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Strategies for Addressing Preference Erosion

This report has shown that only a relatively small number of developing and least developed countries are exposed to significant costs from preference erosion. The majority of these countries are either African (and can benefit from some 'preference protection' under arrangements for ACP countries and AGOA) or island economies in the Caribbean or Pacific (which can benefit from some 'preference protection' under ACP arrangements). An important distinction here is that whereas the 'terms of access' under AGOA are decided unilaterally by the USA, the terms of EU-ACP preferences will be determined in negotiations on the detail of economic partnership agreements. Consequently, as discussed below, the terms of preferences under EPAs are relevant to the trade policy negotiating strategies of ACP countries, in a way that AGOA is not. There are also a number of Asian countries, mostly LDCs such as Bangladesh, Cambodia, Myanmar and Nepal, that are exposed to potentially large costs of preference erosion; while they require a strategy for negotiations in the WTO relating to preferences, they are not party to EPA negotiations, but may face some specific preference erosion as a result of EPAs, to the extent that benefits of the EBA scheme are eroded.

The previous chapter discussed policy options in broad terms, distinguishing actions by preference-giving and receiving countries to make preferences more effective. This chapter explores some of these options further to identify strategies and specific actions for countries that are exposed to preference erosion, taking into account the products of most concern to them and the various PTAs they participate in. The chapter also considers adjustment strategies once erosion has occurred. The options are addressed under three broad headings. First, what issues should countries focus on in trade policy negotiations so as to influence the behaviour of preference-giving countries at the international level (Section 5.1)? Second, the actions that individual countries might take to facilitate trade and promote investment to support adjustment in affected sectors are outlined (Section 5.2). Third, consideration is given to how these actions can be financed; exposed countries have limited resources to finance public expenditure and investment themselves, so they will need to attract foreign investment and support in the form of aid (Section 5.3). Section 5.4 concludes by offering answers to the questions asked in the introduction.

5.1 Trade policy negotiating strategies

It is evident that for some countries and products preferential access to major markets has supported increased export production, and in some cases diversification (e.g. AGOA), thereby generating benefits to domestic economic activity, although there is little evidence that such benefits are significant and sustainable in the long run. These countries are exposed to significant costs of preference erosion, both through reduced exports (as market share is displaced) and production, and costs of adjusting to changes in the extent and terms of preferences. While the primary source of future preference erosion is the enhanced market access being negotiated in the Doha Round of multilateral trade negotiations in the WTO, certain regional PTAs are also important, in terms of eroding preferences of non-participants and protecting those of participants. Although preference-receiving countries have a voice in trade negotiations, even if their ability to influence the terms of preferences negotiated is limited, negotiated agreements are unlikely to address the fundamental export problems that are inherent in export commodity dependence, structural weaknesses and rigidities in the preference receiving countries. Domestic policies to tackle these are considered in subsequent sections. Preference-receiving countries are faced with two principal issues in trade negotiations:

1. They should ensure that the potential costs of preference erosion are recognised and acknowledged. Even if erosion cannot be prevented, and as other countries benefit one may not wish to recommend this, the implementation of tariff reductions can be phased to give exposed countries time to adjust. They can also urge that the products of most concern to them are eligible for preferences, limiting exclusions by developed countries, and that markets are not distorted by tariff peaks and tariff escalation.

2. They should propose measures to improve the design and operation of preference schemes, by relaxing the 'terms of access' for preferences. The major issues here are reducing the complexity and increasing the transparency and predictability of rules of origin, product standards and other non-tariff measures (especially safeguard mechanisms) and any graduation criteria.

As discussed in Chapter 4, strict rules of origin undermine the value of preferences and increase the costs of utilising preferences (especially where preference-receiving countries are effectively denied access to the cheapest quality inputs). The potential costs of preference erosion could be offset if rules of origin were made more flexible and less stringent in terms of the source of inputs that can be used and the measure of domestic value added required. Preference schemes would be more beneficial if requirements and entitlements were transparent and fixed for 5–10 years. The cost of change can be minimised by simplifying existing rules and procedures rather than implementing new rules, even if these are less complex.

It would be particularly helpful for exposed countries if negotiations reflected their interests in niche markets. Especially favourable market access terms could be granted for exports of fair trade and organic products from preference-receiving countries. For example, semi-processed fair trade and organic commodities could be exempted from rules of origin requirements. On current evidence, this would relate mostly to bananas, coffee, cocoa and cotton, and perhaps also sugar and tea, so that the level of processing (domestic value added) is quite small. Furthermore, this would tend to benefit existing preference-receiving countries, especially ACP countries, and could encourage them to focus more on fair trade options. For example, Asian apparel producers could seek recognition that they meet appropriate labour standards. Such measures could help to retain a level of preferential access for countries that have already suffered significant preference erosion.

The aspect of rules of origin that may be most affected by this relates to investment, as inputs are generally unimportant, except for apparel. This could affect EU requirements, as foreign ownership is covered by rules of origin, and is a specific issue to be addressed in EPAs. Relaxing ownership or investment rules of origin would be justified for fair trade products as they embody a requirement on the share of the price received by producers, whereas foreign involvement provides monitoring of compliance with fair trade requirements.

Although the governments of preference-receiving countries have very limited ability to influence or intervene in the market structure of supply chains, such as global buyers and multinational intermediaries with market power, they should establish regulatory and oversight institutions to ensure competition in relevant activities concerning preferential trade. Although developing countries have been reluctant to see competition policy included in WTO negotiations, regulatory institutions can be more effective at a regional level. Furthermore, as private agents, especially buyers and intermediaries, often have a dominant position in markets for preference goods, they affect the benefits that accrue to preference-receiving countries. For these reasons, exposed countries should recognise the potential for measures on competition policy in trade negotiations.

Competition policy refers to the set of measures employed by government to ensure a fair competitive market environment, typically involving competition laws and authorities. This is particularly important in ACP countries, where there are often only one or a few major firms in important sectors or with market power in international marketing, so that potential abuse of a dominant position may be a concern. As anti-competitive practices are quite widespread, it can be inferred that they impose costs; implementing competition policy, therefore, would provide benefits that may, in economic welfare terms, be quite large.[22]

The trade reforms inherent in EPAs and WTO negotiations, and associated moves towards greater regional integration will promote increased competition. Competition policy may then be seen as the institutional mechanism to ensure that markets remain accessible and contestable. While competition policy can be implemented effectively at country level, and indeed the focus at least initially should be on the national level, given the prevalence of trade, foreign investment and integration, it is evident that regional co-operation and co=ordination is important. By including minimal commitments in this regard, EPAs (or the WTO) can support the establishment of effective competition authorities and the promotion of fair competition.

The establishment of a competition culture takes time and requires relatively costly institutional reforms; enacting a competition law with limited application in the first instance is a recommended first step. An initial focus on ‘hard core’ cartels can address private cartel agreements to fix prices, restrict output, submit collusive tenders or share markets by allocating customers, suppliers, territories or lines of commerce. These involve a particularly serious and harmful form of anti-competitive conduct that is prohibited by almost every national competition law. Success in anti-cartel efforts depends on international co-operation, as cartels operate in secret and important evidence may be located abroad, while international cartels grow in importance as markets become global. It is therefore difficult for a single national authority to prosecute without co-operation, and this provides an argument for establishing regional authorities, even if their remit is fairly limited. This is particularly relevant in the context of EPAs. Although regional institutions tend to be weak, EPAs could include measures to support regional co-operation on competition policy. Given the market power of large multi-nationals, even with legislation regional authorities may not have the power to restrain cartels and other uncompetitive conduct. The implication is that developing countries would require co-operation from advanced countries to cope with anti-competitive behaviour on the part of advanced country cartels between the large multi-nationals.

5.2 Trade facilitation and investment strategies

As discussed in Chapter 4, the inclusion of investment provisions in trade agreements is useful for investment promotion, co-operation and protection, and can help increase investment, especially foreign investment. Measures to facilitate trade and promote investment will benefit all sectors; specific targeting is justified for sectors affected by preference erosion. To be in a position to utilise altered preference schemes and adjust to preference erosion, exposed countries will need to invest in technology, human resources and institutional, especially marketing, capacity. Trade facilitation (on which we concentrate below) tends to focus on the latter, so investment strategies should identify the needs of preference sectors for new investment in production, especially technology.

From the perspective of adjusting and responding to preference erosion, the important issue for countries exposed to preference erosion is to encourage investment in the production sectors that are best positioned to expand (some of which can exploit preferences) or that will suffer the greatest adjustment costs. Sectors that have already experienced a loss of preferences will decline to some extent, so growth is required elsewhere in the economy, especially to provide employment. The benefits of foreign investment in transferring know-how (technology, management and human capital) need to be set against any rules of origin restrictions on foreign ownership. (As suggested above, these should be addressed in trade negotiations to provide greater flexibility.) In general, while investment measures may aim to target particular sectors, they need not discriminate between domestic and foreign sources: investment incentives should be available to all.

Promoting trade facilitation in broad terms can play an important role in investment in infrastructure and more efficient administrative procedures to reduce trade costs, including transport, ports and trade and customs services. The benefits generally outweigh the costs of implementing the reform, and external assistance can help meet the costs (as discussed in the next section). Following the discussion of trade facilitation in the previous chapter, particular attention needs to be given to:[23]

(a) More efficient customs clearance and port handling to reduce delays and trade costs, especially for bulk and/or perishable exports. Improving clearance procedures leads to dramatic reductions in the time taken for goods to pass through customs, while increasing port efficiency provides even larger benefits in terms of reducing trade costs (and is more directly relevant for exporters). Trade facilitation measures in Mauritius are credited with a major contribution to the reduction of the cost and risk of exporting sugar and, more importantly, apparel.

(b) Measures to improve transport and distribution facilities are effective in reducing trade costs and increasing the profitability, if not volume, of exports. For example, computerised processing systems can reduce the cost of transporting sugar by almost 5 per cent of the shipment value. Similar gains could be anticipated for products like bananas.

(c) Time to market is reduced by efficient transport and logistics services and timely, transparent and predictable administrative procedures. This is especially important for perishable products (e.g. exports of cut flowers from Kenya) or fashion apparel, where changing designs must be incorporated rapidly. Although time does not seem to affect trade volumes, the ability to deliver rapidly is essential to serve a market. African exporters typically face export times twice those of Asian or Latin American competitors. Investments in trade facilitation that reduce shipment times can be highly beneficial, and in principle could compensate for significant reductions in preference margins.

(d) Regional co-ordination is particularly helpful to improve trade facilitation, reduce trade costs and encourage investment. This is especially relevant for landlocked countries, as goods have to travel through neighbouring countries, but can also be important for island economies, as specific ports may serve the main export markets.

5.3 Aid for trade and export development

Measures to actively facilitate trade are increasingly seen as essential to assist developing countries in expanding trade and benefiting from globalisation. As discussed above, promoting trade facilitation can be particularly effective and beneficial, but is costly to implement. The need for external assistance to finance trade facilitation measures has been recognised by donors and within the WTO, and has been included in discussions on so-called ‘aid for trade’ or, more specifically, aid financing of trade facilitation measures.

Existing sources of trade development support

Irrespective of the aid transfer or assistance source involved, the specific national issues and approaches relating to promoting and adjusting to trade expansion need to be clearly expressed within national development plans and strategies (Hoekman *et al.*, 2004). This has been recognised in recent years by the efforts of some developing countries to incorporate a trade policy pillar into their Poverty Eradication Action Plans, and is a response to earlier failures to give sufficient attention to the development of productive sectors in general. The shift in priorities is reflected also in the increasing focus on 'aid for trade' issues of many of the bilateral donors and multilateral agencies.

For example, the Integrated Framework for Trade-related Technical Assistance to Least Developed Countries was inaugurated by six multilateral agencies (IMF, World Bank, UNCTAD, UNDP, ITC and WTO) in 1997. It brought together these multilateral agencies with bilateral donors and national governments to integrate trade into national development plans and assist in co-ordinated delivery of trade-related assistance. An IF Trust Fund was created in 2001, and now has two funding instruments based on voluntary contributions from multilateral and bilateral donors: Window I funds the Diagnostic Trade Integration Study (DTIS), which identifies constraints faced by traders, the sectors of greatest export potential and a plan of action for integrating a country further into the global trading system; Window II is a special facility, introduced in 2003, to finance high priority projects identified by the DTIS.

Direct funding under the IF has been quite limited. A maximum of only US$1 million was available for each country's DTIS (plus a small contribution towards the implementation of priority actions). By 2008, total allocations made by the IF Trust Fund amounted to only US$27 million, funded by contributions from multilateral and bilateral donors of US$50 million, although an indicative budget of US$400 million for an Enhanced IF (EIF) is in place for the next five years.

Even in terms of the countries to which the EIF is limited, the budget is modest relative to reasonable needs. The primary role is to help co-ordinate delivery of assistance. In the absence of substantive core funding for a systematic aid for trade programme, the credibility and effectiveness of the programme will be weakened, especially given the challenge of co-ordination with bilateral and multilateral donors. Increasing aid for trade provision will only improve the capacity of countries to create new export capabilities if the aid is disbursed appropriately and if the receiving countries are able to absorb and effectively utilise or mobilise the funds. Clearly, standard issues of aid effectiveness arise. The WTO is not a development agency, and administrative and technical support remains quite limited. Some enhancement of the WTO's capacity to mainstream trade development within national development strategies would be useful. It would improve the prospects for mainstreaming in a manner consistent with global trading rules, while allowing feedback on the evolution or revision of those rules. It would also allow trading rules, trade policy reform and trade development issues to be more effectively negotiated within the WTO's multilateral negotiating framework, and do this in a way that allows for differential treatment of developing countries.

There is a clear case for extending the programme to cover all countries that will experience adjustment costs from preference erosion and wider trade reform, and need assistance with export development. Indeed, the principle of differentiation ('special and differential' treatment) is not restricted to a distinction between the least developed and other WTO members. Further, the widening of the programme's country coverage would increase the scope for regional coverage and co-ordination of adjustment support and trade development measures, where regional trading arrangements embody both least developed and developing country membership.

5.4 Conclusions: some questions answered

The focus of the preference-receiving countries in multilateral trade negotiations should be on how to implement MFN tariff liberalisation so as to sustain and maintain the benefits of preference margins for a sensible and feasible length of time, and to increase the utilisation and effectiveness of the margins that remain post-MFN reform.

Developing and least developed countries with the greatest exposure to preference erosion also tend to have the greatest need and scope for improving trade facilitation (narrowly and broadly defined). This is especially true of ACP countries, which account for the majority of the countries most exposed to preference erosion. Even if the most immediate direct effects of trade facilitation measures are on imports, there are potential large export-side benefits associated with the clearance of export goods through customs, borders and ports in a shorter time and at lower cost. These benefits are more likely to be realised at relatively lower cost if trade facilitation measures are incorporated into regional agreements, as there are cross-border externalities and economies of scale.

Current aid for trade initiatives of bilateral donors and multilateral agencies signal a greater commitment to direct assistance and more funding for comprehensive development of production and export capacity in LDCs. Greater funding, more ambitious country coverage, more effective integration into national policy formulation and clearer national ownership are required. But so too is stronger co-ordination across donors, agencies and regional country groupings.

The reform of the schemes themselves is, however, only part of the solution. Measures and accompanying funding support for export development (e.g. aid for trade initiatives) in the developing countries themselves are also required in order to increase the capacity of developing countries in general to take advantage of export market opportunities associated with preferences and, of equal if not greater importance, to adjust to the effects of loss of preferences. This is particularly the case for the relatively small number of countries that experienced loss of preferences in important products, notably sugar and bananas. It is also a wider requirement; trade development support measures should be seen both as support in the shorter term for preferential trade, but also as part of the preparation for a world without preferences.

The assessment of the effects of preference schemes and vulnerability to preference erosion answers questions of interest to policy-makers, especially in preference-receiving countries.

What has been the impact of non-reciprocal preferential trade arrangements? In general, for developing countries overall, their impact has been limited. The important exception is developing countries and LDCs that have been beneficiaries of targeted preferences, notably ACP countries which have benefited from EU preference arrangements and African countries which have benefited from US provisions under AGOA.

Which countries and products or sectors would be most affected by the erosion of preferences? Essentially, it is those which benefited from targeted preferences that have already experienced or are vulnerable to further losses from preference erosion. These are mostly ACP countries (developing countries and LDCs, especially if they are dependent on exports of sugar or bananas), and especially sub-Saharan African countries (who also benefit from AGOA). Some Asian LDCs and north African countries are vulnerable to preference erosion on exports of apparel.

What are the key factors constraining a country's ability to benefit from trade preferences? In terms of the features of schemes, restrictive rules of origin are probably the single most important factor, as they impose high costs (in terms of the structure of production and acquiring information about the rules) and tend to be uncertain. Other product exclusions or restrictions, such as tariff peaks, and requirements for product standards, especially where these are uncertain and non-transparent, limit utilisation of preferences. Preference-receiving countries have often lacked the capacity or policy environment to encourage and support producers in availing themselves of preferences.

What are the most important measures that could mitigate constraints on preference utilisation? Preference-receiving countries should implement regulatory and institutional reforms to support trade and export diversification, so that they can benefit from preferences that continue and adapt to a more competitive global trading environment. These are sensible policy options for all countries, but beneficiaries may wish to initially focus on products facing preference erosion. Preference-giving countries should provide more flexible and transparent terms of access, especially for rules of origin and product standards, with targeted and predictable preference terms. The bilateral and multilateral donors also need to continue to support adjustment in the most adversely affected and vulnerable countries, and to ensure that there is additional support in general for aid for trade.

What policy measures are required to address the effects of preference erosion? In general, it is essential to recognise the features of vulnerable countries. Relatively few countries face potentially high losses and these are typically related to specific products, so measures should be targeted. There is a general need for financial and technical support to meet and mitigate adjustment costs and enhance trade facilitation. This will require external funding and co-ordination of effort. Beneficiary countries themselves should support producers and encourage export diversification; ultimately, no country wishes to depend on preferences.