The role of trade policy in development: an empirical investigation

Matthew Cadbury
University of Hertfordshire, UK

Keywords
Trade policy, economic growth, GDP

Abstract

History suggests that trade has had a significant effect on economic growth and hence development; however this is not reflected in economic growth theories and has not been conclusively demonstrated empirically. This paper proposes a new theoretical framework allowing trade variables to affect growth through market access and specialisation; which is based on the thinking of Adam Smith. Market Access can be considered as comprising a home market element and a foreign market element. For the majority of developing countries the home market is small compared with the global economy and therefore a simplification of considering only the degree of foreign market access might be acceptable. Trade/GDP ratio is a readily available measure of the degree to which countries access foreign markets and this is chosen as the proxy measure for market access. An empirical investigation of this kind is likely to experience endogeneity problems and the methodology needs to take this into account. A 2 stage least squares instrumental variables panel regression is used to test the hypothesis empirically. The results confirm the role of conventional growth variables and also show that trade/GDP ratio is positively correlated with subsequent income growth when instrumented by tariff and distance. This finding suggests that trade policy, as measured by tariff levels, restricts market access and lack of market access in turn reduces income growth and hence development. This study makes a contribution in three areas: a new theoretical mechanism for growth driven by specialisation through market access, use of new datasets with Effective Tariff to measure trade policy and methodologically through the use of 2 stage least squares instrumental variables analysis to reduce endogeneity problems. There is also a practical contribution in that most developing countries have higher than average tariff levels and the results of this analysis suggest that this policy choice is counter-productive in promoting development.