.

My colleague at CIE, Andy Stoeckel, has consistently documented the gains to be had in all countries from agricultural trade reform. These reforms will surely occur one day, and there are powerful reasons for both the technology and policies of developing countries to be in shape for that time.

[12] Ryan, J.G. *Canberra Times*, 22 June 2001

Finally, I would like to thank the organisers of this conference. they had given me a chance to talk about prosperity, private voluntary exchanges and agriculture. I have enjoyed doing that.