CHAPTER 2

LITERATURE REVIEW

2.1 Introduction

Tourism is considered an export for a country. In fact, tourism is a composite product (service in this case) that enters into international trade flows as an invisible export item. Artus (1972) states that '*international travel is similar to international trade: it can be described by a system of bilateral and multilateral relationships in which an import of foreign travel services by one country corresponds to an export of such services by another country*'. Nevertheless, tourism differs from other commodity export in the sense that the consumer (tourist) has to consume the product (service) in the exporting country. Tourism demand is relatively both price and income elastic compared with other commodity exports (Mill and Morrison, 1985). In addition, it is often argued that tourism has more environmental, social and cultural costs than other export industries (Mill and Morrison, 1985; Coltman 1989). Since tourism is essentially a form of international trade, it is natural that the international trade literature can shed light on the relationship between tourism and economic growth.

2.2 Relationship between Trade and Economic Growth

The relationship between international trade and economic growth has been of continuing interest both in theoretical and empirical literature. While the international trade theories are supportive of a positive relationship between

exports and economic growth, empirical evidences are rather mixed and that there is still no consensus among economists on the relationship to date.

The doctrine that international trade enhances welfare and growth has a long and renowned history dating way back to Adam Smith. Smith's book on "*An Inquiry into the Nature and Causes of the Wealth of Nations*", which was published in 1776, emphasized the importance of trade as a vent for surplus production and a means of widening the market thereby improving the division of labor and the level of productivity. Smith's **concept of vent for surplus** assumes that resources are not fully utilized prior to trade and that excess resources are then used to produce a surplus of goods for exports. Since the exports are increased without a decrease in domestic production, trade thereby raises the level of economic activity.

Following Smith, David Ricardo developed the **theory of comparative advantage** and published in his book titled "*Principles of Political Economy and Taxation"* in 1817. Based on the assumptions of perfect competition and full employment of resources, this theory states that countries can reap welfare gains by specializing in the production of goods in which they are relatively more efficient than others and then trade with it. These welfare improvements are due to specialization gains, i.e., increased efficeincy in production according to comparative advantage and to consumption gains, i.e., increased choice of goods at lower prices for consumers. Given the more efficient use of resources as well as

the increased production and consumption possibilities experienced by the nation, the nation's income level increases.

However, it is argued that effects from traditional trade theory are essentially static as they arise from the use of surplus resources or the reallocation of resources following increased specialization of production based on comparative advantage. Static gains imply a one-time-only increase in income, not a sustained improvement in growth. Once the surplus resources are fully utilized or reallocation of resources no longer are taking place, the static gains are exhausted. In fact, Baldwin (1984) concluded in a survey of empirical studies that the static effects were of little significance. In this regard, the debate on the positive relation between trade and growth has widened, stressing the dynamic effects which are focused in modern trade theory (Helpman and Krugman, 1985) and in 'new' growth theory (Grossman and Helpman, 1991).

Unlike static gains, dynamic gains from trade continue to shift outwards the whole production possibility frontier of countries if trade is associated with more investment and faster productivity growth based on scale economies, learning by doing and the acquisition of new knowledge from abroad, particularly through foreign direct investment. As such, the dynamic gains from trade manifest themselves in increased growth rate of output in the medium- and long-run. In fact, it is the dynamic effects from trade, which constitute a vital link in the causal relationship between exports and growth that have led to the formulation of

various export-based models to explain how growth in an economy, in a dynamic context, can be determined by expansion in its exports (Meier, 1995).

As this study attempts to provide an analysis of the role of international tourism in growth process from the point of view of the demand side of the economy, only the relevant "demand-driven" models would be highlighted accordingly. One version of the export-based model is that of the staple theory of growth. **Staple theory of growth** postulates that with the discovery of a primary product in which the country has a comparative advantage, or with an increase in the demand for its comparative advantage commodity, there is an expansion of a resource-based export commodity; this, in turn, induces higher rates of growth of aggregate and per capita income (Meier, 1995). Rapidly growing exports of staples can function as an engine of growth as the growth effects can spread to other sectors of the economy and not limited exclusively to staples production (Lundahl, 1991). The export of a staple product has effects on the rest of the economy through diminishing underemployment or unemployment, inducing a higher rate of domestic saving and investment, attracting an inflow of factor inputs into the expanding export sector, and establishing links with other sectors of the economy. Although the rise in exports is induced by greater demand, there are supply responses within the economy that increase the productivity of the exporting economy.

The **open-economy Harrod-Domar model** (1948), an extended version of the basic Harrod-Domar model (Voivodas, 1973), states that there is a negative

relationship between the rate of growth of domestic output and the proportion of exports to total product. As the underlying assumptions of the model are that capital formation is the only source of growth, imports are solely for consumption purposes and there is no distinction between domestic and foreign capital, exports and investment compete for the limited domestic resources in an economy. As such, the rate of growth of domestic product and exports are negatively related.

The **two-gap model** developed by Chenery and Associates (1962, 1966, 1970), an extension of the Harrod-Domar growth model, is another model that establishes the link between exports and economic growth. The concept behind this model is that there are two limits to the amount of capital formation, namely, domestic investment and foreign capital. According to these economists, the relationship between exports and growth hinges on whether the domestic or foreign resource constraint is operative. They argue that if the domestic resource is the binding constraint, exports and investment will compete for the limited domestic resources. As such, they argue that a negative relationship between the proportion of exports to aggregate output and the latter's growth rate will tend to exist. However, if the foreign resource is the binding constraint, the model specifies a positive relationship between the proportion of exports and the rate of economic growth, the intermediate link being the positive relationship between exports and capital goods imports.

In summary, classical and neoclassical trade theories suggest that **international trade serves as an engine of economic growth**, stimulating a rise in aggregate

economic output following improved resource allocation and production efficiency (Emery, 1967).

2.3 Causality between Trade and Economic Growth

Is trade causing economic growth or is it that economic growth leads to trade? In the development economic literature, export-led growth hypothesis maintains causation runs from exports to economic growth as exports are generally regarded to contribute positively to economic growth through such means as facilitating the exploitation of economies of scale (Helpman and Krugman, 1985), relieving the foreign exchange constraint (McKinnon, 1964), enhancing efficiency through increased competition (Bhagwati and Srinivasan, 1979; Krueger, 1980) and promoting the diffusion of technical knowledge (Grossman and Helpman, 1991). Furthermore, the neoclassical trade theory suggests that **exports are the engine of economic growth** due to a better resource allocation and improved production efficiency (Emery, 1967).

On the contrary, Kravis (1970), Romer (1986) and Lucas (1988) argue that **export expansion is the handmaiden of economic growth**. Kravis (1970) states that evidence does not support the engine-of-growth hypothesis as economic growth in the 19th century was mainly the consequences of favorable internal factors while external demand was an added stimulus. Romer (1994) emphasizes that economic growth is an endogenous outcome of an economic system, not the result of forces that impinge from outside. Superior economic development will

inevitably lead to export expansion. As such, the implied causation is then from domestic growth and accumulation to trade. The reverse causality occurs when the long run accumulation of physical and human capital, combined with up-to-date technology, increase the overall productive efficiency of one country and in the process tip the scales of comparative advantage in international trade in favor of that country (Afxentiou and Serletis, 1991). Such a reversed causal sequence can be justified in terms of neo-factor proportions and neo-technology approaches of the comparative advantage theory as well as the less conventional Linder theorem (Dodaro, 1993). Further theoretical support for this sort of causation comes from 'new' trade theories where the economies of scale are viewed as "path-dependent" and can be a precursor of export growth (Helpman and Krugman, 1985).

The link between trade and economic growth may be more complex. Bhagwati (1988) is of the view that the causal relationship between exports and growth can be a two-way rather than suggested by the one-way relation as mentioned earlier. He points out that the two-way relation or feedback could give rise to either a virtuous or vicious cycle. A virtuous cycle occurs when export expansion stimulates domestic production and the increased production encourages more exports. Conversely, a vicious circle takes place if domestic production and exports outweighed each other. For example, within a vent-for-surplus framework, as a consequence of the ensuing increase in aggregate demand, growth may create a situation whereby more of the nation's output is absorbed

domestically, leaving relative less for the export market. Consequently, economic growth and export growth could be seen as moving in opposite directions (Dodaro, 1993). Jung and Marshall (1985) also point out that a situation where exports are promoted at the expense of domestic consumption and efficiency or as a consequence of distortive foreign direct investment, are another similar but weaker case that exports growth brings about a decline in output growth. Besides Bhagwati, this type of two-way causal relation has also been noted by Grossman and Helpman (1991) in their models of North-South trade.

In summary, the existing theories suggest that three causal relations may be hypothesized, namely, **export-led growth, growth-driven exports and bidirectional causality or feedback**.

2.4 Related Empirical Evidences

Many studies have been undertaken to examine the relationship between international trade and economic growth. These empirical studies have reported mixed results with some studies successfully identifying a positive linkage between a country's rate of economic growth and exports, while others have failed to demonstrate this linkage.

Evidence of a positive relationship between exports and economic growth in a large number of developing countries and for different periods of time have been found by empirical studies, starting with the work of Emery in 1967 and

continuing throughout the 1980s. These studies (Emery, 1967; Maizels, 1968; Voivodas, 1973; Michaely, 1977; Balassa, 1978; Williamson, 1978; Fajana, 1979; Tyler, 1981; Feder, 1983; Kavoussi, 1984; Ram, 1987; Moschos, 1989; Salvatore and Hatcher, 1989; Park and Prime, 1997) have applied OLS technique (except Michaely which used Spearman rank correlation method) on cross-sectional data by regressing the growth rate of GDP on the growth rate of exports. This approach made an a priori distinction between independent and dependent variables with the implicit assumption that causal ordering among variables was known either from theory or observation, which is the former variable unidirectionally causes the latter (Ahmad, 2001). As such, a statistically significant export growth coefficient is interpreted as evidence that export causes economic growth. However, it is recognized in several studies that the causal link between export expansion and economic growth cannot be established despite the facts that variables are correlated (Ram, 1985; Jung and Marshall, 1985; Edwards, 1993).

With the introduction of improved econometric time-series techniques in the 1980s, the causal relation studies have moved beyond simple correlation studies. A summary of all major studies relating to estimation of export-GDP causality since mid-1980s is shown in Table 2.1 (Ahmad, 2001). These studies have used a variety of statistical techniques, datasets and country groups. As a result, a wide spectrum of results with sharply divergent conclusions is inevitable. Generally, the statistical tests used in these studies can be divided into two broad categories,

that is, (i) first-generation tests employing the Granger or Sim procedures without testing for unit roots and stationarity and (ii) more powerful second-generation tests that utilize cointegration and error-correction model approaches which combine the short-run prediction of causality with the estimation of long-run equilibrium.

Ahmad (2001) points out that the empirical results using first-generation tests should be interpreted with great caution because these tests generally do not examine the existence of the long-run equilibrium relationship between exports and economic growth. Meanwhile, the results of studies using second-generation cointegration tests are generally more reliable. The formal tests of Granger-causality and of cointegration reveal that empirical support for the export-led growth hypothesis in both developing and developed countries is considerably weaker than what the earlier correlation studies had estimated. In fact, two contrary hypotheses, namely, (i) it is economic growth that causes exports to growth and (ii) the two variables have a two-way feedback relationship, have on balance more statistical support. This implied that economic growth may have other underpinnings not related to exports.

Table 2.1: Summary of Cointegration and Causality Studies Relating to the Exports-Economic Growth Relationship

(i) Using First Generation Statistical Tests

Study	*Methodology*	*Dataset*	*Results*
Jung & Marshall (1985)	Granger test	37 developing countries, 1950-81	Only 4 in 37 countries find support for export-led growth
Chow (1987)	Sim test in bivariate systems with filter	8 export-oriented NICs (Argentina, Brazil, Israel, Mexico & Asian NICs), 1960-84	Exports cause GDP growth in Mexico; no causality in Argentina; bidirectional causality in others
Hsiao (1987)	Comparison between Granger & Sim tests	Asian NICs, 1960-87	GDP growth causes exports in HK on both Granger and Sim tests; no causality in other countries on Granger test; bidirectional causality on Sim test
Kunst & Marin (1989)*	Granger test with AIC for lag length	Austria, 1956-82	No support for export-led growth in productivity
Chan et al. (1990)	Granger test with impulse lags	Taiwan, 1952-87	GDP growth causes exports
Ahmad & Kwan (1991)	Granger test with AIC lag selection	47 African countries, 1981-87, pooled cross-section data	No causality for the full sample; real GDP causes exports for high-income group; real GDP causes a rise in the share of manufactures in total exports for low income group
Kwan & Cotsomitis (1991)	Granger test	China, 1952-85	No causality during 1952-78; bidirectional causality for 1952-85
Sharma et al. (1991)*	Granger test with FPE criterion	Germany, Italy, UK, Japan & US, 1960-87	Exports cause GDP in Germany & Japan; GDP causes exports in UK & US
Bahmani-Oskooee et al. (1991)	Granger test with FPE criterion	20 developing countries, 1951-86	Exports cause GDP in 3 cases; bidirectional causality in 2 cases; no causality in others

Table 2.1: Continued ***(Using First-Generation Statistical Tests)***

Study	*Methodology*	*Dataset*	*Results*
Giles et al. (1992)*	Granger test	New Zealand, 1963-91	Exports cause GDP growth in food & beverages, and metal sectors; GDP causes exports in minerals; bidirectional causality in live animals; no causality in manufactured goods
Gordon & Sakyi-Bekoe (1993)	Causality tests using 5 different techniques	Ghana, 1955-87	GDP causes exports on Granger test; the causal relation is reversed on Holmes and Hutton test
Dodaro (1993)	Granger test with 2 lags	87 developing countries, 1967-86	Exports cause GDP growth in 4 cases; bidirectional causality in 10 cases; no causality in others
Kwan & Kwok (1995)	Exogeneity of export growth	China, 1952-85	Support for export-led growth
Jin & Yu (1995)*	Granger causality with FPE tests	Korea, Japan, Canada & US, 1960-87	No support for export-led growth; bidirectional causality in Japan & Korea
Kwan et al. (1996)	Exogeneity of export growth	Taiwan, 1953-88	Only weak support for export-led growth
Reizman et al. (1996)	2- & 3-variable Granger-causality tests	9 Asian countries in the Summer-Heston dataset	Mild support for export-led growth

Table 2.1: Continued

(ii) Using Second-Generation Statistical Tests

Study	*Methodology*	*Dataset*	*Results*
Kovacic and Djukic (1990)*	Cointegration tests, Granger test with 4 different lag selection criteria	Yugoslavia, 1952-87	No cointegration between variables; manufacturing GDP causes exports
Afxentiou & Serletis (1991)*	Cointegration test, Granger test with Schwartz criterion	16 developed countries, 1950-85	Bidirectional causality in US; GDP causes exports in Canada, Japan & Norway; no causality in others
Kugler (1991)*	Cointegration test, Granger test	US, Japan, Germany, France & Switzerland, 1970-87	Exports cointegrated with other variables (real GDP, investment & consumption) only in France & Germany
Ahamd & Harnhirun (1992)	Granger test, cointegration & error-correction models (ECM)	5 members of ASEAN countries	No causality in Thailand; GDP growth causes exports in others
Serletis (1992)*	Cointegrated test, Granger test, Schwartz criterion	Canada, 1870-1985	Exports cause import growth which in turn cause the GDP growth
Marin (1992)*	Cointegration test, Granger test with ECM	Germany, UK, US & Japan, 1960-87	Exports cause manufacturing productivity growth in all countries except US
Oxley (1993)*	Cointegration test, Granger test, ECM	Portugal, 1865-1985	GDP growth causes exports
Krugler & Dridi (1993)	Cointegration tests	11 developing countries, 196-89	Exports are cointegrated with other variables (real exports, investment and consumption) in 7 cases
Bahmani-Oskooee & Alse (1993)	Cointegration tests and ECM	9 developing countries, 1973-88	Exports & GDP are cointegrated in all cases

Table 2.1: Continued ***(Using Second-Generation Statistical Tests)***

Study	*Methodology*	*Dataset*	*Results*
Dutt & Ghosh (1994)	Various cointegration tests	26 developing countries, 1953-91	Exports & GDP are cointegrated in 20 out of 26 cases
Van den Berg & Schmidt (1994)	Various cointegration tests	17 Latin American countries, 1960-87	Exports and GDP are cointegrated in many cases
Love (1994)	Granger test, VAR models	20 low-income and lower middle income developing countries	Exports cause GDP in 14 cases and GDP net of exports in 5 others
Sulaiman et al. (1994)	Granger test, VAR models	South Korea, 1967-89	Exports cause GDP growth indirectly via changes in money supply
Ahmad & Harnhirun (1995)	Johansen cointegration test with 2 unit roots, Granger test	ASEAN countries, 1966-90	No cointegration between exports and GDP in any country except Singapore; bi-directional causality in the case of Singapore
Jin (1995)	5-variable VAR model	4 Asian Little Dragons 1973:1-1993:2	Significant feedback effects in the short run but no long-run relationship
Ahmad & Harnhirun (1996)	Engle & Yoo cointegration test, Granger test, ECM	ASEAN countries, 1966-88	No cointegration between variables; GDP causes exports in all countries
Jin & Yu (1996)*	6-variables VAR model with cointegration	US, 1959:1 to 1992:3	No support for export-led growth; no cointegration
Thornton (1997)*	Cointegration & Granger causality tests	6 European countries from mid-19th century to 1913	Export-GNP causality in Italy, Norway & Sweden; GNP-exports causality in UK; bi-directional causality in Denmark & Germany
Ahmad et al. (1997)	Cointegration tests with ECM models	ASEAN countries, 1966-94	No cointegration between variables; mixed results on causality tests

Table 2.1: Continued *(Using Second-Generation Statistical Tests)*

Study	*Methodology*	*Dataset*	*Results*
Islam (1998)	Cointegration & Granger causality tests	15 Asian NICs, 1967-91	Variables are cointegrated only in 5 countries; short-run causality from exports to growth in 10 out of 15 countries
Biswal & Dhawan (1998)	Cointegration & Granger causality with ECM	Taiwan, 1960-90	Variables are cointegrated & causality is bidirectional
Yamada (1998)*	Granger causality in VAR model	US, Canada, UK, Italy, France, Japan, 1975:1-97:2	Causality from exports to productivity only for Italy
Kwan et al. (1999)	Tests of cointegration & exogeneity	Hong Kong 1969-92; South Korea 1953-92; Singapore 1965-91	No cointegration between variables; mixed results on exogeneity

* denotes studies on developed countries
Source: Adapted from Ahmad, J. (2001)

2.5 Analyses on Tourism-Economic Growth Relationship

As in the export-led growth hypothesis, a tourism-led growth hypothesis would based on the same arguments for which tourism would become one of the determinants of overall long-run economic growth, given the fact that tourism income from foreign tourists is export earnings for host countries. Likewise, as discussed in the preceding section, the causal relations between tourism and economic growth can be hypothesized, namely, tourism-led growth, growth-driven tourism and bi-directional causality. While there is much literature on trade-growth relationship, very few empirical studies have been undertaken to examine the relationship between tourism expansion and economic growth. These limited studies have reported divergent conclusions.

When tourists visit a country, they consume a package of goods and services comprising both priced goods and services and unpriced natural amenities. If all goods and services consumed by tourists in the destination country were tradable, an increase in tourism would bring benefits to the economy as it would only be a reallocation of the destination for some imports and exports. However, some of the priced goods and services consumed by the tourists are non-tradables and consumed by domestic residents as well. In this case, tourism expansion which increase demand for the non-tradables would certainly bring about some impacts on the domestic economy of the host country.

Using a general equilibrium international trade model, **Copeland (1991)** examines the economic effects of an increase in tourism in a small, open economy and determines conditions under which an increase in tourism is welfare-improving. The study reveals that in the absence of taxation, distortions and foreign ownership, an increase in foreign tourism benefits the host country only through its effects on the price of non-tradables. An increase in the price of non-tradables amounts to a terms-of-trade improvement in the presence of tourism. In the presence of factor mobility, the price of non-tradables is less responsive to demand shocks; hence the benefits of a tourist boom are smaller. The presence of domestic commodity taxes will typically increase the benefits of tourism, since they allow some extraction of rents from unpriced natural amenities which are consumed jointly with priced goods and services. Finally, in the presence of

foreign ownership of immobile factors (e.g. land), an increase in tourism can reduce welfare if the increase in the flow of repatriated earnings is sufficiently large.

Conventionally, travel receipts as recorded in the balance of payments are defined to include food and accommodation and other tourist expenditures incurred after the tourist arrives in a foreign country, while international fares to and from the destination are excluded. It is as though the host country exports restaurant meals and hotel nights to its foreign visitors, while its own citizens import them from foreigners when they travel abroad. As such, the bulk of a tourist's expenditures are spent on the consumption of non-traded goods and services in the host country. In many of the host countries, the non-traded goods and services are consumed both by domestic residents and tourists. A major difference in local resident's consumption of the non-traded goods and services and the tourist's consumption is that the latter's consumption brings in foreign exchange. In this regard, tourism income from foreign tourists would have brought about either a favorable or unfavorable impact on the economic growth in the destination country.

In the static framework, there are two analytical papers that examine the relationship between tourism and welfare where tourists consume non-traded goods and services. **Hazari and Ng (1993)** use the dependency model of trade to analyze the consequences of tourists' consumption of the non-traded goods and

services on the domestic economy of the country receiving the tourists. Since the price of non-traded goods and services for tourist is determined in the tourist-receiving country by forces of foreign demand, local demand and supply, there exists the element of monopoly power in price determination. The study shows that an increase in the tourist's consumption of non-traded goods and services affects the domestic consumption possibility locus which may reduce the welfare of the local residents. Accordingly, the analysis shows that an expansion in tourism may be welfare reducing in a monopoly power framework.

Conversely, a study by **Hazari and Kaur (1995)** shows different findings. The economists use Cassing's (1977) analytical framework which extends the Komiya (1967) model and obtain two interesting results as follows:

(i) In the absence of monopoly production of non-traded goods and services, an increase in tourism is necessarily welfare improving. In other words, in a Komiya (1967) type first-best model, tourism is always welfare improving.; and

(ii) In the presence of monopoly production of non-traded goods (with/without foreign ownership) and services, an expansion of tourism may result in a decline in the welfare of domestic residents. This fall in welfare arises from an adverse movement in the price of the non-traded good. This good when consumed by tourists, becomes an exportable good, therefore a fall in its price represents deterioration in the terms of trade, hence welfare.

Subsequently, **Hazari and Sgro (1995)** developed a dynamic model to capture the impact of tourism in a dynamic growth setting. They have developed a model in which the growth in tourism has a favorable impact on the long-run growth of the economy. This favorable impact is generated by tourism acting as a time-saving device which allows the domestic population to consume now rather than later. This feature shows that growth in tourism facilitates foreign capital inflow thereby reducing the need for high domestic rates of saving and capital accumulation.

More recently, **Balaguer and Cantavella-Jorda (2002)** examine the role of tourism in the Spanish long-run economic development, using the export-led growth hypothesis in view of the fact that tourism income is the major export income for the Spanish economy. They have applied the time series techniques such as cointegration and causality testing to examine whether the tourism-led growth hypothesis is valid for the Spanish economy. The results of the study indicate that, at least, during the last three decades, the Spanish economy growth has been sensible to persistent expansion of international tourism. The increase of its tourism activity has produced multiplier effects over time. In addition, the Spanish economists attempt to test the causal relationship between tourism and growth after establishing the existence of the long-run relationship between tourism and growth in the Spanish economy. The findings show that international tourism earnings affect unidirectionally economic growth in Spain while external

competitiveness, which is proxied by the real effective exchange rate, has a bidirectional causal relation with the Spanish economic growth.

2.6 Conclusion

The review of literature in the preceding section indicates that there have been relatively few studies in the area of tourism and growth, and the existing works do not use the same methodology. Likewise, in Malaysia, papers on tourism and growth have been few and far between. In addition, there is no study using techniques of cointegration and Granger-causality tests to investigate the relationship between tourism and economic growth in Malaysia thus far. Accordingly, a paper using these time series techniques in examining the tourism-growth relationship in Malaysia would make a modest contribution to the existing empirical studies.