

Preferential Programs and Economic Growth

Proponents of the preferential programs argue that the tariff advantages provided under these programs have the potential to stimulate growth in recipient countries' exports. This, in turn, will increase prices for exports relative to imports (terms of trade), and that could create incentives to invest in the production of export commodities that generate the highest return under preferential programs. In theory, if this leads to an overall increase in investment, economic growth in the recipient countries is stimulated.

In reality, the economic implications of preferential market access programs on recipients are complex and depend on a variety of factors (Bora et al., 2002). Recipients' internal factors include exchange rate, tax, and fiscal policies that affect countries' trade performance and that are almost impossible to isolate from the impacts of nonreciprocal programs. These factors complicate efforts to assess the success or failure of these programs. In addition, most countries are parties to multiple reciprocal and nonreciprocal agreements and that participation complicates attempts to measure the effectiveness of individual programs. Changes in the global trade situations and policy and market conditions of the program providers are also important factors that need to be taken into account. The indirect impacts of the programs such as allowing for development of economies of scale (i.e., enlarging recipients' markets to increase operational efficiency), improving trade knowledge of recipients, and program potential to attract foreign direct investment, are difficult to assess.

The available literature on the assessment of these programs' impacts is diverse, ranging from macro to micro studies with differences in data and methodologies (Brown, 1988; OECD, 2003). Many studies done during the first 15 years of the GSP program demonstrated that it had expanded exports (all commodities) of developing countries (Brown, 1988). The export growth was concentrated in a few products, mainly products that are based on labor-intensive production. More recent empirical research argues that the apparent loss of trade market shares of the low-income program recipients, Sub-Saharan Africa in particular, is not because of the nature of the implementation of preference programs, but because of supply constraints in program recipient countries (Nilsson, 2002; Cline, 2004). Overall research conclusions are that those programs that offer deep tariff cuts and broader commodity coverage such as CBERA and Lome/Cotonou, and perhaps EBA and AGOA in the future, have the best chance of improving export performance of the program recipients (Cline, 2004).

Another important issue that influences the trade impacts of these programs is the nature of program design. Research shows that these programs tend to stimulate export growth if the commodities covered by the program are better matched to fit the export profile of the program recipients (Clark, 1997). The experience of the CBERA countries shows that for tropical commodities such as pineapples and cantaloupes, in which exporting countries have comparative advantage, the tariff preferences provided by the program led to a growing export market even after the incentives were reduced (Loper et al., 2003). However, for commodities such as meat, which would not otherwise have been exported, tariff differentials created a

policy-induced “comparative advantage.” When the margin of preference declined, those exports disappeared quickly. In such cases, the limited benefits of these programs come at great costs—they encourage high-cost production and result in diverting limited resources away from more productive activities. Further, to the extent that the programs insulate producers from competitive pressures, they may slow down the adoption of new cost-reducing technologies and, thus, hinder innovation and economic adjustment. In these cases, the trade created is not based on implementation of domestic economic reforms in order to become competitive. Rather, it is based on the existence of preferences, causing recipients to become less competitive, more reliant on preferences, and highly vulnerable to preferences’ removal (Stoeckel and Borrell, 2001; Topp, 2001).

The case of the sugar industry in the Caribbean is a good example of the dilemma facing the exports of developing countries benefiting from preferential programs. Trends in sugar production and exports of the Caribbean countries have been declining in the last couple of decades despite preferential access to the EU and U.S. markets. According to Mitchell’s study (2004), without preferential sugar programs the export revenues of the countries would have declined more sharply, 60 percent in 2000-01, assuming no change in world prices. The reason for these declining trends is the growing production costs that stem from inefficiencies of public-sector control and management of the sugar industry. It is not clear how preferential programs contributed to the inefficiencies in the management of sugar export in these countries, but according to the Mitchell’s conclusions, the sugar industries of the region will face severe challenges in the coming years. Many countries must diversify or move to alternative/value-added production such as refined sugar or ethanol production.

In addition to expanding trade, preferential programs can have long-term impacts on investment and income growth (Clark, 1997). The expansion in trade allows beneficiary countries to restructure their export sector and consequently attract investment. This leads to economic growth. The impact of preferential programs on investment is not instantaneous, and there is a limit to how much a country may benefit from these programs. Investment benefits of the program depend on recipient countries’ orientation, infrastructure conditions, resource availability, and access to other preferential programs (Clark, 1997; Skripnitchenko and Abbott, 2002; and Skripnitchenko, 2003). Country-specific economic and political conditions are also influential in foreign investment decisions. The risk factors associated with any new investment abroad—such as language and cultural barriers, legal differences, incomplete information relative to local firms, and political instability—slows the investment process, even in those countries that enjoy the incentives of trade preference programs and are low-cost producers.

As for the relationship between preferential programs and an upward trend in recipients’ economic growth, the evidence is less conclusive. The improvement in investment and the terms of trade between traded and nontraded sectors as a result of preferential programs is expected to lead to reallocation of resources, leading to the economic growth of program recipients. In practice, those countries with a higher level of economic development that possess adequate infrastructure are in a better position to take advantage of reduced tariffs offered by the programs (Brown, 1987 and

1989). This also means that these programs often fall short of achieving a primary aim to improve the economic and social conditions in the poorest recipient countries. This limitation is acknowledged even by those who support these programs (Stoeckel and Borrell, 2001; Topp, 2001). Constraint in expanding production capacity is the reason for the limited economic gains of preference programs in the low-income countries. Topp argues that improving the programs' effectiveness requires collective action by all program providers. He suggests that donors could more effectively use the equivalent of tariff revenue forgone under these programs by increasing direct development assistance to the poor countries (Topp, 2001).

In sum, research indicates that preferential programs have limitations in delivering the expected economic benefits, in particular in the case of lower income countries. The literature shows that improvement in program design can enhance program effectiveness. The argument is that while, in principle, these programs provide increased market access for a wide number of products, the preferences offered do not always match the export profile of the recipients. The complicated implementation procedures also limit the potential trade benefits. Preferences must actually be requested and beneficiaries must meet requirements on how and where the products are produced. Experts cite complex and restrictive rules-of-origin requirements—meant to ensure that the tariff preferences are confined to the intended recipient—as a limitation on beneficiary countries' ability to fully use tariff preferences offered under these programs. To the extent these costs approach, or even exceed, the value of the margin of preference, the incentive to increase exports declines or disappears completely (Mattoo et al., 2002). Other nonprogram costs, such as compliance with a donor country's sanitary and phytosanitary regulations, also can impede recipients from benefiting from preferences.