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Economic Liberalization and Globalization

vs.

India's Poor

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Summary

Today, many in the national and international NGO community perceive globalization and economic liberalization as a threat claiming that it widens inequalities and increases overall poverty. While it is true that inequality is on the rise in a rapidly globalizing world the real culprit is not globalization itself but rather a lack of economic reforms and economic liberalization. This paper aims to show that many in the international NGO community confuse cause and effect. The root cause of poverty is not economic liberalization – it is the exclusion of the poor from the market economy. Hence, in order to fight poverty, NGO's should not oppose globalization and economic liberalization but rather instrumentalize them in favor of the poor.

1. Introduction

In India today a good 300 million people live below the poverty line, with a great majority of them residing in the rural areas of the country. While overall poverty data have improved since economic reforms had been introduced in the early 1990s not all have benefited from this paradigmatic change.[1]

Some members of the national and international NGO community reject globalization and economic liberalization exactly on these grounds. They argue that due to these processes inequality has risen and refer to a widening gap in income of the rich and the poor. While it is true that inequality is on the rise in a rapidly globalizing world the true culprit is not globalization itself but rather *a lack of* economic reforms and economic liberalization in the countries affected. This paper aims to show that many in the international NGO community confuse cause and effect. The root cause of poverty is not economic liberalization – it is the *exclusion* of the poor from the market economy. Hence, in order to fight poverty, NGO's should not oppose globalization and economic liberalization but rather instrumentalize them in favor of the poor. That is, the role of NGO's should be to hold the state accountable by ensuring that it fulfills its obligation towards the poor to enable them to participate in the market economy.

The argument is laid out in three parts. The first section takes a journey into India's economic past to demonstrate why a reform process became necessary at the beginning of the 1990s. Subsequently, I will show how globalization enhances economic growth and why it matters for the poor. As economic growth is a necessary but not a sufficient condition for poverty eradication the final section discusses essential complementary measures.

2. How the Left Went Wrong

India's problems today are mainly the result of economic failure and mismanagement in the first four decades since independence. Under Nehru, the newly independent republic subscribed to the aims of speeding up economic growth, following a policy of social justice and to a dogma of economic self-sufficiency. While enhanced growth and social justice were seen as necessary tools in the urgent fight against poverty the policy of "self-reliance" did not only aim at an independence from foreign goods but was also seen as a precondition for the

[1] See Agrawal and Srinivasan, pp. 128 – 133; and Bhalla, S., p. 42.

country's newly-won political independence. Thus, a policy of import substitution replaced international trade in goods and commodities. High tariffs and quotas on imported goods, so the argument ran, would deter imports from industrialized countries. In doing so, the economic planners hoped they would encourage growth within the manufacturing sector so that the majority of the working population would eventually move from agriculture to industry. Like many centrally planned economic objectives, this goal, too, was not achieved – employment in manufacturing between 1960 and 1980 grew only at an annual rate of 3 per cent, not faster than the country's population and the vast majority of India's working force – a good 60 per cent – still remains employed in the agricultural sector. [2]

With its policy of import substitution, India had followed three aims. First, it aimed at securing the country's economic independence which was expressed with the term "self-reliance". Second, it wanted to help the creation of a domestic industry by this policy measure. Finally, due to the expected reduction of imports, the government expected to increase the central bank reserves.

There are mainly two reasons why this policy did not work as intended. First, industrial production was more capital-intensive than agricultural production (a car factory needs more complicated machines than a rice farmer). As a result, India needed both people who could work with these machines and people who could manufacture them. Both required higher skills than many workers in the agricultural sector possessed – so only the relatively higher skilled workers could change from agriculture to (the better paid) industrial jobs. Additionally, capital-intensive production by its very nature does not require as many workers per output as labor-intensive production. Fostering a capital-intensive sector, then, will not succeed in providing jobs for a vast majority of relatively low educated workers. Second, India's very restrictive labor market and its strict job security laws were responsible for the country's meager economic performance so that a high number of its population remained in poverty.[3] As it is difficult for employers to lay off workers when the economic outlook becomes gloomier, firms are not inclined to higher more workers during boom phases – they rather outsource their production to the informal sector than to hire workers themselves. What is more, since import-substitution favours the production of capital-intensive goods, it directly harms the agricultural sector (where developing countries usually have their comparative advantage). Import-substitutions, therefore, has a negative impact on poverty reduction.

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[2] See Krugman, Paul R., and Maurice Obstfeld, pp. 254 – 262.
[3] See Agrawal and Srinivasan, pp. 147 – 148.

With import-substitution, though, the poor are doubly hurt. Since production concentrates largely on the domestic market, which is usually too small in terms of effective domestic demand, the economic can fall into a "growth trap". Also, a reduction of imports leads to a smaller demand for foreign currencies. This, in turn, forces the domestic currency to appreciate which further decreases the incentive to produce goods for the export markets.

The policies of import-substitution and economic self-sufficiency combined with very strict job security law led to the creation of a huge informal sector in the Indian economy[4] which would have never come about to this extend under a private market system.

An additional economic policy mistake needs to be pointed out. Rather than implementing an economic model based on privately owned companies to compete for employees and consumers, the government of India followed a socialistic approach by creating state-owned public sector units. As jobs in those state-owned companies were rather secure (for those who were lucky enough to be employed), incentives to work hard and to produce quality work was lower than in a competitive market economy. Consequently, both output itself and the quality of the output were lower than what a private company could produce with the same amount of workers.[5] Not only did this policy harm job seekers and consumers – it also proved to be unsustainable with regard to public finances. The majority of the public sector units constantly ran on a loss so that a good amount of the taxpayer's money was needed to support them. Rather than *creating* tax monies, therefore, state-owned companies *consumed* them – leaving not much for public investment in education and health.

The dominance of the state in the Indian economy can be characterized by a few exemplary points. In the government's opinion it did not suffice to restrict itself on merely supplying the necessary infrastructure and regulatory framework to the economy. With the creation of public enterprises it reserved a large part of the economy for the state and prevented the private sector from entering. Those parts of the economy that remained for the private sector were again regulated as a certain fraction was reserved only for small-scale industry. In addition, a complicated license-system was created to control private industries. Foreign direct investment and joint ventures where foreign enterprises held the majority were prohibited. Table 1 shows average tariffs for selected countries in 1986.

[4] About 90 per cent of India's labour force is employed in the informal sector.
[5] See Agrawal and Srinivasan, p. 147.

Table 1

Country	Capital Goods	Consumer Goods	Manufacturing	Tariff Rate on Imports
Argentina	25	21.9	22.9	13.8
Bangladesh	80.5	116.1	100.8	15
China	62.5	130.7	91.2	NN
India	**114.5**	**128.5**	**121.7**	**41.3**
Morocco	18.1	43	27.8	16.6
Mexico	23.5	32.2	24.7	6.8
Thailand	24.8	48.5	33.5	12.5
Turkey	34.9	55.3	37.1	7

Table 1: Average tariff rates (Source: World Bank. 1989, p. 137.)

India's tariff system differed from those in other developing countries in two aspects. First, tariff rates were extremely high. Apart from Bangladesh and China, tariff rates in other developing countries were far lower. Second, while the tariff levels in other countries declined over time, in India it increased before 1990. This was not only due to protectionist policies. For the Indian government high tariffs were also a major source of income as table 2 demonstrates.

Table 2

Country	Share of tariffs by the value of imports		Share of tariffs by tax income	
	1980	1987	1980	1987
Bangladesh	19.8	17.9	39.1	38.7
Brazil	16.0	8.7	8.7	2.5
India	**29.7**	**61.9**	**24.8**	**34.8**
Indonesia	4.7	4.7	4.5	6.4
Mexico*	11.0	3.9	7.7	6.5
Pakistan	24.6	24.7	34.8	38.8
Thailand	10.1	11.1	21.8	20.6
Turkey**	39.1	11.8	12.3	17.8

*Table 2: Indian tariff structure in comparison with selected countries. *Numbers are for 1979 and 1987; **Numbers are for 1980 and 1988. (Source: Askoy, M. 1992. p. 19.).*

In addition to its strict policy on imports the Indian government also actively engaged in export policies. For one, there was the aim to secure a sufficient supply of goods in the domestic market. Thus, the agricultural sector was largely affected by export controls although this is where India had a comparative advantage. A second aim of export controls was to influence world market prices. As a result, India's share on world exports declined from 2 percent in 1950 to 0.5 percent in 1990.[6]

Panagariya summarized the effects of these policies as follows: "By the late 60s and early 70s, profit opportunities the protected market had created had already given rise to a substantial entrepreneurial class. It was a pity that progressively tighter controls forced these entrepreneurs to operate in a sheltered environment and to engage in rent-seeking activities rather than to compete with the best in the world. As a result, both productivity and product quality suffered."[7]

In such an environment, neither the aim of enhanced growth nor the goal of social justice could be met. Instead, the poor suffered more on the way to a crisis that was waiting to happen.

3. Into the Crisis

During the 1980s India's fiscal deficit increased from 6 percent of GNP to 8.4 percent of GNP due to higher public spending. The growing deficit was largely financed through India's central bank which led to an expansion of the monetary base and higher inflation rates. In addition, private savings needed to be used to pay for public consumption reducing resources for private investment. To hold the inflation rate down, the government reduced public investment and increased the cash-reserve-ratios and the statuary-liquidity-ratios. As a result of the expansive fiscal policy, India's current account deficit worsened and foreign debts grew.

At the beginning of the 1990s, and basically with the start of the gulf war, the combination of India's policy wrongs led to a balance of payments crisis. As oil prices hiked central bank's reserves shrank from 3.11 billion US dollars in August 1990 to 896 million US dollars in January 1991.[8] Pressure on the Indian Rupee additionally reduced reserves while

[6] See Srinivasan, T. 1994. p.178.
[7] Panagariya, A. 1994. p. 205.
[8] See Agrawal, P. et al. 1995. p. 159ff.

the central bank tried to stabilize the exchange rate. In June 1991, then, the country's reserves had dwindled to a value equal to a two-week's import volume. It was in this situation that the country finally not only opted for a stabilization of the economy but also for fundamental structural reforms.

The decision for structural changes, opening of the economy and a withdrawal of the state from economic activity did not come too soon. A rather centralized and closed economy had left millions in unemployment or underemployment and brought India the unflattering reputation of being host to the world's largest number of people living in absolute poverty. The results of India's policy for the poor can best be seen in table 3 where we compare its growth rate and social indicators with those of other Asian countries.

Table 3

Country	Growth Rate (GNP)[a] 1980-93	Life Expectancy[b]		Child Mortality[c]		Literacy Rate[d]	
		1960	1992	1960	1992	1970	1992
India	3	44	60	165	89	34	50
Indonesia	4.2	41	62	139	66	54	84
Rep. Korea	8.2	54	71	85	11	88	97
Malaysia	3.5	54	70	73	14	60	80
Thailand	6.4	52	69	103	26	79	94

Table3: [a] annual per capita growth rate in percent; [b] Life expectancy at birth in years; [c] Child mortality per 1000 births; [d] Share of literate adults in percent. (Source: Bajpai, N. and J. Sachs. 1997, p. 136).

To remedy this situation, reforms need to achieve at least two major goals. First, economic growth must be enhanced to increase the nation's income – to make the pie bigger, so to speak. This could mainly be achieved through a greater integration into the world economy. Second, to fight poverty it is equally necessary to enhance the poor's abilities. This is a question of how the pie is shared and thus addresses the question of institutional quality. We will deal with each of these points in turn.

4. Make It Bigger

Today economists across the board agree that a private and open market economy is superior to any other solution as far as generating economic growth is concerned. Simply put, economic growth is the rate at which a nation's income is rising. A country's per capita income will rise when the growth of its national income is higher than the rate of its population growth. In this case, then, there will be more money for consumption and investment. In sum, the standard of living rises when economic growth is greater than population growth. For this reason, most economists stress the importance of economic growth for poverty reduction.

In theory, opening an economy to the world market enhances economic growth through a variety of channels.

First, there are static (or one-time) gains. This is, because consumers gain through cheaper imports when trade barriers are removed. Consumers will not only face lower prices but also a greater variety of goods. Further, for the economy as a whole can allocate its resources in a more efficient way as it can now concentrate on those sectors where it has a comparative advantage. This is the classic argument for free trade going back to the days of Ricardo.

Second, with the opening of the economy to foreign markets domestic producers will be able to sell to a bigger share of consumers. With this, they can achieve economies of scale by reducing their average production costs. These points are stressed by Krueger (1980) and Bhagwati (1988). Similar arguments are made by Lucas (1988) and Young (1991) who emphasize the importance of the "learning-by-doing"-effect.

Third, former national monopolies will now have to compete with foreign companies. As monopolies tend to sell their products for higher prices, creating competition through openness to trade will trigger a tendency for lower prices. Higher competition will also lead to an improved cost control and thus to more efficiency of the domestic industry.

Fourth, openness can lead to an increase in total factor productivity.[9] As it is then possible to get access to better technologies the productivity of the capital stock can be increased and cheaper imports will also help to reduce costs of production.

Finally, greater openness will also lead to positive externalities. As Grossman and Helpman (1991) show in their research, this happens, through an easier transfer of know-how and technology. Due to an increasing transfer of know-how, the domestic industry will be able to

[9] See Harrison, A. and G. Hanson. 1999, p. 3.

imitate foreign technologies. This sort of imitation played a dominant role in the growth process of the newly industrialized countries of East Asia.[10] Also, foreign direct investment leads to a direct transmission of new technologies which can then diffuse with greater ease.

While theory is quite straightforward in stressing the advantages of openness for the eradication of poverty, the empirical literature has not yet established the final proof for this positive link. Overall, it does, however, tend to support the theoretical considerations. Empirical studies by Roemer and Gugerty (1997), Dollar and Kraay (2001) and Deininger and Squire (1998), for instance, show that the income of the poor tends to increase proportionally with growth in per capita income. Bannister and Thugge (2001) examine the importance of openness for the eradication of absolute poverty. They point out that increased openness leads to possibilities for cheaper imports which affect the poor for instance in the case of medication. More openness, then, can have a positive impact on health care which in turn helps to increase productivity. This is a direct positive effect for the poor. Wälde (2000) also finds positive correlations for openness and growth, which in turn helps reduce poverty, but emphasizes that a causal link can not be established and that policy recommendations must depend on the situation of the respective countries. Contrary to other studies, Weller and Hersh (2002) reach rather sober conclusions concerning the effect of openness on poverty eradication. For the short run, they find that the poor are more negatively affected. For the long run their conclusions are ambiguous. The general conclusion to be drawn from the theoretical and empirical literature on openness, growth and poverty is that there exists a positive relationship between greater openness and economic growth. Higher growth rates, in turn, are a precondition for the eradication of poverty. Naturally, high growth rates can not be achieved through openness alone. The complementary measures needed in India shall, therefore, be explored next.

5. Way to Grow

As mentioned above, India's economic planners were not able to spur economic growth with their policy measures. Until the early 1990s growth rates hardly exceeded 3 per cent while after the introduction of economic reforms annual growth rates were between 6-8 per cent. This change was largely a result of economic liberalization.

[10] See Wacziarg, R. 1998, p. 4.

Before 1990 India had a rather closed, centralized and state-run economy. This resulted in the formation of a huge informal sector where the majority of the work force earns its living without any legal protection. A lucky few managed to get secure jobs in public sector units or directly in the public sector. This system of 'bribe and prejudice' especially marginalized members of scheduled castes and tribes and those of religious minorities. A liberal market system – on the other hand – is based on merit. Those with the right qualifications are able to move on in life and not necessarily the ones who are better connected or able to pay the highest bribes. This is the first reason in favour of liberalization – it sets the individual free from a state that all too often suppresses its potential with ideologies and dogmas.

In addition to a greater choice for job seekers and consumers liberalization and privatization stimulate economic growth and consequently help to alleviate poverty. Changing loss-making public sector units into private companies, for instance, creates an environment where companies become taxpayers instead of receiving money from the government. This widens the tax-base which is an essential part for further public investment in education and health care. Further, most market economists emphasize the importance of decentralization. This is in close connection with Mahatma Gandhi's vision of a decentralized organization of production units. A liberal economy that allows competition will bring about a number of small firms and companies. This is much needed especially in the rural areas where investment in non-agricultural production is very low so that unemployed farmers often need to migrate to urban areas. The introduction of a market-based economy can prevent this by setting incentives for the formation of small companies in the rural areas. One additional measure will raise the likelihood of such an outcome. As mentioned, India's strict labour laws urgently need revision. Presently, those who have jobs are very well protected by these laws and the high level of unionization in the country. The majority, however, is excluded from such generous protection and forced to work in the completely unprotected informal sector. This is a rather perverse situation and needs correction.

Contrary to a widespread belief, a liberal economic system is not about freedom for big companies – it is about freedom for all people living in the economic system. The state and well-run governmental institutions have a crucial role to play in creating and guaranteeing this freedom – as will be explored next.

6. The Role of Institutions

So far we have focused largely on the *generation* of a nation’s income. There is, however, a second component that needs to be addressed shall poverty reduction be successful – that is the *distribution* of this income. For both, the generation as well as the distribution of income the state plays a crucial role. As far as generating national income is concerned the state has to ensure equal market access for all its citizens. The question of income distribution needs to be addressed since an open market economy does not merely create winners in each country. Some industries will face a tough time through higher competition (especially if they haven’t been used to competition yet). The solution in this case is not, however, to reject liberalization (as it achieves higher growth rates than any other economic system) but rather to create an effective system of compensation for those who do not initially gain from it. The tasks of the public sector in these cases shall be addressed in this section starting with the case of income generation.

To achieve a fair market economy, the state needs to ensure equal possibilities for the participation of all citizens. This is a clear assignment to the political leaders for public investment in human and physical infrastructure. Human infrastructure mainly means the provision of basic education and basic health care. It is the state's responsibility that its citizens are being made aware of their rights to protect them from exploitative politics and other powerful participants within the market economy. Moreover, the state must equip its people with the necessary skills to successfully partake in the processes of a market-based economy. Both aims can only be achieved if the state provides both the necessary quality and required quantity of basic social services such as education and health care. Further, public investment in physical infrastructure is needed in form of power supply, roads and irrigation measures. The lack of public investment in human and physical infrastructure is a major determinant for rural unemployment and forces a great number of people to migrate to the already overcrowded urban areas with the well-known adverse consequences. In addition to public investment there is another responsibility for politicians. To ensure certain equality among market participants the distribution of assets needs to be reviewed. In the rural areas, a small number of rich landowners often abuse their economic power to the disadvantage of landless labourers. For this reason, many economists recommend for developing countries to carry out reasonable land reforms to shift assets in favour of the poor.

The above mentioned points refer mainly to the process of income generation. The responsibility of politics, however, does not stop with these measures. Equally important is its role in the distribution of the national income. In this case, public policy plays a major role. As mentioned earlier in this paper, in the short run privatization and globalization will not only create winners. Increased competition among and within countries will lead to a process where inefficient companies need to adjust – sometimes in form of firing workers. In this context it remains important not to confuse cause and effect. What makes adjustment necessary in the first place is the wrong economic policy of the past. The effect is the need to adjust. Now, to work against the effect would be a rather futile thing to do as it would merely extend economic suffering. What is needed is public assistance to those who would otherwise loose out in the process of liberalization. Public assistance in this sense has to reach from public employment measures, proper unemployment insurance, and a system of loans and credits for the poor. This form of public assistance will enable people to bridge necessary periods of adjustment without falling into poverty and to reorganize their lives.

7. What Role for NGOs?

A problem often occurring in this respect is that of state-failure. Where a country lacks well working political institutions, the interests of minorities, the marginalized or the poor are not seldom harmed and ignored. Missing democratic structures, high levels of corruption, and ethnic fractionalization are characteristics of the political reality in many developing countries. The question of the power structure within a society, then, needs to be addressed when we want to make economic liberalization work for the poor.

In this respect, it is surprising, however, how focused the majority within the NGO community stays towards addressing market failures. Globalization, so the argument often goes, benefits only the rich and hurts the poor. The conclusion drawn from this statement is that market forces should not be allowed to get loose. The question that in my opinion needs more attention, though, is why developing countries did not manage to eradicate poverty during those periods where economic liberalization was not even thought of in the majority of these countries. Had the problem of poverty received proper attention by the respective governments it would not be so widespread up to this day. The issue at hand for NGOs, then, is twofold. First, they need to address the problems of state-failure to help the poor to make their voices heard in the process of political decision making. Second, where economic liberalization does affect the poor in the short run and where state support does not happen, NGOs need to act as a surrogate for state support – this at least until proper political institutions are in place. Both tasks will lead to a real empowerment of the poor.

The first issue is one of advocacy. Since the poor lack the means to lobby for their own interests in political decision making, NGOs need to take over this part of lobbyism. In the past decade many national and international NGOs came about which took over this role. What they need to ask themselves, however, is whether they really do act in the interests of the poor by opposing economic liberalization and globalization. As should have been become clear from the argument laid out so far, is that an economic policy which opposes liberalization can not be in the interest of the poor. It favours a small fraction of society but directly hurts the poor by creating mass unemployment and an informal sector where people have to work under the worst conditions.

It is true, though, that market forces need control through the state. A clear legal framework and political institutions that manage economic liberalization properly are necessary conditions for an economy that is supposed to benefit all members of society. In many cases where the social contract is breached, however, those institutions can not be expected to work to the advantage of the poor. It is then, where the second task of NGOs comes into play – the grassroots work. Many NGOs in India work at this level. They take over responsibilities which could normally be expected to be assumed by the state. Thus, they provide safety nets, health care services and education. In addition, they remedy market failures. In cases where the poor would not be able to obtain credits from banks, for instance, microfinance programs help the poor to obtain the financial assistance they often need to build their existence. The true underlying nature of this problem, however, is not one of uncontrolled market powers. It is, again, one of state failure. Thus, it surprises that a large number of grassroots organizations seem to focus more on the possible negative externalities of economic liberalization than on the existing (and in my opinion more decisive) problem of state-failure.

Advocacy and grassroots work help to empower the poor. This is very necessary in constituting a society with a well functioning social contract – i.e. with well functioning political institutions. NGOs are very much needed, therefore, in this process of empowerment of the poor. Too often, though, they blame the negative impact of neoliberalism for the situation of the poor. Instead, they should shift their focus to the problem of state-failure. The establishment of well functioning political institutions together with efficient working markets need the highest priority in the fight against poverty. In this respect, NGOs should welcome globalization as a necessary process in achieving these goals. Not only does globalization help to realize higher growth rates; according to empirical investigations by Brunetti and Weder (2002) countries with a higher degree of openness have better governments. Thus, from a political economy point of view, increased openness can also help to fight corruption. Both must be in the interest of all those who want to assist the poor in the process of their own empowerment.

8. Conclusion

This paper aimed to show that globalisation and economic liberalization are not processes to be afraid of and thus to be opposed. On the contrary, for India today globalization today is a fact – many Indian IT specialists are wooed by the developed world, Indian students are able to exchange knowledge, culture and values with their counterparts in North America, Europe, and Australia, and a certain layer of India's population is able to choose from a greater variety of consumer goods and services. This is not a negative development at all. What is disappointing and, in the end, harmful for society as a whole is the fact that a huge portion of India's society is excluded from these developments. Hence, this paper argued for more liberalization and globalization – meaning: to empower the poor to be able to participate in the market economy. In doing so I tried to clarify the following two points:

a) The current problem for India is *not* economic liberalization. The root causes of poverty lie in the economic mismanagement of the past which made economic adjustment inevitable.
b) For the state there remains a crucial role to ensure a smooth working of the market economy. Public investment and public assistance are essential if the country is not to fall back into a situation once described as palaeo-liberalism – a state where 'survival of the fittest' is the only rule.

Today, the “cake” baked by economic activity is rather small in many developing countries due to distortions in economic policy which include corruption, a centrally planned economy etc. and its pieces are in many cases quite inequitably shared. The first problem is, then, that those countries do not use the right ingredients to bake a bigger cake. This paper argued for using the right ingredients which means for a country to turn its policies towards those of a private market economy open to international trade.

As shown, a bigger cake alone, however, is not sufficient for poverty eradication. During the 1980's the dominant economic theory proposed a 'trickle down' approach for development. In our analogy this would mean: bake a bigger cake and the lucky few on the table will leave more crumbs for the impoverished masses sitting beneath it. This approach, clearly, needs to be opposed. What is needed in addition to a bigger cake is to create access to the table for those who currently sit underneath it.

What does this mean for NGO's? The main conclusion to be drawn from this is in my understanding: fighting against economic liberalization is a fight against the effects and not the causes of the problems. What is needed is for NGO's to become the voice of the poor and thus to hold the state accountable to ensure that it lives up to its responsibilities towards all who signed the social contract. In other words: NGO's need to fight for the participation and against the exclusion of the poor from the process of globalization and liberalization. This is true empowerment.

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