Global trade entrenches poverty traps

October 27 2017

Competition between countries on global markets, says conventional wisdom in economics, is a Darwinian process that will weed out not only high-cost firms but also societal norms and institutions that are impediments to low-cost production.

Countries whose laws and customs are not attuned to producing high-quality goods at low cost will be the losers in the global competition game. And they will have to adopt the ways of the winners. Or so the story goes.

But a theorem published this week in the American Economic Journal: Microeconomics suggests that greater engagement in the international exchange can actually reinforce productivity-impeding practices that keep countries in poverty.

The authors show that rather than push countries to adopt the organizational methods (which they call "institutions") and social norms ("cultures)" that made the winner countries successful, greater engagement in international exchange will instead reinforce the productivity-impeding practices that left a country behind in the first place.

"An implication is that, to the extent institutions or cultures are holding a country back, having more trade with other countries is not going to spark a kind of race to the top. Rather, it locks countries into the status quo," says economist Samuel Bowles of the Santa Fe Institute, who co-authored the paper with Marianna Belloc of Sapienza University of

Rome.

Take an example from the past: The antebellum American south, which relied on slave labor to produce a simple good (cotton), could outcompete other nations in this product. Being part of the world economy is what made cotton "king" of the southern economy and this promoted the institution of slavery on which its competitive advantages were based.

But the slave economy could never be part of the industrial revolution, which required a kind of labor that could not be motivated by the whip. The south's advantages in global trade had effectively created a poverty trap.

"Freer trade allows each country to specialize in producing the things it's least bad at," Bowles says. "The result is it's going to prolong their badness—it will tend to make whatever institution or culture that accounts for the backwardness of the country more persistent, not less."

A second theorem in the paper shows that allowing freer cross-border movement of people—as employees—and firms—as employers—has the opposite effect, which Bowles describes as "accelerating a race to the top."

More information: Marianna Belloc et al, Persistence and Change in Culture and Institutions under Autarchy, Trade, and Factor Mobility, *American Economic Journal: Microeconomics* (2017). DOI: 10.1257/mic.20160079

Provided by Santa Fe Institute