4

Future Prospects and Policy Options

The literature reviewed in the previous chapters has shown the relative significance of various preference schemes for developing and least developed countries. For most developing countries and many LDCs, preference margins are quite small, so preference rents are negligible and the implications of preference erosion are small. In this context preference rents can be interpreted as the (additional) export value derived by beneficiaries, which depends on their ability to take advantage of the margins. Typically, a number of countries are offered the same preferences (this is especially true for LDCs) and it is the more competitive producers who are best able to benefit. This is true whether the margins are large or small, although the size of the potential rent is greater if margins are large and/or if few countries receive the full preference margin. In most cases, margins are relatively small and available to many countries, so the likely losses from preference erosion are not great, overall or for individual countries.

It should be recognised that while some countries lose, others stand to derive a net gain from general preference erosion. The gainers will be the most competitive producers, whether or not they benefited from preferences. Consider a case where the margin was initially equivalent to 6 per cent of the export price and this is reduced to 3 per cent. Beneficiaries that were originally competitive are likely to remain so (though rents decline) and only the most competitive non-beneficiaries are likely to increase market share at the lower margin. The importance of such considerations was illustrated in the previous chapter, allowing for competition effects on preference erosion.

However, preference rents have been large for a few beneficiary countries where preferences are concentrated in a few products of particular importance to them. This is most likely to be the case when explicit or implicit quotas are associated with the preferences. For example, the Sugar Protocol includes explicit quotas, whereas some EU countries have an established preference to import bananas from particular Caribbean islands. In cases where existing margins and rents are high, preference erosion may be costly; we describe such countries as 'exposed to erosion' (in the cases of sugar and bananas they will have experienced significant erosion already). This chapter concentrates on the implications of current trade negotiations for preference erosion and on how exposed countries can adjust and respond.

Prevailing preference (tariff) margins are only part of the story. As discussed above, various non-tariff barriers (NTBs), in particular rules of origin and product standard requirements, determine the ability of beneficiaries to actually benefit from preferences (the value of the rent derived). In a scenario where margins are reduced, preferences can be provided or maintained by relaxing other requirements. Improving the performance of preference schemes will involve changes in the preference packages to enhance existing and stimulate new 'offensive' export interests of preference-receiving countries. It

will also involve preference-receiving countries undertaking certain measures that support an enabling environment for efficient investment and production for exportation in line with their 'offensive' export interests in eligible products. There is also a need for adaptive measures to address costs of preference erosion which are substantial for some countries (adjustment measures are considered in Chapter 5). Accordingly, the study looks at measures for improving preference schemes from both the perspective of improving the preference scheme package (measures at the international or preference-giving country level), and of what preference-receiving countries can do to position themselves to reap the fullest possible benefits from the remaining preference margins. We focus on the USA (AGOA) and EU (especially EPAs) as being the most important markets for countries exposed to preference erosion.

Section 4.1 provides an overview of the potential for preference erosion implied by current negotiations in various preferential agreements (specifically, the Doha Round of the WTO). Section 4.2 identifies the characteristics of countries 'exposed to erosion' in respect of these negotiations. The core point is that only a relatively small number of countries needs to be concerned that preference erosion will have a significant impact on them, and for these the concerns typically relate to only a few products. Having identified the exposed countries, Section 4.3 considers improvements to preference schemes that could reduce or ameliorate the potential costs of erosion, and Section 4.4 considers the types of complementary policies beneficiary countries could implement to counter the adverse effects of preference erosion. Section 4.5 summarises the policy implications.

4.1 Implications of current trade negotiations for preference erosion

As discussed in Chapter 3, ongoing trade negotiations in the WTO imply preference erosion, and this will impose costs on 'exposed' countries. The Doha Round launched on 13 November 2001 aimed for increased market access to promote growth and development through increased trade, particularly of developing, small and vulnerable members of the WTO. General tariff reductions, and hence a reduction in existing preference margins, are the primary means of achieving increased market access. Other important negotiating issues, especially concerning trade in agricultural products, include reducing the level of domestic support given to domestic producers and exporters, and reducing or eliminating trade-distorting export subsidies. We provide a brief account of the likely scale of tariff cuts on the basis of the '6 December 2008 version' of draft WTO modalities for achieving increased market access.

Negotiations concerning increasing market access centre on lowering bound tariffs by means of some formula that will ultimately reduce applied (MFN) tariffs and therefore reduce preference margins. It is developed countries that grant most preferences; preference erosion will therefore result from reductions in MFN tariffs by developed countries. Although tariff reductions by other countries, notably developing countries, will not erode preferences, they are not irrelevant. Enhanced market access at a global level (such as multilateral tariff reductions) increases the size of the global (export) market.

Competitive producers with the greatest ability to increase export supply can expect to benefit most, but marginally less competitive producers (including those whose preferences have been eroded) may still benefit. This can arise where they focus on niche markets or have preferential non-tariff access (including where they are linked into global buyer or supply chains) or where major exporters shift their focus towards the largest markets, leaving opportunities for smaller exporters, perhaps in regional markets.[12] Furthermore, tariff reductions by preference-receiving countries should encourage increased efficiency in export production, including through access to cheaper intermediate imported inputs, so that they become more competitive.

The size of tariff cuts achieved under WTO negotiations depends on several factors:

(a) The level of current bound tariffs: current formulae prescribe steeper cuts on higher tariffs and increase with the level of development of members. Take the case of agriculture products as an example, where differentiation between developed, developing and LDCs is most pronounced and contentious. For developed members, the cuts for agricultural products start from 50 per cent for tariffs below 20 per cent, rising to 70 per cent for tariffs above 75 per cent, subject to a 54 per cent minimum average and with some constraints for tariffs above 100 per cent. For developing countries, tariff reductions between 33.3 per cent and 46.7 per cent are proposed, although it can be less if they meet a 36 per cent average reduction. LDCs are not required to reduce bound tariffs.

(b) Whether the product is 'sensitive' (all members can declare some products as being 'sensitive') or 'special' (a category available only to developing country and LDC members), as designed to take into account various concerns as stated in Paragraph 16 of the Doha Ministerial Declaration:[13] tariff cuts for agricultural 'sensitive' products will be a proportion of the normal cut, but a quantity of the product will be allowed in at a lower quota, while for 'special' products the cuts will be smaller for some and others may be exempted completely.

(c) Whether the applied tariffs are lower than the bound tariff: it is bound tariffs that will be subject to cuts, although the tariffs actually applied are often lower than the bound rate. In principle, a country could significantly reduce bound tariffs without having to actually reduce the tariff applied. For example, where a developing country has a bound tariff of 100 per cent for agricultural products, but an applied tariff of 25 per cent, the bound tariff would be cut by 42.7 per cent (to 57.3 per cent), but the applied tariff will not be affected (although the 'space' for future policy action will have now an upper limit of 57.3 per cent instead of 100 per cent).

(d) Country status: LDCs are exempted from making tariff cuts on any products and developing countries are generally expected to make smaller cuts and have more flexibilities than developed countries. Small and vulnerable developing countries will make even smaller cuts, with even more flexibilities. Countries that have recently acceded to the WTO will also have special terms.

(e) Special safeguard mechanisms designed to stem injurious import levels: developing countries will be able to use this mechanism, which will allow them to increase tariffs on a temporary basis.

For non-agricultural market access, tariff cuts will be made using a simple 'Swiss formula', which delivers the steepest cuts for the highest tariffs.[14] The Swiss formula uses coefficients which represent the maximum post-reform bound tariff rate. Developed countries have a lower coefficient than developing countries. The NAMA modalities text of December 2008 indicates that all developed countries will use one coefficient of 8, whereas developing countries may choose one of the three suggested coefficients of 20, 22 or 25. Each coefficient, however, will be linked to the scale of 'flexibilities' available, with more flexibilities being given to members that opt for a lower coefficient (a lower coefficient implies a lower bound rate and under the Swiss formula this means a deeper tariff cut) and vice versa. Thus, members opting for a coefficient of 20 (22) would be entitled to make smaller or no cuts on 14 (10) per cent of sensitive tariff lines, on condition that the import values of these sensitive tariff lines do not exceed 16 (10) per cent of the total value of non-agricultural imports. At the other extreme, developing members choosing a coefficient of 25 will be required to apply it to cut tariffs on all tariff lines without exception.

As a result of the Swiss formula, developed countries will have bound tariffs averaging well below 3 per cent (most developed countries already have very low or even zero bound rates for almost all NAMA tariff lines) and tariff peaks averaging less than 8 per cent even on the most sensitive products – although certain specific sensitive products would have tariff peaks higher than this. For developing country members applying the tariff cuts, the majority of tariff lines will have bound tariffs of less than 12–14 per cent and their average bound tariffs would be 11–12 per cent, depending on the coefficient and flexibilities used. A small number of tariff lines would have bound tariffs of above 15 per cent. As it happens, the difference between bound tariffs and tariffs actually applied ('policy space') would be substantially reduced after applying cuts using the Swiss formula.

Developed members will be expected to cut tariffs gradually over a period of five years and developing countries will have a longer period of ten years, starting from 1 January of the year following the entry into force of the Doha Agreement. Certain recently acceded members will not be required to undertake tariff cuts beyond their accession commitments,[15] but others, such as China, Chinese Taipei and Croatia, will be expected to cut their bound tariffs and will have an extended implementation period of three years to phase in their Doha commitments. Members carrying tariff lines with unbound rates will be required to bound the rates using a mark-up of 25 percentage points which would then be added to their applied rates, in effect on 14 November 2001 (the day after the launch of the Doha Round). The resulting rates will form the basis for the formula cuts.

In both cases (agricultural and non-agricultural products), cutting bound tariffs can depress MFN tariffs, which in turn will depress preference margins. It is in this context

that the Harbinson text (TN/AG/W/1/Rev.1 of 18 March 2003) calls for an arrangement that would preserve preference margins by slowing MFN liberalisation affecting long-standing preferences in respect of products of vital export importance for preference-receiving countries. Flexibilities allowing preference-giving countries to shield such products from any or deeper tariff cuts can preserve preference margins. However, as in previous rounds, this has been unpopular with certain developing members which do not have, or have limited, benefits from preference schemes.

Changes to specific regional arrangements may also imply preference erosion, although the nature of this depends on both the prevailing situation and likely changes. While there are no specific proposals to reduce preferences in AGOA, tariff reductions under Doha will reduce preference margins, and any tightening of rules of origin will reduce utilisation. The general prediction is that there will be some reduction in the value of preferences, and hence in the benefit of AGOA. The case of EU-ACP preferences is more complicated. Economic partnership agreements will preserve preferential access to the EU for ACP countries (although Doha tariff reductions will reduce margins). However, as EPAs require reciprocity, so that ultimately tariffs on imports from the EU will be eliminated, there will be an erosion of regional preference margins as the EU becomes more competitive in regional ACP markets. On the other hand, proposed rules of origin under EPAs are less restrictive than current requirements; this is likely to enhance preferences, especially for developing countries that are more likely to export processed products to the EU (e.g. apparel and tinned fish), and their utilisation. To the extent that rules of origin are relaxed a number of years before ACP countries have to eliminate tariffs on imports from the EU, EPAs offer a net benefit during this transition period to ACP countries in terms of preferences.

There are numerous regional and bilateral PTAs, which for certain countries and products will have implications for the 'post preference erosion' scenario facing countries that benefit from preferences. In general PTAs increase the pool of countries with access to preferences and therefore reduce the value (preference rent) attainable by individual beneficiaries. It is not possible, even if adequate information were available, to consider the implications of all PTAs. In general, any effect would be very limited for preference-receiving countries; what matters for an individual country exposed to preference erosion is whether particular PTAs will allow the entry of new suppliers on comparable preference terms in the markets of most concern to them.

4.2 Characteristics of countries exposed to preference erosion

As reviewed briefly in Section 3.2 above, there are now a number of analytical and empirical studies that assess the likely implications of the Doha negotiations for preference margins and through that the effects on preferential trade (in particular exports of preference-receiving countries). Doha negotiations have been slow, given the wide gaps that exist among members on issues concerning the formula and level of ambition in tariff cuts, flexibilities to take into account the special and development needs of some

sections of the WTO membership, and the scheduling and duration of the implementation of commitments. As the negotiating gaps have narrowed, the proposed sizes of various parameters (including the size of coefficients for tariff cuts) have also changed, and this means that some of the parameters and assumptions used in earlier studies have become obsolete. Nonetheless, the formula and coefficients contained in the December 2008 draft modalities remain within the range proposed at the beginning of the negotiations and used in earlier studies (e.g. in Low *et al.*, 2005). This means that some useful insights can be gleaned from earlier studies. In particular, they serve the current purpose of identifying the countries and products most exposed to costs of preference erosion.

Table 4.1 Developing countries that are exposed to preference erosion

Most vulnerable	Preference margin	Main products			
		Sugar	**Bananas**	**Apparel**	**Other**
Middle-income countries	**4.9**	**X**	**X**		**X**
Mauritius	39.9	XX			
St Lucia	32.9		XX		
Belize	29.3	X	X		X
St Kitts and Nevis	28.7	XX			
Guyana	24.2	XX			
Fiji Islands	24.1	XX			
Dominica	15.9		XX		
Seychelles	12.2				XX
Jamaica	9.7	XX			
St Vincent and the Grenadines	9.4		XX		
Swaziland	8.2	XX			
Honduras	6.7	XX			
Tunisia	5.9			XX	X
Côte d'Ivoire	5.7		XX		X
Morocco	5.7			XX	X
Dominican Republic	5.5	X		X	X

Preference margin expressed as a percentage of export value.
Main products: XX (X) indicates that the product accounts for more than 50 (20) per cent of the value of preferential trade.
Middle-income countries: reports average for 78 countries.
Source: Based on Alexandraki and Lankes (2004), who apply partial equilibrium techniques to estimate export losses from preference erosion for middle-income countries (see Table 3.2 above).

Table 4.1 lists the 16 most exposed developing countries and the products of most importance to them.[16] The majority of the most exposed countries (seven of the top ten) are in the Caribbean region (only Guyana is not an island), benefiting from preferences for sugar (five) or bananas (four); the other three countries in the top ten are small islands: Mauritius (sugar), Fiji Islands (sugar) and Seychelles (mostly fish). Thus the top ten are all ACP countries, as are three more of the top 16 (Côte d'Ivoire, Dominican Republic

and Swaziland), for two of which sugar is a major product. The countries lower down the list tend to be more diversified in exposure although, with the exception of the two north African countries (where preferences are predominantly for apparel), sugar or bananas remain as main products. This exposure is associated with potential large costs in terms of export earnings and government revenue (see Table 3.3 above).

Table 4.2 LDCs that are exposed to preference erosion

Country	Agriculture	Manufactures	ACP	AGOA
Angola	XX		√	√
Bangladesh	XX	XX		
Cambodia	XX	XX		
Congo (DRC)	XX		√	√
Gambia	XX	XX	√	√
Guinea-Bissau		XX	√	√
Haiti		XX	√	
Lesotho	X	XX	√	√
Madagascar		XX	√	√
Malawi	XX	X	√	√
Maldives		XX		
Mauritania	XX	XX	√	√
Mozambique	XX	XX	√	√
Myanmar		XX		
Niger	XX		√	√
Senegal	XX	XX	√	√
Solomon Islands	X	XX	√	
Tanzania	XX		√	√
Togo	XX		√	√
Uganda	XX	XX	√	√
Zambia	XX		√	√

XX indicates the top 14 countries most affected by preference erosion before allowing for competition effects. X indicates additional countries that are most affected by preference erosion after allowing for competition effects.

Table 4.2 lists the 21 LDCs that appear to be most exposed to preference erosion (Nepal and Burkina Faso are also likely to be exposed, but to a lesser extent). Although the data did not allow us to identify the main products, in the clear majority of cases exposure applies to agricultural and non-agricultural (predominantly apparel) products. The majority are in Africa (as are the majority of LDCs that benefit from both ACP and AGOA); two (Haiti and Solomon Islands) benefit from ACP only. Although non-ACP LDCs and ACP countries are entitled to similar preference margins in their access to the EU under EBA, effective non-tariff preferences (especially rules of origin) may not be comparable. It follows that Bangladesh, Cambodia, Maldives and Myanmar are particularly exposed to preference erosion, as they will not benefit from any 'preference protection' conferred by EPAs to ACP countries or by AGOA to African countries. Furthermore, as these countries export apparel, the cost of preference erosion is likely to be large.

Most exposed LDCs and many exposed developing countries are in Africa and are thus susceptible to the erosion of AGOA preferences if rules of origin are tightened. This would have the most significant impact on apparel exports to the USA, the benefits of which are concentrated on countries such as Lesotho, Kenya, South Africa and Swaziland. Stevens and Kennan (2004a) note that the utilisation of and benefits from apparel exports under AGOA are very vulnerable to tighter rules of origin, and hence the beneficiaries are all exposed. Furthermore, the majority of exposed countries are ACP countries, and are likely to be affected by the details of the finalised EPAs for preferences. As EPAs are designed to preserve preferential access to the EU, and may even enhance it through more flexible rules of origin, the primary concern is any loss of preferences vis-à-vis the EU in their own regional markets. However, as argued in Morrissey and Zgovu (2007), there is considerable scope for maintaining these regional preferences through the appropriate choice of sensitive products to exclude from reciprocal liberalisation, i.e. through retaining tariffs on imports from the EU that compete directly with intra-regional ACP trade.

4.3 Improving preference schemes

There is ample evidence that preference schemes are valuable to some preference-receiving countries. For some countries and products preferential tariffs provide key incentives to expand export production and diversification, and implicit economic rents that can represent substantial shares of the value of domestic economic activity. It is also widely acknowledged that for a large number of countries and products, preference schemes have delivered benefits below their full potential, leading some analysts and countries to question the efficacy of the schemes as a strategy for trade development in developing countries. Moreover, underperformance of the schemes has added pressure to underplay the importance of preference schemes at the Doha Round of multilateral trade negotiations. While preference schemes may have been operationalised in such a way that they 'underperform', in the sense that the countries that are expected to benefit do not increase trade under preferences to a significant extent, for some countries and products the fundamental export problems lie in inherent structural weaknesses and rigidities in the preference-receiving countries. For example, some sub-Saharan African countries depend heavily on a few primary products exported in raw or semi-processed state, with low and declining terms of trade, and a trading environment which has little to do with the effectiveness of preferences. These and other impediments to export diversification and competitiveness partly explain the stylised fact regarding the utility of EU preferences granted to ACP countries, that ACP countries' total exports to the EU grew by less than 4 per cent, whereas exports from other developing countries grew by 75 per cent during 1988–97 (EU, 1999).

In view of the undoubted economic importance of preference schemes for preference-dependent countries, coupled with the fact that there are clearly issues that explain the schemes' underperformance, there is a credible case for seeking ways to improve the

delivery of preference schemes. Such measures can be distinguished from measures to promote exports in general; even where the measures are similar, the existence of preferences suggests the sectors on which to focus. This section explores some of the avenues and policy frameworks that might increase the effectiveness of preference schemes for the benefit of preference-receiving developing and least developed countries. The prospective significant preference erosion will require policy responses that not only address the associated adjustment costs, but also enhance the economic value of the outstanding preference margins. Considering that even in the absence of preference erosion there is already more that needs to be done to improve the performance of schemes, the presence of preference erosion raises the need for reform and adaptive measures around whatever preferences remain in future.

There is a large body of literature that shows that the main reasons preference schemes have performed below expectations are the low levels of preference uptake and utilisation by preference-receiving countries; the presence of intrinsically weak domestic policies; rigid structural frameworks for investment and production in many preference-receiving countries; and an unfavourable external market environment (e.g. a long-term downward spiral of commodity prices and major oil price shocks) against a background of rigid economic structures that do not adequately respond to changing market incentives. Improving the design and operation of preference schemes can only touch on some of these; policy and institutional reforms in beneficiary countries (considered in the next section) can address some of the others. It is beyond the scope of this study to address broader issues, however relevant, such as the role of services and migration, the global economic environment and the importance of private actors (especially multinationals and global buyers) that often dominate trade, supply and marketing chains.

Low preference utilisation rates are a result of problems on both sides, that is, the preference-giving and preference-receiving countries. Here we focus on the preference-giving side (beneficiaries are addressed in the next section). Preferences are under-utilised or inaccessible to some extent because of:

- The stringent conditions attached to them (e.g. rules of origin, product quality, environmental standards and other non-tariff measures);
- Complexity of the rules and conditions, which become more pronounced in preference-receiving countries that lack the financial, physical and technical capacity to comply with and/or execute them;
- The presence of tariff escalation, particularly affecting products which are of actual or even potential export interest to some beneficiary countries. This is especially relevant for processed commodities;
- The exclusion of certain products from the list of preference-eligible products (this relates to the preceding point;

- Safeguard mechanisms that can prevent the export of specific products to preference-giving countries if certain threshold export shares are exceeded;
- Rules for graduation of preference-receiving countries that attain a specified share of the export market to preference-giving countries may be too strict, e.g. in not recognising that market share must be maintained to deliver sustainable gains;
- Preference schemes are discretionary and non-contractual, making them unpredictable as they can be altered or withdrawn as deemed necessary by the preference-giving countries. This is a disincentive to investment in trade by beneficiaries;
- Preference margins that are too low to make it economically worthwhile for importers in preference-receiving countries to claim preferential tariffs (this relates to the preceding point);
- A potentially large proportion of preference rents are captured by private intermediaries involved in the transactions, such as importers, buyers or retailers. The value of the preferences does not necessarily accrue to producers, or even to the beneficiary countries.

Thus, the effectiveness of schemes can be improved by altering aspects of the schemes, i.e. through actions by preference-giving countries. The remainder of this section covers the principal issues.

Making rules of origin more development-oriented

Strict rules of origin are one of the most commonly cited reasons for the poor performance of preference schemes. The WTO Agreement on Rules of Origin, effective from 1995, defines rules of origin as: 'those laws, regulations and administrative determinations of general application applied by WTO Member countries to determine the country of origin of goods …' In short, rules of origin are put in place, among other reasons, to ensure that only products 'originating' from partner countries granted preferential access (e.g. by way of zero or low duties or tariff quotas) benefit from the preferential treatment so given.

Effectively, rules of origin have been used as protection measures; in this way, they prevent firms based in non-partner territories from establishing 'shell' companies in the preference-receiving countries to import almost fully finished goods and re-export them with little or no processing solely in order to obtain tax relief in the final destination, preference-giving country. In short, it prevents 'trade deflection'. Rules of origin are also intended to encourage sufficient value-added production, which can then stimulate investment, employment and sustainable development in the beneficiary countries.

There is a danger if rules of origin require more value addition than is 'commercially normal', with notional preferences becoming under-utilised or not utilised at all. The EU's rules of origin have been used to help open up the EU market, reciprocally or otherwise, to imports from partner countries, in such a manner as to afford adequate protec-

tion for the EU interests involved. The EU has come to agree with claims that the present rules of origin reflect mercantilist policy aims. They do not correspond to the global production model of the market, nor do they correspond to the new manufacturing and processing operations which are currently taking place (the fragmentation of global production). They do not reflect technological advances and actual market, trade, industry and agriculture conditions, and are too complex and lack transparency (COM, 2005).

Inappropriate rules of origin can lead to significant cost increases and therefore undermine product competitiveness. Rules of origin requiring beneficiary countries to source certain inputs from within the exporting country or from the preference-giving country could force producers to obtain inputs from high-cost sources and ignore least-cost sources that are not party to the preference scheme. This would clearly render beneficiary country exports uncompetitive even when the tariff is low or zero. It is for this reason that some countries source inputs from least-cost sources and export high quality and price competitive products on non-preferential tariff terms.[17]

Cumulation (sourcing from within a participating region, e.g. ACP producers sourcing inputs from other ACP countries) may be of some benefit where least-cost inputs can be sourced from other members of the preference scheme. (It also encourages investment and production from such members.) However, for certain specific inputs, none of the participating members may be able to provide least-cost inputs, implying that there is a limit to which cumulation can be useful. In such cases, increasing the proportions of inputs from countries outside the preference scheme would be desirable to afford the preference-beneficiary countries the opportunity to produce and take advantage of the preferences associated with the products in question.

Action: Preference utilisation and benefits could be enhanced if rules of origin were relaxed so that they reflect the needs of beneficiary countries (i.e. are development rather than protection oriented). In response to the criticisms and shortcomings of its rules of origin, the EU in December 2005 initiated a review in order to make them simpler and more development friendly. The other QUAD countries and Australia should also be encouraged to review their rules of origin to afford the beneficiary countries deeper access to their domestic markets than is currently the case, partly on account of stringent rules of origin.

Reduce or eliminate complex non-tariff barriers and support investment for product quality and compliance

Rules and conditions in some preference schemes are not only demanding but also complex, raising the costs of compliance and therefore undermining the value of the preference margins. For example, certain product quality controls (some, no doubt, for valid consumer health and safety and environmental considerations) require elaborate and expensive outlays and maintenance of modern capital and machinery, and implementation of costly procedures.

Action: Preference-giving countries can help poor preference-receiving countries meet the required standards by providing technical and even financial assistance to meet them. Funding for such investment can be channelled through the most cost-effective avenues available. Preference-giving countries may also support preference-receiving countries in obtaining funding from other sources, including multilateral sources and the donor community. This theme is considered below in the discussion of trade facilitation (and related aid for trade).

Reduce remaining tariff and quota restrictions on excluded products

All preference-giving countries have tariff peaks and quotas that restrict export expansion (without preferences) in some preference-receiving countries that have the capacity to expand production of eligible goods.

Action: Preference-giving countries should make a full and early removal of all remaining tariff (especially tariff peaks) and quota restrictions on beneficiary exports to allow full advantage of the remaining preference margins.[18] The QUAD countries would experience negligible welfare and tariff revenue losses from relaxing restrictions on the exemption of preference-receiving countries from non-zero MFN tariffs.

Extend product coverage

Without lowering tariffs on excluded products, there is still some scope for expanding the coverage of preference schemes offered by the QUAD countries and Australia to other products where positive MFN rates currently apply, in order to benefit small and poorer LDCs and non-LDCs in sub-Saharan Africa, the Caribbean and elsewhere.[19] In part this arises because the more competitive developing country producers have established a market share in non-preferred products and would remain competitive (especially as preferences are generally being eroded). This also applies to low-income countries that may have received some preferences, even if these are not as widespread as those granted to traditional beneficiaries such as the ACP, e.g. Bangladesh, Cambodia and Vietnam. Similarly, preference-receiving countries have not developed production of non-preferred products, at least not in preparation for global competition, and would begin from a relatively weak position. The literature shows that non-reciprocal preferences have tended to encourage specialisation in preference-eligible products at the expense of other non-eligible products.

Action: Although the general impression is that extending product coverage is likely to benefit very few developing countries, and none of the poorest LDCs, there may be potential to create 'new' trade by preference-receiving countries in products that have been excluded from the list of preference-eligible products. Alternatively, it may be possible to provide special non-tariff preferential access terms for particular products, such as fair trade products or those produced by smallholders.

Relax safeguard provisions and graduation of preference-receiving countries

Preference-giving countries build in automatic safeguard provisions to suspend or discontinue preferential treatment if imports of preference-eligible products from a given preference-receiving country exceed some threshold share of total imports from a given country. This clearly discourages expansion of preference-eligible products and acts as a disincentive to invest and produce for the preference markets, particularly where it is only commercially viable to produce on a large scale, which may mean large investment outlays. The implication of tight safeguard provisions is that the actual value of preferences is reduced substantially, because producers are unable to avail themselves of economies of scale in production or exporting (shipping larger volumes reduces unit marketing and transport costs).

Some preference schemes (e.g. the US scheme) include provisions that 'graduate' preference-receiving countries when they attain certain shares in export markets (to preference-giving countries) or pass other 'indicator thresholds' such as per capita income. The problem with such provisions comes about when the indicators or thresholds are set so low that preference-receiving countries graduate too quickly, e.g. if the improvement is actually temporary. Even if a deterioration in performance in subsequent years renders the country eligible for preferences again, the uncertainty created discourages sustained or long-term investment in beneficiary countries. More generally, discretionary and non-contractual elements make preference schemes unpredictable, as they can be altered or withdrawn as deemed necessary by the preference-giving countries. This is clearly a disincentive for long-term investment in preference-eligible products which some preference-receiving countries would be in a position to produce and export.

Action: Safeguard and graduation provisions should be relaxed or removed, or where possible preference-receiving countries should be guaranteed a certain minimum period before graduation is considered. This will allow the country and producers to establish and entrench any gains made. Preference schemes would be more beneficial if entitlements were transparent and guaranteed for a reasonable length of time, irrespective of performance during the period. Indeed, performance beyond a threshold implies that the scheme is working and it would be helpful to allow it to continue for a reasonable period. Defining a reasonable period is difficult, but given the normal length of time for the realisation of sustainable returns on investment, between five and ten years would be appropriate in most cases. Such a period is consistent with the time developing countries are allowed to implement commitments under trade agreements such as those negotiated within the WTO.

Reduce preference rents captured by non-beneficiaries

There is evidence that importers and intermediaries (including in transport and distribution) capture a considerable proportion of the benefit of preference schemes.[20] These private agents tend to have market power and typically dominate the supply chain for

many products, permitting them to appropriate the preference rents. Their position is strengthened when preference schemes have high compliance requirements and administration costs. Furthermore, private agents with a dominant position in buying (such as large retailers) or importing can add their own requirements on standards and impose additional costs on importers or producers, further reducing the real benefit that accrues to the beneficiary country.

Action: It is generally difficult for policy-makers to influence or intervene in the market structure of supply chains. The preference-receiving countries could establish regulatory or oversight mechanisms to encourage competition in relevant activities concerning preferential trade and monitor the effects of market power concentrated in the hands of a few importers. Where this is not possible (for example, where there are a few large global buyers, such as for sugar, coffee beans and cocoa), measures could be put in place to curb the exploitation of market power by private agents.

4.4 Policy responses in preference-receiving countries

The factors limiting the ability of beneficiary countries to fully avail themselves of preferences typically relate to the production and export environment and are not specific to the products receiving preferences. Thus, policy strategies relate to export promotion and increased economic efficiency. However, resources are limited and not all measures can be implemented, so initial efforts could focus on products for which preferences are available. From the perspective of beneficiary countries, low preference utilisation can be due to a number of factors:

- The countries do not have adequate capacity or do not produce competitive exports, given the specific preference margins, even where large product quotas are granted. Many preference-receiving countries are allowed quotas which they cannot meet, due to a lack of production capacity or a supporting environment to permit economically viable production.
- There is inadequate capital (human, physical and social) to support commercially viable foreign and domestic investment in preference-eligible products and upstream activities. Limited financial resources and underdeveloped financial markets and regulation hinder efficient capital flows and investment in physical infrastructure, technical know-how and business acumen.
- There is inadequate supporting domestic trade and other economic policies and regulatory institutions (e.g. production is restricted by burdensome trade and investment taxes, or lack of transparent investment practices and regulation, and investment protection).
- There is political instability and poor governance (e.g. in countries such as the Democratic Republic of Congo, Zambia and Zimbabwe).

- Climate and other natural conditions are adverse. Small island economies, which we have noted are prominent among countries exposed to preference erosion, are particularly vulnerable to natural disasters (e.g. hurricanes and floods) and trade shocks (e.g. volatile world prices). Many African countries are also vulnerable to weather events (droughts and floods) and trade shocks. In general, preference-receiving countries are also economies that are particularly vulnerable to adverse shocks.

These problems are inherent difficulties faced by low-income countries or specific problems faced by small island states (especially if they are remote). They provide good reasons why these countries should receive trade preferences. While previous attempts to address these underlying problems have had limited success, action is essential if countries are to benefit from preferences and adjust to preference erosion. Some of the actions that can be taken by preference-receiving countries are set out below. The benefits are not restricted to preferential exports, and similar measures are also appropriate when adjusting to a loss of preferences. The aim is to enhance competitiveness.

Internal policy reforms

Improvements in preference schemes are unlikely to yield benefits in cases where beneficiary countries have persistent deficiencies in markets and institutions (for finance, regulation, industry, agriculture and governance) and in the infrastructure necessary for creating and sustaining a credible environment for investment, production and foreign trade. Low-income countries in Africa have a particularly weak business environment.[21] Improving the business environment encourages investment and increased efficiency in production which will encourage exports and help countries benefit from trade opportunities, including preferences. This points to the need for further concerted efforts to reform the domestic business environment (and expedite regional integration), coupled with attempts to achieve lasting political stability, the lack of which is often cited as a significant disincentive, and to promote competitive and sustainable investment and production for the domestic and export markets.

Action: A specific area for reform is investment legislation, which is receiving attention in trade negotiations and arrangements. Investment provisions can be used to serve a number of purposes – investment promotion and co-operation, liberalisation and market access, and investment protection; the evidence suggests that their incorporation in agreements does increase foreign investment (Morrissey, 2008). Almost all preference-receiving countries participate in regional trade arrangements, implying that there is also a role for such groups to foster inter-regional and intra-regional investment and through that export development and diversification.

In relation to maximising benefits from preference schemes, beneficiary countries need to invest in upgrading technical knowledge, human resources and institutional capacity to take full advantage of preferential agreements which require in-depth knowledge of market access terms and conditions in preference-giving countries. Some needs in this respect are addressed under the trade facilitation issues reviewed below.

Trade facilitation

Supporting and promoting trade facilitation has become an important feature of development policy in recent years (Milner *et al.*, 2008). Some of the emphasis has been on investment in infrastructure to reduce trade costs, including transport, ports, and trade and customs services. More broadly, it is recognised that speeding up administrative procedures could have a major impact in reducing the costs and time required to distribute goods. Reducing barriers to trade, promoting regional integration, reducing transport costs, trade facilitation and improving the environment for producers are all seen as necessary to enhance the capacity for trade. Milner *et al.* (2008) establish that there is a body of evidence to show that improved trade facilitation can:

- Significantly lower trade costs, especially reducing timescales;
- Bring about significant increases in the volume of imports and exports, that may be even greater than the direct gains from trade policy reform;
- Allow for improvements in government revenue collection;
- Generally contribute to welfare improvements and economic growth.

These benefits must, of course, be viewed against the costs of implementing the institutional, infrastructure, human and resource upgrades required to achieve the appropriate level of reform. Here too there is empirical and case study evidence that the benefits are likely to considerably exceed the costs (although financially constrained developing countries may still require aid and external assistance to meet the costs).

There is therefore evidence and experience that can be drawn on to incorporate trade facilitation within regional integration agreements, as there are evident benefits from regional co-operation and co-ordination (e.g. in customs and port procedures, and investment in infrastructure). Although trade facilitation is often viewed as narrowly concerned with the ease and speed of customs procedures, improvements in which lie at its heart, Milner *et al.* (2008) show that even greater trade cost reductions and trade and welfare benefits may be reaped from a broader view, that incorporates transportation, distribution and communication issues.

There are a number of ways in which trade facilitation is relevant in the context of improving utilisation of preferences.

(a) In broad terms, reducing the costs of trade will tend to stimulate increased trade; this may have the most immediate impact on imports, but should also benefit exporters (e.g. improved customs clearance or port handling reduces delays, which is especially beneficial for perishable exports, and exporters often import intermediate inputs).

(b) Trade facilitation supports regional integration, as many of the measures relate to border procedures and/or would be more effective with regional co-ordination and co-operation. For example, improved trade facilitation in the context of regional

integration supports investment measures in EPAs (Morrissey, 2008). General improvements in the regional business and trade environment can benefit export producers in all countries.

(c) Measures related to customs procedures tend to increase the efficiency of revenue collection and are therefore typically associated with increases in revenue, providing resources to government. This implies some increase in government funding for measures that support exporters or to offset the adjustment costs of preference erosion.

(d) Enhanced trade facilitation enables countries to respond more effectively to other measures that reduce trade costs. For example, simplified rules of origin or requirements to comply with product standards can reduce trade costs; producers in countries with better trade facilitation can more easily available themselves of the benefits.

Investment promotion

Investment is a major determinant of economic growth. In general, low-income countries have relatively low levels of investment and its productivity tends to be low. This is one of the reasons why growth performance in low-income countries has been lower than desired. For example, many factors help to explain poor growth performance in sub-Saharan Africa, including natural and structural characteristics, which increase trade costs; poor governance and weak political will in relation to implementing market reforms, that make investment less attractive; and a lack of resources for financing investment. Low productivity of investment has also been an important factor.

Increasing the level and productivity of investment is essential to deliver increased and sustainable growth. Focusing on sub-Saharan African countries and foreign direct investment (FDI), Morrissey (2008) reviewed four issues to identify the types of investment measures and regulatory reforms, in particular those that could be incorporated in preferential trade agreements, that might encourage increased foreign investment. Effective and efficient policies depend on country circumstances, but they lie in four broad areas:

- Policies that provide political stability (e.g. governance) and enhance economic fundamentals, such as stable macroeconomic management, to provide a more attractive private sector environment;
- International policies conducive to investment, including integration and/or investment agreements;
- Policies that streamline regulatory and administrative procedures so that it is easier to do business, e.g. reducing start-up costs, flexible labour markets, protecting property rights and contract enforcement;
- Specific investment measures and incentives that are well designed, targeted and implemented consistently.

A number of regulatory reforms are likely to encourage investment, especially FDI, and competitiveness, thereby enhancing the growth impact of investment. The problems most developing countries face in respect of FDI are that the level is generally very low and typically it is highly concentrated in particular countries and/or sectors, with low levels of technology transfer and low linkages or spillovers for the rest of the economy. Regional integration and regulatory reforms provide an opportunity for LDCs, and poorer developing countries, to attract higher levels of more diversified FDI, larger markets, lower transactions costs associated with trade and investment, and generally a more favourable business environment.

The important issue for countries that need to adjust and respond to preference erosion is to encourage investment in the sectors that are best positioned to expand output, exploiting preferences where relevant, or that will suffer the greatest adjustment costs. In both cases, policy will need to be forward looking over a 5–10-year horizon. Measures to facilitate trade and promote investment in general will benefit all sectors, although targeting sectors affected by preference erosion is justified. These issues are considered in further detail in Chapter 5.

4.5 Summary and implications

If and when the Doha Round of negotiations resume and further multilateral liberalisation of trade is agreed, enhanced market access commitments will lead to preference erosion as MFN tariffs are reduced. Although a relatively small number of developing countries and LDCs are exposed to costs of preference erosion, the potential costs to these beneficiaries could be large. Most of the countries exposed to the erosion of preferences are either island economies in the Caribbean and Pacific (which benefit from ACP provisions) or countries in Africa (which benefit from ACP provisions and AGOA). A few Asian countries, notably Bangladesh, Cambodia, Myanmar and Nepal, are very exposed because they benefit from preferences concentrated in apparel, but will not gain 'preference protection' under the ACP (EPAs) or AGOA. The impact of preference erosion can be ameliorated by actions by preference-giving and preference-receiving countries to improve the design of preference schemes and enhance the ability of beneficiaries to expand competitive export production and utilise preferences.

There are a number of measures that preference-giving countries can implement to increase the effectiveness of preference schemes:

- Relax requirements relating to rules of origin, product quality, environmental standards and other non-tariff measures to reflect the needs of beneficiaries;
- Eliminate restrictions, tariff peaks and tariff escalation that affect products currently excluded from preference schemes, but that are products of actual or potential export interest to beneficiary countries;
- Ensure that preference schemes are predictable and long term, to facilitate investment in export production;

- Ensure that preference margins are sufficiently large to provide a real incentive to use them.

For preference-receiving countries, the important policy response is to create a favourable business and investment environment. Certain areas for regulatory reform are also important, and suggest domestic policy reforms that could be supported by preference-giving countries:

- Trade facilitation measures that reduce transaction costs and encourage domestic production and investment;
- Measures that make it quicker and easier to establish a business or make an investment (i.e. reduce red tape);
- Improved access to finance and financial services – access to credit is a major constraint on domestic investment in Africa;
- Improvements in the legal system that make property rights more secure, e.g. contract enforcement and investor protection.

Such measures can be an important part of a coherent strategy to increase the attractiveness of a country for investment, foreign and domestic, that can support more competitive production.