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OECD

ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT

Making open markets work for development

Introduction

Will developing countries really gain substantially from further multilateral trade liberalisation? This is a vital issue for the Doha Development Agenda (DDA) talks at the World Trade Organization (WTO) and a requirement for their successful conclusion.

It is clear that many developing countries have benefited from multilateral trade negotiations and the resultant market-opening agreements in the decades since the Second World War. Further market opening should help more of them to better integrate into the world economy.

This may seem a straightforward proposition, but realising this objective is an extremely complex and time-consuming process. Before anyone can reap the benefits, countries have to agree on what aspects of trade to liberalise, when, and in what order. Each country has its own economic situation and priorities to consider, so it takes tremendous effort to develop the consensus required for successful negotiations.

Studies carried out at the OECD suggest the likely gains are well worth the effort for developing countries. One such study considered a variety of tariff liberalisation scenarios and found overall potential welfare gains for developing countries of up to USD 68 billion (or the equivalent of up to 2% per capita, depending on the region).

But these gains would be shared unevenly between developing countries, and the changes could cause particular problems for certain countries or sectors. Three potentially thorny issues are the likely effect of reductions in developing countries' trade preferences; the impact on government revenue of tariff changes and the impact of liberalising services trade. All these issues need to be addressed if the Doha Development Agenda talks are to fulfil expectations.

This *Policy Brief* offers an overview of the OECD's work on the likely impact of changes in all three areas, identifying positive and negative impacts and suggesting ways to ensure positive outcomes. ■

Observer oecd

What is the impact of trade preferences?

A significant share of imports from developing countries enters the OECD area without preferential treatment. But some developing countries rely on *tariff preferences* on certain goods – a lower tariff applied to their goods than to similar goods from other countries – as a means to break into a new market. This can help a developing country with a natural competitive advantage to gain a foothold in the international market and build up a position where it can compete without need of preferential treatment. But preferences can also encourage countries to develop sectors where they will never be fully competitive.

Further trade liberalisation may lessen the advantage offered by trade preferences, for example by bringing general import tariffs on particular goods closer to the preferential level already granted a developing country. This will put pressure on countries currently benefiting from trade preferences even in competitive sectors, and all the more so in sectors where a beneficiary country is relatively uncompetitive. In some cases, the adjustment may prove costly and painful to address. Consequently, some countries have raised the issue of preference erosion as a concern under the DDA negotiations.

Although the main beneficiaries of trade preferences have often been developing countries with relatively high income levels and pre-existing supply capacity, such as Brazil or Thailand, some small or poor countries have also succeeded in expanding preferential exports. Two industries of particular concern are textiles and clothing, where until January 2005 quantitative restrictions limited the market access of many large suppliers. Meanwhile, certain other developing countries have had some type of preferential access to developed country markets through more generous treatment with respect to quotas, tariffs or terms of access (known as "rules of origin"). Countries such as Bangladesh, the Dominican Republic, Haiti, Honduras and Lesotho have substantial preferential exports in these sectors. In the case of Lesotho, an IMF report lists the growth of the textile industry among the "daunting medium-term problems", because it has been driven by preferential treatment from the United States and may not be sustainable as the trade preferences decline. Agriculture is another area of concern; some developing countries receive a large amount of export earnings because of privileged access to developed country markets that are otherwise protected by high barriers. Mauritius, for example, exports a large amount of sugar to the European Union under trade preferences.

Any assessment of the impact of multilateral tariff reductions must balance these negative aspects against the potential gains of further market opening in general. We need to ask, for example, whether the loss of advantage in one market due to preference erosion will be more than offset by the benefits of access to new markets thanks to lower trade barriers generally.

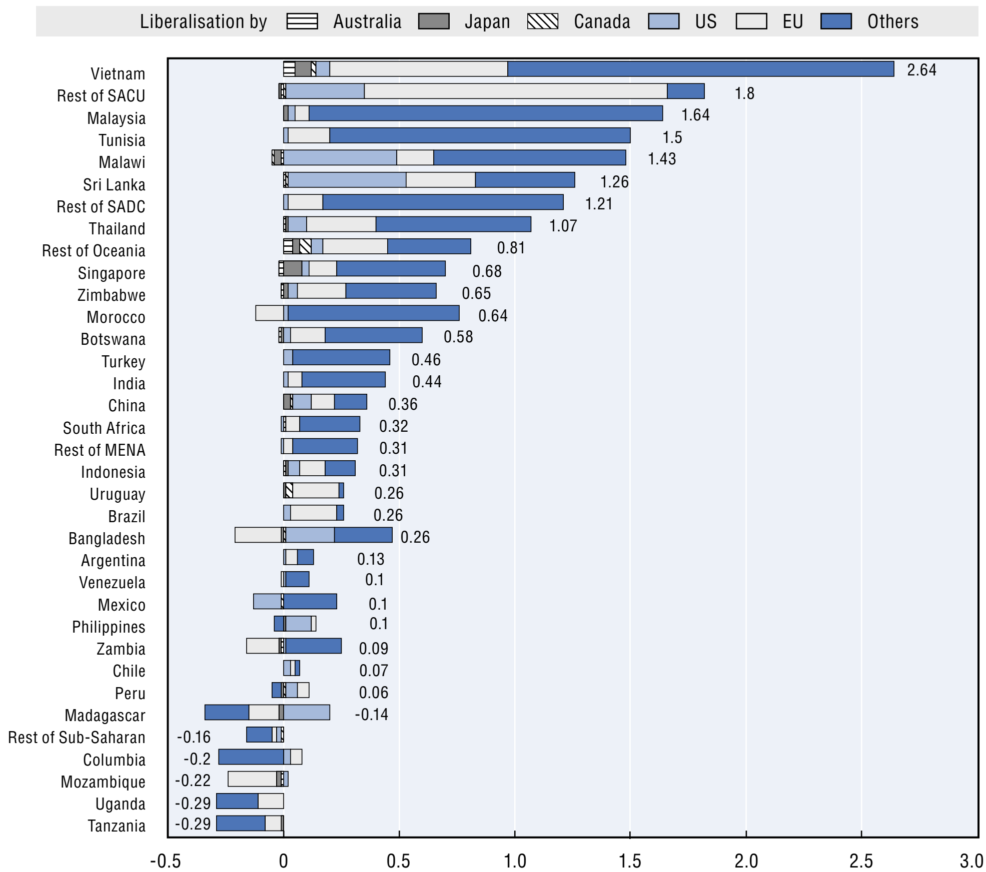
Studies of various scenarios at the OECD show that most developing countries would benefit if major preference-granting countries cut their tariffs. However, this is not true for all developing countries. In a few regions, primarily in certain parts of Africa, there may be net losses in welfare (Chart 1). This may be a problem that significantly affects a small number of countries and an even smaller number of products (*e.g.* bananas, sugar and apparel), but it will pose a challenge for policy makers contemplating the effects of preference erosion.

The best policy response for a developing country facing an erosion of its trade preference advantage may well be similar to that recommended in response to trade liberalisation more generally – capitalise on new opportunities, while taking steps to facilitate adjustment for sectors on the negative side of the equation. This means that trade policy reform must be accompanied by complementary policies such as promoting macroeconomic stability and developing an appropriate social safety net for those who lose their livelihoods. If the sector benefiting from trade preferences could become internationally competitive, policy makers may seek to reinforce that competitiveness by support for upgrading infrastructure or human resources (*e.g.* through training). Where new opportunities arise, a focus on facilitating adjustment, redeploying resources and promoting entrepreneurship may be appropriate.

Chart 1.

PER CAPITA WELFARE GAINS FROM A SIMULTANEOUS 50% REDUCTION IN TARIFFS

BY THE QUAD COUNTRIES AND AUSTRALIA (PERCENTAGE CHANGE IN PER CAPITA WELFARE)



Notes: Welfare gains from trade liberalisation refer to the equivalent variation in income and can be broken down into two components: *i)* the change in efficiency with which countries use their resources and *ii)* the change in its terms of trade.

Regional groupings include: *Rest of Middle East & North Africa*: Algeria, Bahrain, Egypt, Iran, Iraq, Israel, Jordan, Kuwait, Lebanon, Libya, Palestinian Territory, Oman, Qatar, Saudi Arabia, Syrian Arab Republic, United Arab Emirates & Yemen; *Rest of Oceania*: American Samoa, Cook Islands, Fiji, French Polynesia, Guam, Kiribati, Marshall Islands, Federated States of Micronesia, Nauru, New Caledonia, New Zealand, Norfolk Island, Northern Mariana Islands, Niue, Palau, Papua New Guinea, Samoa, Solomon Islands, Tokelau, Tonga, Tuvalu, Vanuatu & Wallis and Futuna; *Rest of South African Development Community*: Angola, Democratic Republic of the Congo, Mauritius & the Seychelles; *Rest of South African Customs Union*: Lesotho, Namibia & Swaziland; *Rest of Sub-Saharan Africa*: African countries not shown elsewhere.

Source: Lippoldt and Kowalski, OECD, 2005.

International action can help to ensure that trade liberalisation favours development and works to offset the loss of preferences. This might include such elements as strengthening WTO rules, recognising that resource constraints in small- and low-income countries may require temporary exemptions from multilateral rules, and greater efforts to tie trade-related assistance to national development priorities. Donors can also support adjustment bilaterally; the EU, for example, has made development assistance available to finance sectoral restructuring in some countries affected by preference erosion.

A recent World Bank study underscores the importance of multilateral liberalisation in helping most developing countries to improve their market access and reduce the discrimination they face from the prevailing web of regional trade agreements. At the same time, the report acknowledges risks of net losses from preference erosion for some, generally smaller, developing countries. This does not mean that preferences should be maintained. Rather, the report indicates that appropriately designed development assistance can provide a less distorting and more cost-effective alternative to preferences, for example by supporting reforms that will help sustain growth. ■

How will lower tariffs affect government revenue?

Some developing countries that rely on import tariffs for much of their government revenue are also concerned about the effect that lower tariffs will have on their public finances. Indeed, the Doha Work Programme that sets the framework for the current WTO negotiations includes instructions for negotiators to take into account the particular needs of countries dependent on revenues from import tariffs.

A recent OECD study looked at this issue in detail and assessed the likely impact on a sample of developing countries while suggesting how efficient tax policies could help replace lost tariff revenue.

The study found that revenue losses from tariff reductions for many countries would be less severe than might be expected. For one thing, many developing countries already apply import tariffs that are significantly lower than the maximum or “bound” rate allowed under current WTO agreements. If tariff reductions do not take the maximum rates below the rates currently being applied, it would not have any immediate effect on revenue. Large gaps between allowed maximum rates and actual applied tariffs, however, do highlight the need to seek ambitious tariff liberalisation commitments in the DDA negotiations in order to secure meaningful welfare gains for participants. If governments simply reduce the theoretical maximum rates to levels equal to the current applied rates, then there is no market opening, simply an assurance that the government cannot raise rates in the future.

Also, many developing countries concentrate high import tariff rates in manufacturing sectors where price has a large influence on demand. So any loss of revenue from lowering the highest tariff rates is likely to be offset by the effect of increased demand.

The results for an individual country will depend on many factors, including its existing tariff profile, the composition of its trade, the extent of tariff reductions agreed in the WTO talks, and how they are applied. However, some countries are still likely to lose revenue. For example, tariff cuts of the "Swiss formula" type currently under consideration in the DDA are designed to reduce high tariffs by a larger proportion than low tariffs. Such cuts would likely lead to a deeper percentage revenue loss for countries with relatively high initial tariffs, particularly if their tariffs are close to the allowed maximum levels. At the same time, the comparatively deep and effective multilateral tariff reductions may also lead to larger trade creation and welfare gains for them.

The effect of tariff reductions on government revenue also clearly depends on how heavily a particular country relies on import duty as a source of income and how difficult it will be to replace this with other revenue. Estimates for 12 developing countries indicate that for nine of them, the potential drop in revenue as a result of tariff reductions is relatively small and the required fiscal adjustment is therefore manageable, especially given the net efficiency gains expected from liberalisation. In some cases, however, the required fiscal adjustment may be more extensive (Table 1).

Trade taxes are in any case a relatively inefficient way of raising revenue, and many countries have been shifting towards other forms of taxation such as income, sales or value added taxes for some time. Indeed, the need to strengthen domestic taxation to offset revenue losses from trade liberalisation has in many cases been a key consideration in adopting value added taxes (VAT). But while there may be a compelling *theoretical* argument for simultaneous reform of tariffs and the tax system, there is considerable controversy as to whether this is a feasible strategy in practice for developing countries.

Past attempts at co-ordinating tariff and domestic tax reforms have produced both successes and failures. This mixed evidence calls for an assessment in advance of which countries may be particularly vulnerable to tariff cuts agreed in the DDA negotiations. Also, revenue concerns should be included in any special and differential treatment provisions to help disadvantaged

Table 1.

ESTIMATING THE MAGNITUDE OF REQUIRED FISCAL ADJUSTMENT UNDER VARIOUS LIBERALISATION SCENARIOS (%)

	Customs and other import duties		Simulated percentage impact on tariff revenue		Estimated impact on revenue (%)		Estimated impact on tariff revenue as a % of GDP	
	% of revenue	% of GDP	Swiss 5	Swiss 15	Swiss 5	Swiss 15	Swiss 5	Swiss 15
Argentina	4	1	-45	-4	-1.8	-0.2	-0.3	0.0
Brazil	3	1	-53	-10	-1.6	-0.3	-0.4	-0.1
Chile	4	1	-35	-1	-1.4	0.0	-0.3	0.0
Columbia	5	1	-44	-4	-2.2	-0.2	-0.4	0.0
India	15	2	-75	-48	-11.2	-7.2	-1.3	-0.9
Indonesia	3	1	-26	-9	-0.8	-0.3	-0.2	-0.1
Madagascar	26	3	-15	-3	-3.9	-0.7	-0.4	-0.1
Morocco	16	5	-74	-42	-11.8	-6.7	-3.5	-2.0
Peru	9	1	-58	-11	-5.2	-1.0	-0.8	-0.2
Thailand	10	2	-66	-35	-6.6	-3.5	-1.2	-0.6
Uruguay	3	1	-27	1	-0.8	0.0	-0.2	0.0
Venezuela	5	1	-52	-3	-2.6	-0.2	-0.6	0.0

Note: The Swiss formula is applied to bound rates and applied rates are reduced only if the resulting bound rate falls below the initial applied rate.

Sources: OECD, based on simulations using the GTAP model and IMF International Financial Statistics data.

developing countries adjust to the changes, whether in the form of extended implementation periods or coordinated financial assistance to help them overcome financial, technical or capacity constraints.

Designing and implementing an appropriate tax to compensate for revenue losses will involve costs, but these are temporary while in terms of improved allocation of resources the gains they achieve from liberalisation are permanent. Therefore, from an economic point of view, these costs should be seen not as an obstacle to liberalisation but rather as necessary investments paving the way to long-term gains. ■

How significant are the gains from more open services trade?

Liberalising trade in services is an important aspect of the DDA talks, and recent OECD studies stress the importance of this for developing countries. In many cases, barriers to trade in services remain high in comparison to those in merchandise trade, and services are an increasingly important sector of economies in both the developed and the developing world, so gains from services liberalisation are expected to be greater than those from goods trade liberalisation.

Services are important inputs in the production of most industries; OECD analysis suggests that the potential benefit of liberalising services trade would not stop with services, but would also improve the efficiency of supply for agriculture and manufacturing. In addition, liberalising services inputs to agricultural and manufacturing production is likely to ease any adjustment strains which those sectors may face. An OECD study shows that if services barriers are taken into account, the effective rate of protection for some agricultural and manufacturing sectors actually turns negative, meaning that services barriers – combined with barriers on other inputs – amount in effect to a tax on these industries and compound the distortions arising from barriers on trade in agricultural and manufactured goods. ■

How to adjust to change?

Developing countries may well need technical assistance to help them to participate fully in trade negotiations and to implement international obligations. They may also need help with trade capacity building to be able to take advantage of new trade opportunities from multilateral trade liberalisation; this could help counterbalance the losses that some may suffer through declining tariff revenue, eroding preference margins or adjusting to other changes in the trading environment. Such help should be seen as an essential complement to trade reform and liberalisation, not a substitute for it.

For most developing countries, the economic impact of preference erosion and lower tariff revenue will be manageable although they will have to make economic adjustments to meet the new situation. But for some countries trade policy alone will not be sufficient to handle these particular adjustment issues, and they may need extra help to ensure that they benefit effectively from the opportunities of further multilateral liberalisation and any remaining trade preferences. The WTO can help developing countries to maximise the benefits of trade reform and integration efforts by recognising the need for complementary measures and an effective, meaningful special and differential treatment of those countries most affected by economic adjustment issues.

Successful structural adjustment – enabling labour and capital to move from declining to expanding areas of activity – is characterised by a number of common features including macroeconomic stability; labour market flexibility, long-term investments in human resources and infrastructure; and a careful sequencing of reforms that help sustain the adjustment process. Trade and regulatory reforms are an essential part of the process and are needed to stimulate exports, improve local business conditions and foster competition. In turn, such reforms promote investment.

Countries that have taken advantage of the opportunities afforded by trade liberalisation have tended to tailor their strategies in close consultation with public and private stakeholders. A consultative national policy-making process is important to ensure a coherent approach to trade and, likewise, to ensure an appropriate integration of trade policies into comprehensive development strategies. Many developing countries have prepared Poverty Reduction Strategy Papers through a participatory process involving domestic stakeholders as well as external partners, including the World Bank and International Monetary Fund. Increasingly, the trade dimension is being integrated into these papers. International donors can support this process through trade-related technical assistance and capacity building that is aligned around local strategies and systems. ■

What are the lessons for the DDA?

Further trade liberalisation, particularly non-discriminatory, *multilateral* trade liberalisation, promises to help developing countries to better integrate into the global economy. The evidence indicates that this liberalisation will generally tend to promote growth and should therefore be encouraged and welcomed by developing countries. At the same time, the relationship between trade and development is complex and multifaceted. In order to maximise the potential gains from liberalisation, developing countries will need to continue to assess individually their situation and priorities in terms of trade policy and domestic policy reform while taking account of their overall development strategies.

Although most developing countries stand to gain from further multilateral trade liberalisation, others may suffer losses at least in the short-to-medium term or they may face particular adjustment challenges. A successful response will require action in a range of policy areas, domestically and internationally. The stakes are high, since failure to respond adequately may jeopardise the potential outcomes of the present negotiating round. ■

For further information

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