Chapter 13
Trade Policy

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13.1 Introduction

There is a preponderance of cross-country evidence that trade liberalization and openness to trade increase the growth rate of income and output. In addition, numerous individual country studies over the past three decades suggest that “trade does seem to create, even sustain higher growth” (Bhagwati and Srinivasan 1999). A country’s trade policy is the key link in the transmission of price signals from the world market to the national economy. Undistorted price signals from world markets, in combination with the exchange rate, allow resource allocation consistent with comparative advantage, thereby increasing productivity. An open trade and investment regime encourages integration into the global trading environment and the import of diverse and modern technologies that are important for productivity improvements.

Trade, growth, and the poor. Growth in incomes of the poor is strongly related to overall growth in the economy—although the relationship differs substantially from country to country. The link of overall growth to poverty reduction has been demonstrated both in cross-country analyses (Dollar and Kraay 2000), and for individual countries. Trade liberalization can therefore be expected to help the poor overall, given the positive association between openness and growth. However, in the short run, liberalization may have a negative impact on some of the poor, depending on their sources of income and the impact of liberalization on the prices of goods and services the poor consume. There is therefore a need to examine the impact of trade liberalization in some detail to help to design policies that would protect those among the poor who may be adversely effected, especially in the short run.

Characteristics of the poor. Knowledge of how the poor obtain and how the poor spend their income is important in designing pro-poor policies (see Annex K). Food is by far the most important item of expenditure. In Bangladesh, for example, food represents about 73 percent of the total expenditures of the poor, with fuels, housing, and clothing combined accounting for just 21 percent. The sale of unskilled labor tends to be the most important source of income for the poor, complemented by the value of “own consumption”—that is, the imputed value of what the poor consume from their own production.

In general, the impact on the sources of income of the poor will be a more important determinant of the effect of liberalization than the effect on the prices of the things that they consume. The reason is that trade reform will affect many relative prices, some of which will move in offsetting directions. As the poor generally have limited assets, the most important of which is low-skilled labor, the impact on wages and employment therefore dominates.

Complementary policies and institutions. While a liberal trade policy is necessary for growth and poverty reduction, it is not sufficient in itself to promote trade growth. When trade reform has been implemented in an unstable macroeconomic environment or has been implemented without any effort being made to strengthen trade-related domestic institutions or without appropriate complementary policies, it has often either been reversed or has failed to stimulate growth. This chapter will discuss important “behind-the-border” reforms that should accompany trade liberalization to effectively allow a country to integrate into world markets. Such reforms should include development of a regime that encourages investment and competition, including openness to foreign direct investment (FDI), so that business services are supplied at competitive prices, and should include macroeconomic policies that encourage stable prices and a competitive real exchange rate. Although the poor are very diverse, they frequently work in the rural sector and in the urban informal sector. Thus, policies that affect agricultural and labor markets are important complements to trade reform for the poor.

Political economy of protection and the poor. Even when trade reform would benefit the poor and the economy broadly, it will often be resisted. The sectors that receive the greatest protection under the existing system will be aware of the benefits they gain from that protection, and will oppose reform. The expansion of exports that reform would support is likely to be economy-wide, often with new and sometimes unexpected industries emerging; the employment and income gains from reform are thus likely to be diffuse, and the same is true for the consumers who would gain from the reform through lower prices and greater choice. It is this diffuse nature of the gains to consumers and producers that explains why those who oppose liberalization—the beneficiaries under a protected trade system—often
are dominant in political lobbying. The redistributive effects of trade reform can be a major factor impeding the launch of welfare-improving policy changes (Rodrik 1998).

Barriers to trade are typically put in place to protect domestic producers from international competition, and usually benefit powerful interest groups, not the poor. Nontariff barriers are especially pernicious in this regard as they effectively result in transfers from consumers, including the poor, to license holders. These so-called rents arise because the restriction on imports results in domestic prices that are above the world price. In the case of a tariff barrier, the government collects the revenue that is implied by the difference between the world price and the tariff-inclusive domestic price, but in the case of a nontariff barrier this implicit revenue is captured by those who hold the license to import. There is evidence that in developing countries such rents are a major cause of inefficiency, as companies and individuals seek to obtain import licenses and to influence policy in general (Krueger 1974). Import license holders are often among the wealthiest members of society. Thus, in addition to the inefficiency costs of trade protection, protection will often transfer income toward the rich and away from the poor. The negative effect of trade reform on the incomes of those who benefit from the existing trade structure, and the positive effect on the incomes of those who suffer under existing arrangements, can in percentage terms, be much larger than the (average) economy-wide income effects of liberalization. This is because trade policy is inherently a redistributive policy.

Structure of this chapter. Section 13.2 of this chapter describes briefly the experience with successful trade policy reform and discusses adjustment costs and the implications for the poor. Section 13.3 discusses and evaluates the principal trade policy instruments and institutions. Section 13.4 closely examines agriculture and business services, which are likely to be of particular importance for a poverty reduction strategy. Section 13.5 discusses and evaluates the most important complementary policies, as well as general and trade policy-specific safety nets. Section 13.6 briefly summarizes the principal points in a successful strategy for using trade for poverty reduction. A framework for analysis of the short-term and long-term impact on the poor of trade reform is provided in technical note K.1.7

13.2 Trade Policy Reform, Growth, and Poverty Reduction

13.2.1 Models of successful trade integration and poverty reduction

In the last 40 years of the 20th century, several countries have been highly successful in increasing incomes and reducing poverty. Most notable is the experience of the East Asian and Southeast Asian economies, especially Singapore, Hong Kong, Japan, Taiwan (China), and the Republic of Korea. In the final 15 years of the century, Chile and Mauritius also saw remarkable increases in income. All of these countries dramatically increased their exports (and trade to GDP ratio), raised incomes, and reduced poverty and are now active participants in the global trading environment. There are no examples of countries that have significantly reduced poverty without significantly increasing their exports. Although export expansion is thus the common element to all the success stories of poverty reduction, there are considerable differences in the models of trade policy that these countries and economies have adopted. The success stories may be grouped into three broad categories:

- **Economy-wide trade liberalization.** Hong Kong, Singapore, and Chile are examples of economies that adopted liberal trade regimes without nontariff barriers. Hong Kong and Singapore practiced free trade (zero tariffs), while Chile employed low uniform tariffs.

- **Protection with offsetting policies for exporters.** Some economies that experienced rapid growth in trade and GDP did so in the context of trade regimes characterized by significant import controls on the domestic market. Korea, Taiwan (China), and Japan (in the early stages) are the main examples. The key to understanding these experiences is to look at all of the factors that affect competitiveness and the incentives to producers to sell in the domestic versus the export market. Protection creates incentives to produce and sell to the domestic market. Protection of intermediate products and services creates a bias against export industries, because it raises their costs relative to potential competitors in world markets. Success has been achieved in the East Asian cases by managing elaborate systems that offset the bias against exports (see box 13.1). The experiences of nearly all other developing countries that protect their domestic markets are quite different.
Notably, the institutions needed for effective implementation of duty drawback systems (see section 13.3.1) have been shown to be weak in most Sub-Saharan African countries (World Bank 2000c). This suggests that the Korean model is not recommended for most developing countries given institutional capacity constraints and the risk of capture by special interests that will obtain rents.

- Protection with export processing zones. In a protected trade regime that discourages exports, export processing zones (EPZs) may be used to place exporters on a footing similar to that of producers for the domestic market, by providing tariff-free access to intermediate inputs and reducing regulatory constraints. Mauritius since 1985 has expanded exports significantly and reduced poverty through the employment of EPZs in a trade regime that was not liberal overall. However, while many other countries have introduced EPZs, few have actually succeeded in stimulating exports substantially and on a sustainable basis through this mechanism. There is a role for EPZs in countries with institutional constraints (Watson 2000), although there are potential pitfalls (see section 13.3.7).

The most practical way of stimulating trade and opening up an economy to the international market is through the use of a liberal trade regime, rather than through a complex structure of protection and export incentives. Duty drawback mechanisms are generally ineffective in developing countries. Lobbying for protection and subsidies engenders corruption and inefficiencies that hurt the poor. These problems can be avoided by simple and transparent protection regimes of low uniform tariffs. For low-income countries with weak trade-related institutions, EPZs can be an effective vehicle to promote exports, not only because they allow duty-free access to imported inputs, but also because they provide a means to deal with infrastructure and public sector service-related weaknesses that impede investment (Watson 2000).

13.2.2 Adjustment costs of trade liberalization: Impact on the poor

Political dynamics and a fear of adjustment costs can inhibit trade reform efforts, even if international evidence generally supports the view that the adjustment costs to the economy of trade liberalization are small in relation to the benefits (Matusz and Tarr 2000). Papageorgiou, Choksi, and Michaely (1990) concluded, for 19 developing countries, that trade liberalization did not generally result in decreased employment, even in the short run. Compared with the pre-liberalization period, manufacturing employment was larger one year subsequent to the completion of liberalization in all but one of the 12 countries for which data were reported, and manufacturing employment was higher in 12 of 13 cases during the liberalization period compared with the levels registered prior to liberalization. Parker and others (1995) and Harrison and Revenga (1995) performed similar but less extensive studies for industrialized market economies, with similar results.

It is useful to bear in mind that small and medium-sized enterprises (SMEs) account for a substantial share of new income earning opportunities. About 20 percent of all start-ups in six African economies and the Dominican Republic were SMEs (Liedholm and Meade 1995). The high start-up rate, where the business environment is supportive, adjustment to trade reform can be rapid. In general, the magnitude of dislocation caused by liberalization may not be significantly larger than dislocations associated with the everyday workings of the economy in many countries.

Box 13.1. How Korea Overcame the Anti-Export Bias of Protective Trade Policies

During the 1960s and 1970s especially, the Republic of Korea had relatively high import tariffs and also used nontariff barriers. Both exports and the economy nonetheless grew rapidly. In principle, tariffs impose a bias against exports by making production for the home market more profitable than production for overseas markets. Korea managed an elaborate system that offset the bias against exports. Two of the most important mechanisms used were an efficient temporary admission system (supplemented in the 1980s by a duty drawback system) that allowed tariff-free access to intermediate inputs for exporters (and “indirect” exporters), and the provision to exporters (and indirect exporters) of preferred access to working capital at interest rates that were considerably lower than the interest rates paid by firms supplying the domestic market. The development and enforcement of these policies over a long period required strong political will, supported by a broad national consensus, and a highly competent administration.

Private adjustment costs can be substantial or can be small, depending on the size of subsidies (direct and indirect) prior to reform and on whether or not the markets function well. Evidence shows that adjustment costs are typically short term and end when workers find a job. In developing economies, trade liberalization should favor labor, since exports will typically be labor-intensive. Significant shifts within an industry typically occur after trade liberalization, tending to minimize the dislocation of factors of production since some sectors will expand while others contract. Moreover, the duration of unemployment for most industries is not high, especially where workers were not earning substantial rents in their original job. Finally, in many industries normal labor turnover exceeds the dislocation caused by trade liberalization, so that downsizing where necessary could be accomplished without layoffs.

It is difficult to disentangle the effects of trade liberalization from other events occurring simultaneously, but generally manufacturing employment increases subsequent to trade liberalization. Overall, individual country studies suggest that adjustment costs are low relative to the gains from liberalization; however, the extremely poor may be incapable of sustaining themselves even for short periods under adverse adjustment costs. There may also be some poor groups that do not gain, and others of those that should eventually gain may lose in the short run. Complementary policies—particularly the provision of an efficient social safety net—are therefore necessary to minimize adjustment costs and to help make trade reform work effectively for the poor. In general, attaining and sustaining a high rate of economic growth is a key factor in improving outcomes for the poor over time.

13.3 Trade Policy Instruments and Institutions

The first step in developing trade policy for growth and poverty reduction is to understand how the present trade regime works, including nontariff barriers and to whom licenses and permits are issued. Other important questions to answer include the following:

- What is the structure of the tariff (including its dispersion, exemptions, and rebates)?
- How much revenue comes from tariffs?
- What policies are in place that may tax or subsidize exports?
- Are trade-related institutions, such as standards organizations, export finance, and marketing facilities, adequate to support an expansion of exports?
- Does the pattern of protection favor the income of the poor or a segment of the poor, and can policies be designed to assist the poor during the transition?

This section describes the principal trade policies and the institutions that influence the flow of goods and services, and suggests how these might be evaluated. Complementary policies to trade reform are discussed in section 13.5

13.3.1 Nontariff barriers

Nontariff barriers include mechanisms such as quotas, licenses, and monopoly rights to import. Nontariff barriers encourage competing interests to lobby for import licenses, an activity (known as “rent seeking”) that wastes valuable resources. Nontariff barriers also lack transparency, and thereby may allow protection to escape scrutiny. As discussed above, the political economy of protection suggests that import controls (and sometimes export controls) are usually put in place to benefit powerful interest groups, not to help the poor.

13.3.2 The tariff regime

Most low-income developing countries have differentiated tariff structures with significant tariff escalation (Michalopoulos 1999). The underlying motivations include fiscal objectives, import substitution, and the political weight of vested interests. Because tariff escalation affords high “effective” protection to final goods producers, the development of intermediate industries is discouraged.
A uniform tariff conveys a number of advantages (Tarr 2001), the most important of which is that the gains to industry lobbying are much smaller (and may be negative). Indeed in Chile, which has had a uniform tariff since 1979, a progressive reduction of the uniform tariff from 11 to 6 percent, to be accomplished by 1 percent per year reductions between 1998 and 2003 was supported by industry groups and passed by the legislature.

A uniform tariff greatly simplifies customs operations and direct administrative costs, and eliminates opportunities for avoidance, and, hence, corruption (which may have positive spillover effects into other dimensions of government activity).

Customs and other officials in low-income countries have tended to argue that implementing uniform tariffs is not feasible in practice. However, Chile, El Salvador, and the Kyrgyz Republic have successfully introduced tariff structures with very small dispersion, and Hong Kong, Singapore, and Estonia have a uniform tariff of zero.

Uniformity does not imply that there can be no exemptions for products of social importance, such as essential medicines or mosquito nets (Bannister and Thugge 2001). However, care should be taken that such exceptions target only products that are critical to attain social and public health objectives.

13.3.3 Emergency protection, antidumping, and other trade remedies

Liberalization of trade gives rise to adjustment pressures as import competition intensifies. For this reason, reform programs often reduce tariffs and other trade barriers gradually, ideally in conjunction with measures to facilitate adjustment. However, in some instances imports expand so rapidly that governments choose to intervene by raising trade barriers. Import surges that create serious difficulties for a domestic industry may also occur independently of liberalization. An effective response in such cases could be a safeguard measure that imposes a temporary duty on all imports of the product concerned. This is only justified if both the domestic industry is seriously injured by import competition, and protection is in the national interest (that is, the associated costs to consumers would be less than the benefits that would accrue to producers). Safeguard actions should be temporary, lasting no more than two or three years, with the objective of facilitating industry adjustment to increased competition. Tariffs are preferred to quotas, for reasons of transparency and political economy.

Many countries tend to use “antidumping” as a safeguard instrument where imports are sold for less than is charged for them in the exporter’s home market. That is, duties are imposed to offset price discrimination across markets. This is ill-advised. Antidumping is an instrument that is easily captured by industries to raise the price of imports, and requires the use of scarce administrative resources. If there is a need to raise protection because imports are hurting domestic industry, it is preferable to use WTO-consistent safeguard actions, which suggest that countries consider the impact of taking action on the economy as a whole, including the poor, as opposed to simply on the affected industry. In practice, however, the question of whether or not it is in the nation’s interest to offer protection to an industry under competition is seldom asked.

Antidumping instruments are not a preferred option However, where antidumping procedures are used, efforts should be made to establish procedures that require the national interest and the impact on the poor to be taken into account prior to the imposition of an antidumping duty.

13.3.4 Special customs regimes for exporters

Tariffs on imports hurt exports in various ways. In order to compensate, countries have developed compensatory measures for exporters. Programs like duty drawback (involving the repayment of duties paid on imported inputs that are embodied in subsequent exports) and temporary admission (defined below), if properly administered, can allow exporters duty-free access to imported intermediates. Although the more general exchange rate bias against exports that results from protection remains, provision of tariff-free access to imported intermediates for exporters can be crucial. This is also the case
for countries with uniform tariffs, although the need for duty-free access obviously declines as the average level of the tariff falls.

The main problem with duty drawback schemes is that their administration can be costly and cumbersome, particularly when tariffs are high. Exporters in many countries complain of delays in repayment and sometimes a lack of repayment, which is particularly detrimental to small and medium-sized enterprises and small farmer organizations. When tariffs are high there is also the risk of fraudulent claims (Mitra 1992). Empirical evidence suggests that in countries that do not have well-functioning public administrations, duty drawback is ineffective.

Temporary admission may be more effective at allowing tariff-free access to intermediate inputs. Rather than require payment of duties on imported inputs, this mechanism requires firms to document, ex post, that the relevant inputs were used in the production of exports. This approach encounters the problem of “leakage” of goods into the domestic economy. A frequently used option to control such leakage is the bonded warehouse—or, on a greater scale, an export processing zone (see section 13.3.7).

### 13.3.5 Export subsidies

Export subsidies may be appropriate to offset market failures; including, for example, information problems faced by individual firms seeking to enter new markets. In practice, countries have often used such subsidies indiscriminately, in part to offset the anti-export bias created by other policies. To be effective and not distort incentives, such policies should be horizontal in nature, not sector-specific. While subsidies can stimulate exports, this may come at a huge cost to the budget. The impact will be regressive if subsidies accrue to rich exporters. Using subsidies to offset the negative effect of other policies (such as protection) on exports is also inappropriate: in such cases, a better approach would be to reduce import protection and introduce instruments such as drawback or EPZs.

Countries that are members of the WTO have become more constrained in the use of export subsidies, although there is an exemption for the least-developed countries with per capita incomes of less than US$1,000.

The main problem with export subsidies is their use by high-income countries for agricultural commodities. This has a destabilizing effect on world prices and is highly detrimental to producers in developing countries.

### 13.3.6 Export taxes

Developing countries often impose export taxes on primary commodity exports. In some cases, such as the extraction of minerals, these are imposed instead of royalties as a way to raise public revenue. In other cases, export taxes have been used to support local processing industries, which often has an adverse effect on the poor (see box 13.2).

Export taxes result in lower prices being paid to farmers for their commodities than the prevailing price in world markets. Elimination of such taxes would raise the incomes of farmers, the majority of whom tend to be poor, but would reduce the profitability of processing facilities that may employ poor urban labor. Examples include cocoa and coffee processors in West Africa that buy cocoa and coffee beans at prices below the export price; textile firms in Pakistan, India, and francophone West Africa that obtain domestic cotton at favorable prices from parastatal export monopolies or as a result of export taxes or restrictions (see box 13.3); leather processing firms in India that buy local and partly processed hides at low prices as a result of cascading export taxes; cashew nut processors in Mozambique that benefit from export taxes on raw cashew nuts; and cashmere wool processors in Mongolia that benefit from the price-reducing effect of an export tax on raw cashmere. In all of these cases the export taxes and restrictions have both efficiency and equity effects.

In most cases, the net poverty effect of removing export taxes and restrictions would be strongly positive. There are many more poor farmers that would benefit from export tax removal than there are industrial workers who might lose, and the highest incidence of severe poverty is usually found in rural
Box 13.2. Madagascar’s Marketing Board for Vanilla Exports: Taxing the Poor

In 1960, the international market for natural vanilla was dominated by Madagascar, the world’s lowest-cost producer of high-quality bourbon vanilla. Controlling 60 percent of world exports of natural vanilla, Madagascar organized a bourbon vanilla cartel with the Comoros and Réunion, setting high export prices and restricting supply by regulating its domestic market through a marketing board which fixed low producer prices and required licenses to grow, prepare, and export vanilla.

If the marketing board were to be assessed by the effect it had on export prices of vanilla from Madagascar, it was a clear success: the export price of vanilla increased from US$10 per kilogram in the late 1960s to more than US$65 per kilogram in the early 1990s. However, Madagascar’s share of world markets declined to 30 percent as Indonesia took advantage of high world prices to develop its own export capacity, so that the total value of Madagascar’s exports constant throughout the 1970s and 1980s.

Who benefited from the bourbon vanilla cartel and the marketing board’s domestic policies? Indonesian producers were the winners, Madagascar’s producers the losers. The average annual production of each of Madagascar’s 60,000 small producers is 130 kilograms, for an average income of US$650 per plantation. Estimates of producer prices that would have prevailed in Madagascar had the marketing board been abolished are close to US$26 per kilogram, well above the US$5 price fixed by the board. Taking into account the increase in production that such a change in prices would have generated, abolition could have increased vanilla producer incomes eightfold.

An alternative to free trade would have been to eliminate intervention in the domestic market but to exploit Madagascar’s market power in international markets through an export tax. Estimates suggest that the optimal export tax would have been close to US$25 per kilogram, instead of the US$61 implicit tax that was imposed on producers.

Why where these policies not adopted? A possible explanation is that taxation of small producers generated an important income redistribution from the rural poor to the urban elite.

Source: De Melo, Olarreaga, and Takacs (2000).

areas. For example, the cashmere export tax in Mongolia reduces the incomes of about 250,000 goat-herding families, most of whom are poor and the poorest of which are heavily dependent on income from cashmere. In contrast, there are only about 2,000 workers employed in cashmere processing. Moreover, part of the income the export tax transfers from the goat herders goes to the owners of the processing firms (Filmer 2001, and Takacs 1994). As is generally the case, safety net options for those adversely impacted by export tax elimination should still be carefully considered, especially when the impact on processors is severe (see section 13.5.6).

Box 13.3. Rural Poverty, Cotton, and Parastatals in West Africa

In most of francophone Africa, the national parastatal company is the sole authorized purchaser and processor of seed cotton, and is the sole seller of the products of ginning: cotton lint and cotton seed. It also supplies inputs to the farmers, owns and operates all the cotton gins, and provides the transport needed to supply the inputs to the farms, the seed cotton from the farms to the gins, the lint to the ports or to local textile firms, and the seed to local oil mills or to other markets. It is also responsible for the sale of the lint, nearly all of which is exported.

Cotton has proved to be an economically very efficient crop, and has made major contributions to the development of rural areas, exports, poverty reduction, and growth. The share of cotton lint exports increased from about 4 percent of world trade in cotton in the mid-1970s to about 15 percent in 1997. However, the absence of any competition in the purchase of seed cotton from farmers means that farmers have been paid prices for their seed cotton that tend to be far below competitive levels. In terms of lint equivalent, seed cotton prices in the francophone African countries have generally been within a range of 40 to 50 percent of the export price of cotton lint, compared to ratios averaging almost 90 percent in India and around 80 percent in Zimbabwe.

Detailed comparative analysis of costs shows that only a small part of the low francophone African seed cotton prices can be explained by higher transport and operating costs. More important are high government taxes, including special taxes on parastatal profits and export taxes on cotton lint; implicit taxes from the sale of lint to domestic textile firms at low prices; and periodic costly management mistakes and corrupt practices. Simulations suggest that removing this taxation would generate large percentage increases in seed cotton prices for farmers (from 45 percent in Cameroon to 87 percent in Burkina Faso), expand output, and increase real farm incomes. Another problem with parastatals is that they typically impose pan-territorial prices, whereby they pay the same price for all locations and at all times of the crop year. These subsidies for transport and storage eliminate any incentive for private provision of these services and result in production in socially inefficient locations. Parastatal monopolies also prevent the development of private credit services.

Allowing private firms to provide the services of the parastatal and permitting farmers to contract with private firms could in the long run be expected to greatly improve efficiency and to introduce distributional advantages for poor farmers. However, it is important to pay attention to supporting services and markets (such as credit and transportation) during the transition to a market-based system. It is also possible that the elimination of pan-territorial pricing would have a negative effect on poor farmers that are located in isolated regions. As is frequently the case, not all would necessarily gain, a fact that underlines the need for a social safety net.

13.3.7 Export processing zones

Export processing zones (EPZs) are enclaves for export production, especially of nontraditional exports, that are often used where economy-wide trade reform is impeded or in which infrastructure and regulatory requirements cannot be met on a national basis. Effective EPZs have reflected the following characteristics: clear private property rights and investment regulations, no restrictions on foreign exchange, tariff-free imports for export production, moderate levels of taxation, streamlined administrative procedures, and private sector management. Some of the most successful EPZs are in Mauritius, where in 1994 EPZs generated 71 percent of gross exports and employed 17 percent of the work force. Mexico has also had successful EPZs. Such zones can also have a significant effect on female employment. EPZs in Bangladesh tend to employ women (70 percent of Chittagong EPZ employees are women, a much higher ratio than the national average), and in the Dominican Republic, EPZ employment was an important factor in decreasing the proportion of women among the poor from 23 percent to 16 percent in the period 1986–1993 (Madani 1999).

Experience has shown that development of EPZs, including provision of infrastructure and management, should be privately handled. Publicly developed and managed EPZs have typically been unsuccessful. Attracting investment into EPZs is a function of many factors, including some that are national in nature, such as political stability and sound macroeconomic management. An overvalued exchange rate will discourage exporting from EPZs just as much as from the rest of the economy. In general, the conditions for EPZs success involve the same complementary policies that are required to make a trade reform successful. Consequently, EPZs are best regarded as transitional mechanisms to be used in the pursuit of an overall liberal trade regime.

13.3.8 Other trade-related institutions

In addition to the commercial policy instruments discussed above, there are a number of other trade-related institutions that can have important implications for the impact of trade reforms. These include customs clearance, export finance, product standards, and access to information on market opportunities.

Efficiency and transparency in the area of customs clearance is an important determinant of the costs associated with trade. Burdensome and redundant procedures (red tape) can give rise to substantial uncertainty and are often associated with rent seeking and corruption. Minimizing the scope of discretion by simplifying the clearance process as much as possible, including by adopting international standards for classification of goods, eliminating most exemptions, and providing officials with training and appropriate information technology, are important dimensions of trade reform.

Export finance is a major constraint inhibiting exports in many low-income developing countries, arising from overall weaknesses in the financial sector, particular difficulties in assessing the creditworthiness of traders and/or because traders do not have sufficient collateral. To the extent that the poor are involved in trading activities, they may face special difficulties in obtaining access to the trade credit they need—just as they face difficulties in accessing other parts of the financial sector. While trade finance should be left to the private sector, any effort to expand exports and to promote increased opportunities for the poor in the export sector needs first to investigate whether credit is a problem. If so, remedies should be sought as part of the overall effort to increase access to finance for low-income producers.

Product standards based on international norms are important to poverty reduction. When used appropriately exchange is facilitated, and safety, health, quality, or preservation of the environment is better assured. As the poor have less access to information and do not have the resources to buy higher-quality goods and services, they are more dependent than the better-off on efficient standardization and consumer protection regimes.

This presents a dual challenge: to reform regulations and establish efficient testing, certification, and laboratory accreditation requirements to facilitate exports, while at the same time attaining sanitary, phytosanitary, and product standards. Both technical and financial assistance may be needed. Institutional arrangements need to be developed to ensure that poor firms (such as farmers, small producers, and artisans) have access to standards organizations—through cooperatives and similar collective
organizations—and are not unduly penalized because of their use of labor-intensive production technologies.

Marketing of exports internationally is a challenging task for all low-income countries, which must overcome problems of lack of information, product and country recognition, and concerns about quality. Foreign partners and FDI can be helpful in providing the necessary contacts and advice, but frequently it is necessary also to organize a local association of exporters or producers. Where the producers are a large number of small poor farmers, cooperatives and similar ventures can be helpful in ensuring that the potential benefits from exports are realized by the poor. Marketing boards have been used in a number of countries, sometimes with adverse repercussions for farmers, as in the case of vanilla in Madagascar (see box 13.2).

13.3.9 International cooperation: Regional integration and the WTO

Most developing countries are members of regional integration agreements (RIAs). From the viewpoint of the efficiency of resource allocation, however, RIAs between developing countries (so-called South–South agreements) are likely to hurt member countries because low-priced imports from non-partner countries are replaced with higher-priced products from partner countries (World Bank 2000b). A solution to this problem is for member countries to lower their external trade barriers, thereby reducing the inefficient displacement of non-partner country imports: by lowering external trade barriers sufficiently, a harmful RIA can be turned into a beneficial one.

The effects of an agreement among developing countries are likely to be asymmetric, with the poorer member countries losing at the expense of higher-income members (World Bank 2000b). This is in part due to the fact that the better-developed country produces protected manufactured goods that are imported on balance by the less developed country at a higher price to its partner country for imports it could buy more cheaply on international markets. This problem emerged in the 1960s in the East African community, where Kenya gained and Tanzania and Uganda lost, and in the Central American common market, where El Salvador gained and Honduras lost. In both cases, the more advanced country resisted external tariff reduction, which led to resentment and subsequent breakdown in implementation of the agreements.

Potential losses of the poorer member country. In fact, the losses from regional trade arrangements can be reduced by lowering external trade barriers. In terms of implementation, as in the cases of the planned Free Trade Agreement of the Americas or the ASEAN Free Trade Agreement, each country can lower its tariffs independently and can thus protect itself from adverse consequences. For a customs union such as the West African Economic and Monetary Union or MERCOSUR, the member countries must agree to jointly lower the common external tariff. Customs unions among developing countries should therefore be approached cautiously, since tariff policy is taken out of the hands of national policymakers.

Space constraints prohibit a detailed discussion of the WTO, which has many provisions that constrain the use of trade-related policies by members, including developing countries (see box 13.4). See www.worldbank.org/trade and www.wto.org for more information and references to the literature. A major relevant dimension of the WTO from a poverty perspective lies in the reciprocal liberalization of trade barriers. Although most major industrialized markets provide preferential access for exports from developing countries, especially from the least developed nations, trade restrictions are prevalent, especially for agricultural products, apparel, and other labor-intensive products.

13.4 Sector Issues

The manufacturing sector has typically been most favored by protection. Much of the foregoing discussion focuses implicitly on reforms in that sector. Trade reforms directed toward agriculture and service sectors can also provide significant opportunities for poverty reduction, as explained below.
### Box 13.4. The WTO and Poverty Reduction

The WTO agreements involve legal commitments by governments regarding the rules and policies they follow in the conduct of international trade in goods and services. As such, the agreements contain no explicit references or direct links to policies affecting poverty. Their impact derives from the trade policies that governments have committed to pursue based on their WTO commitments. More than 100 of the 140 WTO members are developing countries. (The WTO does not define what constitutes a developing nation; this is largely left to self-selection.) Almost all of the more than 30 countries seeking to accede to the WTO are also developing countries or economies in transition.

Within the WTO agreements, developing countries are supposed to receive favorable treatment (usually referred to as “special and differential” treatment) aimed at addressing their particular circumstances in international trade. The poorest of the developing countries—the 49 countries on the UN list of least-developed countries (LDCs)—are provided with additional favorable treatment. The special and differential treatment provisions involve five sets of measures: (1) developing countries are given more flexibility in terms of their own trade policies; for example, they have not had to reduce their tariffs significantly in previous multilateral trade negotiations and they do not have to bind all their tariffs; (2) exports of developing countries can be charged lower preferential tariff rates in industrialized or other developing country markets; (3) developing countries are given longer transition periods to implement provisions contained in some WTO agreements; (4) industrialized countries are supposed to provide developing countries with technical assistance to help them implement the commitments they have assumed; and (5) industrialized countries are to implement their WTO commitments in a manner favorable to developing country interests.

WTO provisions in general, and those which apply to developing countries in particular, tend to be permissive in terms of the trade policies an individual country can pursue, and, hence, do not tend to constrain these policies in ways that would harm the poor. On the contrary, they are on the whole supportive of trade and foreign direct investment policies that would tend to promote poverty reduction. Moreover, the availability in the WTO of an effective dispute settlement mechanism and the guarantee of MFN (“most favored nation”) treatment for all its members can be of special importance to developing countries in their dealings with more powerful industrialized country trading partners. Thus, it is important for all developing countries to be members of the WTO.

At the same time, the permissiveness of the WTO special and differential treatment provisions has been a problem for LDCs, enabling developing countries to maintain higher levels of domestic protection that have harmed their own economies. Furthermore, export subsidies, which are often used to offset the disincentives of protection, are a drain on the budget, and, hence, are not affordable and cannot be relied upon to provide the sustainable, labor-intensive export growth that would help alleviate poverty.

**Source:** Hoekman and Kostecki (2001) and McCulloch, Winters, and Cirera (2001). See also http://www.wto.org/

### 13.4.1 The importance of agriculture

Trade reforms affecting agriculture will critically impact its overall poverty impact (see chapter 15, “Rural Poverty”). Agricultural importables (mainly staples) are typically protected, while agricultural exportables are often subject to export taxes. Agriculture as a whole has tended to be taxed indirectly through protection of the manufacturing sector, and overvaluation of the real exchange rate (Schiff and Valdes 1992 and 2000), as well as through the operation of marketing boards or similar parastatals. Trade reform, which should cover both agriculture and manufacturing, will therefore typically raise agriculture’s domestic terms of trade and help the rural poor. The same is true for macroeconomic fiscal policies that result in a real exchange rate that is closer to a sustainable equilibrium.

Some of the rural poor, however, may lose. Foremost among these are people who are employed or who produce in highly protected, low-productivity sectors. Examples include maize in Mexico, wheat in Morocco, and various import-competing crops in many developing countries. Where the mobility of the rural poor is limited, reduced tariffs in their sector is likely to hurt that sub-group, especially in the short term, as prices of their output fall. Over time farmers can change their output mix toward crops with relatively higher prices. In northeast Brazil, the switch to more profitable crops after trade liberalization and devaluation greatly reduced the negative real income effects for small farmers (Lopez and Romano 2000).

In implementing trade reform, one option is to gradually phase out tariffs according to a preannounced schedule. This is what was agreed for maize in the NAFTA negotiations between the United States and Mexico. Experience shows that otherwise reforms with long transition periods (typically of more than five years) will lack credibility and will be susceptible to defeat by lobbyists. The ability to shift to production may depend on complementary reforms, for example, restructured land arrangements, additional capital, or access to water. If markets for these factors are poorly developed, farmers may be unable to take advantage of new opportunities. Where poor farmers are hurt in the short run, compensation policies such as improving rural infrastructure and public works are also important.
*Fluctuating world prices.* The liberalization of a country’s agricultural trade policies means not only that the country must adjust to the price levels prevailing in international markets, but also that it must adjust to the fluctuations in world prices of agricultural commodities. In many countries, the impact of these fluctuations on the domestic economy is a major motivation for interventions that would separate the domestic and international markets. National export and import controls, parastatals or marketing boards, and variable tariffs all reduce the size of the international market in which a commodity is freely traded and thus increase the sensitivity of international prices to exogenous shocks such as bumper harvests and crop failures. For example, international trade in rice is equivalent to only 5 percent of world rice production. The extent to which some of the largest producer and consumer countries subject import or exports to discretionary government controls is key. Policies aimed at stabilizing domestic prices can have a large impact on prices in the narrow international market, in turn leading to pressures to maintain or increase trade interventions elsewhere. For this reason, all countries have a common interest in reducing the instability of world prices by opening their domestic markets and removing policies that keep domestic markets separate from world markets.

Even with more open global markets, agriculture prices are inherently less stable than the world prices of manufactured goods and the prices of services. Most small countries, however, cannot individually have any perceptible effect on the level or volatility of world commodity prices. Trade liberalization in any individual country, if fully implemented, will often (but not always) mean that domestic commodity prices, including prices at farm level, will become more unstable. Farmers in many countries have repeatedly shown that they can adjust rapidly and efficiently to relative price changes. For the approach of sheltering farmers from price fluctuations to be welfare improving, the extra income of the groups that benefit from interventions must outweigh the net economic losses consequent on distorted consumer prices and changes in the government’s fiscal position. In the short run, safety nets are important to protect poor farmers from large negative price shocks (see chapter 17, “Social Protection”). From a medium- to long-term perspective, it is generally better to target low income groups with actions that would increase the ability of farmers and workers to switch between crops, complemented with welfare and workfare programs, until a reasonable degree of flexibility and responsiveness is achieved.

It is important to recognize that once a price stabilizing policy has been introduced it is difficult, if not impossible, to stop the politically powerful from using the policy to shift the long-term price in their favor. Commodity marketing boards and parastatal monopolies have often stabilized prices at low levels relative to world prices, implying the heavy taxation of small farmers and the transfer of resources to governments and local processing interests, with adverse repercussions for rural poverty. For import substitutes, the forces of political economy generally point in the opposite direction, with interventions originally justified in the name of price stabilization (such as the price band schemes introduced in Latin America during the 1990s) often becoming de facto price support schemes keeping prices artificially high.

**OECD intervention.** Export subsidies on products such as meat, dairy products, and grain depress prices on world markets, and thus also on the domestic markets of developing countries. Some countries (such as Japan) maintain high barriers against imports of wheat, rice, and other agricultural commodities, but policies such as these contribute to world market price instability, constrain exports, and increase import competition. While most low income countries produce commodities such as fruits, nuts, and vegetables that do not compete with subsidized and protected meat, milk, and grain, for some low-income countries (for example, Mali and Burkina Faso, which are meat producers) and middle-income developing countries such as Argentina or Brazil, EU export subsidies are a major factor constraining agricultural exports.

Trade policies which depress agricultural prices tend to benefit consumers. The impact of such policies on farmers, however, depends on whether or not the farmer is competing with subsidized imports; whether or not the subsidies vary significantly over time; and whether the farmer is a net buyer or net seller of the commodities concerned. If there is no domestic production of the subsidized products, there is no need for intervention, as subsidized prices are beneficial to consumers. The situation is more complex where there is domestic production of the commodities concerned. Households that are net buyers of the subsidized product will gain, and subsistence farmers will be unaffected. The urban poor will also generally gain from lower prices. What is most important from a policy point of view is
therefore whether the gains to the non-rural poor are larger than the losses incurred by the rural households that are net sellers. This requires information to ascertain whom and how many subsistence producers, net buyers, and net sellers exist. The nature of the labor force engaged in production on farms that are net sellers is important, since those workers who own land may be able to cut their losses by shifting to subsistence farming, whereas landless laborers face loss of their source of income without having subsistence farming to fall back on.

A key issue is whether the OECD export subsidies are permanent or transitory. If the subsidies are permanent, it will be in the country’s interest to ignore the subsidy for policy purposes because the economic costs of protection to the economy outweigh the benefits to domestic producers. If the subsidies are transitory (and there are capital market or other imperfections), there is a case for temporary protection for those tariff lines subject to competition from subsidized exports so that adjustment costs can be minimized.

In an agricultural sector with a large number of households that are net sellers of OECD-subsidized commodities, it is sometimes argued that higher tariffs on agricultural imports would be appropriate. This would increase the domestic price, thus helping to offset the effect of the subsidy and allowing domestic producers to compete. However, as noted above, differentiated import tariffs distort producer and consumer choices and reduce efficiency. Insofar as developing countries have tariffs that are greater than average on the agricultural imports in question, there is a case for not reducing these tariffs as much or as rapidly as tariffs on other products, given the adjustment costs associated with the downsizing of agricultural production and with the subsequent expansion, after export subsidies and OECD protection are reduced.

However, it is impossible to accurately offset the impact of OECD policies on world prices, as the information requirements for countervailing policies are substantial. There is also a risk that protection may become entrenched and continue even if the foreign protection and export subsidies are removed. More fundamentally, trade intervention is a second-best approach to dealing with the problem. The best policy is to maintain pressure on the EU and other OECD countries within the WTO context for the phase-out of export subsidies and protection of agriculture. Domestically, the policy focus should be on determining the size and nature of the population are affected by OECD trade practices in the short run (that is, the number of net sellers of protected commodities).

**Trade policy as an instrument for poverty reduction**

Trade policy can be a useful instrument through which to pursue rural poverty reduction objectives in certain situations.

- First, trade policy can be used to deal with temporary import surges that have a significant negative impact on the livelihood of poor farmers. In such cases a special safeguard mechanism may be considered, under which temporary protection can be sought if there is severe downward pressure on domestic prices of products that are important to incomes of the poor. Guidance on the general design of any such safeguard mechanism is set out in section 13.3.3.

- Second, where the overall policy regime discriminates against agriculture—that is, policy favors industrial production and/or urban consumers of food—a case could be made in favor of higher protection for poor farmers in low-income countries. Although a more efficient approach would be to lower protection for industry, thereby offsetting any prevailing policy bias against the rural poor, contexts where this cannot be achieved or is achieved gradually, there may be a case for maintaining higher rates of protection on agricultural commodities as a “second-best” policy.

- Third, trade policy can be used in situations where complementary policies, including safety nets, are inadequate and a significant number of the poor are engaged in production of tradable commodities that are sold domestically. In this situation, agricultural trade policy reform should be gradual, involving a preannounced schedule of tariff reductions.

The potential negative impacts of agricultural reform can be attenuated by currency devaluation, and by implementing complementary reforms in the markets for land, credit, and water, to enable farmers to take advantage of the new opportunities, to adjust to changed incentives, and to benefit from...
the reform (see chapter 15, “Rural Poverty”). As noted above, in all cases there is a need for careful prior analysis before reforms are pursued.

For the least developed countries, duty-free access to industrial country markets is a valuable opportunity to be exploited if the standards and rule-of-origin requirements imposed under preferential arrangements can be met. By allowing exported goods to sell at high prices overseas and imported goods to be bought at world prices, such preferential arrangements provide a double benefit. Preferential access provides a positive incentive to produce goods for sale in the protected markets of the OECD countries that grant such access, markets which are both larger than their own and offer higher prices due to protection.\footnote{16}

13.4.2 The role of services

Services account for a rising portion of GDP in even the lowest-income countries. An efficient service sector contributes to the balance of payments, because it is a key determinant of the competitiveness of firms. Key sectors that influence the ability of firms to participate in world trade are telecommunications, transportation, financial services, and other business support such as accounting and legal services.

The gains from eliminating barriers to competition in the various business services can be large and can fundamentally affect a country’s comparative advantage and pattern of trade (Markusen, Rutherford, and Tarr 2000). It has become apparent that in many countries, inefficient business services have become the principal barrier to effective integration in world markets. Inefficient support services reduce the competitiveness of exporters of merchandise goods, constraining growth and efforts at poverty reduction.

Policies to encourage the development of a competitive and efficient service sector, such as liberalizing entry into the sector where possible and encouraging foreign direct investment, should be a major element of global integration and poverty reduction strategies. Liberalization of the service sector entails the reduction or elimination of prohibitions, quantitative restrictions, and regulations that prohibit foreign direct investment, limiting the share of ownership of foreign firms, limiting the number of expatriates that can be employed, or restricting the amount of imports of a particular service (UNCTAD and World Bank 1994). Such restrictions frequently apply to both domestic and foreign suppliers, creating public sector monopolies in the provision of services, such as in air and maritime transport, telecommunications, or financial services. In many such cases, the elimination of public sector monopolies may need to be accompanied with the opening up of service markets to foreign direct investment.

There is evidence of a positive relationship between the private competitive provision of telecommunication services and the availability of affordable telephone connections (see chapter 24, “Information and Communication Technologies”). This is especially true in countries where services were characterized by low density of phone lines or by service rationing (that is, long waiting lists).

There is evidence that freight rates for Sub-Saharan African countries often are considerably higher than for other countries, and thus have contributed to the region’s poor trade performance (Amjadi and Yeats 1995). For many internationally traded goods, the cost of international transportation exceeds the tariff on imports. High transport costs reduce export income and increase the price of imported goods, obliging exporting industries facing high transport costs to either pay lower wages or accept lower returns on capital. High transportation costs are due in part to anticompetitive policies such as the cargo reservation schemes that are maintained by a large number of African countries, and to international shipping cartels and legislated monopoly providers, in both industrialized and developing countries (Francois and Wooton 2001; Fink and Mattoo 2001). For example, all Algerian and Moroccan ports, as well as the main ports in Tunisia, are operated by inefficient government-owned cargo handling companies, which charge 30 percent in excess of the rates that would be quoted by a private independent operator. Licenses required by exporters and importers to charter vessels also create barriers to international trade, since permission to charter is granted only if the national shipping line withdraws. This is estimated to add 20 percent to the usual international freight rates (Amiot and Salama 1996). It is useful to refer to successful cases of trade liberalization, like Chile and China, to see policy options (see box 13.5).
The case of Zimbabwe’s vegetable exports illustrates the importance of efficient transport and related services. Since the early 1990s, farmers near the capital have been supplying produce to the U.K. market by flying freshly picked vegetables overnight to London where they are on the shelves for sale in the morning. Shipments are delivered to order, requiring efficient telecommunications as well as cheap, reliable air transport (Krugman 1998).

Services reform and the poor. Although the poor directly spend less of their income on services than the nonpoor, more efficient services has significant benefits for the poor. Services such as transport, education, and access to communications and finance are vital determinants of the ability of the poor to find employment and to market their production, for example. High transport or marketing costs lower the prices received by poor farmers and raise the prices of food paid by poor consumers. Competition in these sectors is therefore important to poverty reduction, as are resources devoted to “trade facilitation” to improve the efficiency of service networks and to reduce corruption and related transactions costs.

Recent empirical research suggests that access to a public telephone is positively related to the price that farmers receive in district markets for their output. It has been estimated that decreasing the distance to a telephone by 10 percent would lead to a 2 percent increase in local prices (Larson 2000) because of improvements in market information. In some Bangladesh villages, women entrepreneurs provide payphone services at a profit, using mobile cellular technology. Even though rural villagers cannot afford a phone individually, they can afford one collectively (Lawson and Meyenn 2000).

Liberalization of services and the resulting competition are likely to lead to lower prices, greater availability, and improved quality of services. Insofar as the poor are consumers of these services, they are likely to benefit. At the same time, pre-reform prices are set administratively, and typically kept artificially low for end users. Rural borrowers may thus pay lower interest rates than urban borrowers, for example, and the prices of local telephone calls and public transport may actually be lower than the cost of provision. This price structure is financed through cross-subsidization within public monopolies or through budget transfers. New entrants to the sector are likely to focus on the most profitable market segments, primarily urban areas, where the cost of service provision is lower and incomes higher. Utility and financial sector reforms, even if the sector may become more efficient and prices overall decline, may involve increased prices to low income households.7 Ways to ensure that the poor are not adversely affected, like universal service obligations, are set out in part 6, “Private Sector and Infrastructure,” chapters 20–25.
Assessing services policy and performance. The relevant aspects of competition include restrictions on entry; of ownership limitations, private and foreign; and of regulation, especially those elements of regulation designed to achieve pro-poor outcomes in competitive markets. Questions that policymakers should address include the following:

- How much greater would the benefits be if privatization were accompanied by the introduction of competition?
- Are there good reasons to limit entry by policy?
- What institutional features promote the effectiveness of a sector regulator?
- What should the regulator regulate?
- What are the costs and benefits of restrictions on foreign ownership?

In many countries, an assessment of policy and performance in services is frustrated by a dearth of data. Main performance indicators include price and quality variables and measures of access to services by the poor and of the availability of services. The Bank has recently developed templates for an assessment of policy and performance in three key service sectors: telecommunications, air and maritime transport, and financial services. These can be used to by individual countries to benchmark their performance against international experience.

13.5 Complementary Policies to a Trade Reform

Trade liberalization involves reducing discrimination against foreign suppliers of goods and services. This is achieved not simply with respect to quotas and tariffs, but also by strengthening trade-related institutions, in particular customs and standards bodies and appropriate complementary policies to support trade reform.

13.5.1 Macroeconomic and exchange rate policies

To be sustained and to contribute to an efficient allocation of resources, trade liberalization must be supported by a stable macroeconomic environment and a real competitive exchange rate. Trade reform works through the transmission of price signals, which in a regime of high and variable inflation are concealed. Macroeconomic stability is thus a key complementary policy.20

A competitive real exchange rate is also crucial to create conditions for the continued support of liberal trade policies. Where the exchange rate is overvalued, industries that are competing against imports are at a competitive disadvantage, and this generates political pressures for protection that are difficult to withstand in the face of rising trade deficits and declining foreign exchange reserves (see also Shatz and Tarr 2001).

Initially, trade liberalization is likely to lead to a trade deficit because the rise in imports that typically follows liberalization tends to occur faster than the export supply response. A depreciation of the real exchange rate can help to restore a balance between exports and imports, since it makes imports more expensive and exports more profitable, in domestic currency. Under a flexible exchange rate regime, the real exchange rate will adjust through market forces. Under a fixed exchange rate regime, significant trade reform should be accompanied by a devaluation of the domestic currency. The required depreciation is larger the greater the extent of trade liberalization and the greater the lags in the supply response (see Annex K).

Countries that are part of a currency zone limit their capacity to devalue (for example, the countries in West and Central Africa, which are members of the CFA zone). Due primarily to currency overvaluation, there was no economic growth in the CFA zone between 1986 and 1994, when other Sub-Saharan African countries were growing at 3 percent annually (Clément 1994). For some of the CFA countries, including Cameroon and Cote d’Ivoire, the overvaluation induced an output contraction between 1986 and 1994 comparable to that of the Great Depression in the United States (Shatz and Tarr 2001). A number of CFA countries also suffered large increases in poverty (Devarajan and Hinkle 1994). After a major devaluation in 1994, growth strongly resumed. Elsewhere, some countries seek to maintain a fixed
exchange rate through the establishment of a currency board or some other arrangement. In such countries, which include Argentina and Estonia, to contain output losses trade liberalization may have to proceed at a pace consistent with the feasible rate of real exchange rate depreciation.

13.5.2 Fiscal revenue and the design of tariff reform

In 1990, trade taxes as a percentage of GDP averaged 0.6 percent among OECD countries and 4.4 percent among non-OECD countries. Trade reforms might well reduce government revenue, though this need not be the case. Many countries have implemented successful trade reform programs without significant loss of revenue; for example, in the 1990s, Ghana, Kenya, Senegal, and Malawi implemented trade reforms without a significant loss in revenue as a percentage of GDP (Ebrill and others 1999).

If trade reform policy has relied on quantitative restrictions of imports, the conversion of such restrictions into tariffs can increase government revenue. Where tariff rates are high, these tend to generate little or no revenue in practice, so that reduction of tariffs which starts with the highest ones will not have a large fiscal effect. Reductions of tariffs to moderate levels can increase imports (and thus revenues), as the incentive to smuggle is reduced. Tariff collections can also be increased by eliminating some or all exemptions, which often are a significant source of revenue loss. Finally, an exchange rate depreciation, which should accompany significant tariff reduction, will raise the local currency value of imports and thus tariff revenue (see box 13.6).

When tariff rates are already uniform and in the moderate to low range, further tariff reduction is likely to result in revenue loss, however, and can present a serious problem. Alternate broad-based and nondiscriminatory revenue sources should be sought, and trade reform sequenced to coincide with the availability of these alternate revenue sources. Such alternative, broad-based tax instruments will be more efficient (that is, less distorting) than trade taxes. For many products, such as alcohol, tobacco, and petroleum, collection of taxes on domestic production as well as on imports will have low additional administrative costs and will reduce the incentives to develop inefficient import-substituting firms. Even very poor countries such as Cambodia have been able to introduce broad-based consumption taxes that reduce dependence on customs duties and raise much-needed revenues for development expenditures.

13.5.3 Labor and other factor markets

Reforms may be needed to improve the operation of labor markets should accompany trade reforms in order to enhance labor mobility. For example, in Peru in the 1980s, a trade reform failed to generate any supply response because of severe labor market rigidities. Labor legislation prohibited firms from shedding labor, closing plants, or even changing activities. This led to many bankruptcies, contributing to foreign exchange and financial crises and ultimately to failure of the reform (Nogues 1991).

The poor are often concentrated in the informal sector. When combined with trade liberalization, reforms that increase labor mobility in the formal sector can open up additional jobs in the formal sector for workers previously employed in the informal sector. This was the case in Panama, for example (World Bank 1999). The mutually supportive relations between trade, macroeconomic, labor market, and other policies may then serve to increase the credibility and payoffs of each.

<table>
<thead>
<tr>
<th>Box 13.6. Summary of Revenue Impacts of Trade Liberalization</th>
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<tbody>
<tr>
<td><strong>Trade Reform</strong></td>
</tr>
<tr>
<td>Replace NTBs with tariffs</td>
</tr>
<tr>
<td>Eliminate tariff exemptions</td>
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<tr>
<td>Eliminate trade-related subsidies</td>
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<tr>
<td>Reduce tariff dispersion</td>
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<tr>
<td>Eliminate state trading monopolies</td>
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<td>Reduce high average tariffs</td>
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<tr>
<td>Lower maximum tariff</td>
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<tr>
<td>Reduce moderate or low average tariffs</td>
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<tr>
<td>Eliminate export taxes</td>
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Source: Sharer and others (1998).
Property rights for land and water can also be important. For example, Egypt could potentially produce labor-intensive crops such as fruits and vegetables for export to the EU, as do other Mediterranean countries, which would benefit the rural poor (Barres and Valdes 2000). Because Egypt lacks land and water markets, however, the country has been unable to take advantage of this opportunity and continues to grow traditional crops.

### 13.5.4 Competition policies

The prices of manufactured goods are affected by competitive conditions in a country. It may be possible to increase the competitiveness of markets for manufactured goods by lowering external barriers to international competition and by reducing government-imposed barriers to entry by domestic firms. In small countries, an open trade regime is crucial, since there are fewer domestic firms contesting the market. In large countries, administrative and legal barriers against domestic entry are most important, since there are more potential entrants blocked by domestic barriers to entry (Hoekman, Kee, and Olarreaga 2001).

The effect of trade reform is affected by distribution networks. If there are barriers to entry into distribution, those who control this sector may be the primary beneficiaries of trade liberalization, being in a position to pocket much of what used to be collected as tariff revenue and not passing import tariff cuts on to consumers. In agriculture, parastatal marketing boards often strongly restrict competition for the products of poor farmers, but also restrain their incomes. This happened in Madagascar (box 13.2), for example (see also box 13.3 on West Africa). Elimination of these boards (provided that key ancillary services such as transportation and credit provided by the parastatals continue to be supplied) should benefit the poor. Competition among private firms is also important: exclusive government licenses to the private sector should be avoided to prevent a situation arising in which farmers are obliged to pay artificially high prices for their inputs and to sell their outputs to a single buyer at depressed prices. This prescription applies also to import monopolies and exclusive distribution arrangements.

### 13.5.5 Foreign direct investment and intellectual property protection

Foreign direct investment (FDI) is an important channel of technology transfer across national boundaries. Multinational corporations account for a large share of the world’s research and development, and more than 80 percent of royalty payments for technology transfers flow from subsidiaries of foreign companies to their parent firms (UNCTAD 1997). Econometric evidence tends to support the view that developing countries receiving FDI perform better in terms of productivity than their counterparts that are not FDI recipients.

What matters from a poverty reduction perspective is whether or not and to what extent FDI has a positive effect on the incomes of the poor and on the prices of what they consume. Hence, it is important from a short-run viewpoint that FDI involve labor-intensive production and that it result in the transfer of skills through training. Improvements in communications, transport, and information technology, together with trade liberalization, have led companies to locate the labor-intensive parts of production in developing countries. In the 1970s such FDI focused in particular on textiles; more recently it has also included the electronics and auto parts sectors. Such investment can be an important catalyst for the creation of low-skilled employment—as exemplified by Mexico and several Southeast Asian economies.

Trade protection for foreign investors tends to attract the “wrong type” of investment. Protection may also result in losses to the host economy by providing rents to foreign investors at the expense of domestic consumers. Lall and Streeten (1977) studied some 90 foreign investments, using a cost–benefit methodology, and found that more than 33 percent actually reduced national income; this was mainly due to excessive tariff protection that allowed high-cost firms to produce for the local market at high prices, even though comparable goods could have been imported much more cheaply. Encarnation and Wells (1986) similarly found that between 25–45 percent of 50 projects studied (depending on analytical assumptions) reduced national income; again, the main culprit was high protection.
Intellectual property right protection can help attract FDI in sectors that rely on patent protection, helping to tilt the focus of investment projects toward manufacturing (Smarzynska 2000). Intellectual property protection can also be of direct importance to the poor in developing countries, especially for products and sectors that rely heavily on traditional knowledge and culture, such as ethno-botanicals and activities such as writing and performing music. Ineffective protection of intangible assets and intellectual property can have adverse consequences for poor people who are either producers or the beneficiaries of assets that have been built up over time. The costs of intellectual property rights include the price-increasing effect of protection, which can harm the poor by preventing access to drugs and by keeping prices higher than the cost of production. Intellectual property rights protection must therefore be complemented by trade and competition policy instruments that can serve to offset the market power granted to holders of those rights (Maskus 2001).

13.5.6 Safety Nets

One of the most important complementary policies for the poor is an efficient social safety net. Indeed effective social protection is important, independent of the needs related to trade liberalization (see chapter 17, “Social Protection”). The best outcomes for the poor can be expected when as a result of the overall reform process, of which trade is a part, growth accelerates in the economy as a whole. Especially in the short run, however, certain groups of the poor are at risk. It is essential that account be made of the interests of such groups, who are not protected by private savings, when reforms are considered.

All trade policy reforms need to consider the potential hardships faced by poor workers in activities that are opened up to foreign competition by import liberalization. Broadly defined, the policy options range from establishing a general social safety net, to safety net measures targeted to those who would be harmed by the trade reform, to selectively limiting the scope of reforms in order to minimize adverse impacts of reforms on the poor. As noted above, the last approach is difficult to implement effectively, in part because of the poor lack of political power to lobby in their interest. This subsection focuses on safety nets for those affected by reform.

Specific safety nets linked to trade reform have an uneven history. In practice, it is difficult to distinguish workers who are affected by trade reform from those who are harmed due to normal turnover or displacement in an economy. For example, the United States has been providing trade adjustment assistance (TAA) to workers displaced by international trade since 1962 (not linked to poverty), both monetary compensation (called trade readjustment allowances, or TRA) and retraining. In the early years of the program, it was found that income support was typically provided to workers who were not permanently separated from their employers—that is, the program was not well targeted (Corson and Nicholson 1981). However, changes in the design and monitoring of the program in 1982 and 1988 have resulted in better targeting (Decker and Corson 1995).

The results of retraining programs also appear to be mixed (see chapter 17, “Social Protection” and technical note N.2). When retraining is required, as in the United States, it may be ineffective. Generally, the effectiveness of retraining programs tends to increase if they are “demand-driven”; so, for example, subsidized apprenticeships in the private sector may work better than government-provided training programs. In industrial countries, an alternate approach to requiring retraining has been to require individuals to participate in a job search program. This appears to increase the likelihood of employment and to reduce unemployment benefits among recipients (Johnson and Klepinger 1991; Decker and Corson 1995).

It is difficult to justify providing safety net programs to poor people who are harmed due to trade reform when other poor people who suffer equivalent harm as a result of, say, technological displacement or price changes due to shifts in domestic demand are not compensated. In that sense, it is more equitable to employ general, country-wide safety nets to deal with problems linked to trade reform rather than to establish distinct trade-related special safety net programs. Challenges faced more generally in establishing safety nets are addressed in chapter 17, “Social Protection.”
13.6 Trade Policy Reform: Diagnostic Guidelines

When tracing the impact of trade liberalization on the poor, it is important to consider both the pattern of expenditures and the sources of income of the poor. What matters most in the short run, however, is the impact on incomes. The effect of trade reform on poverty in the longer term hinges on the growth process, which in turn will depend on a variety of complementary policies and institutions. In low-income countries, key complementary policies/institutions also need to be analyzed. This section provides a checklist of questions and issues that should be considered in the design and pursuit of trade reform. Interested readers should consult the other tools available to assist policymakers in identifying the impact of trade liberalization on the poor.

13.6.1 What is a “liberal” trade regime?

A trade policy regime should be predictable, transparent, and uniform. The following are elements of a liberal trade policy regime, and are intended to serve as a benchmark against which to judge the prevailing trade regime and to provide guidance on the direction of reforms:

- No licensing, or other approvals, except for health, safety, and environmental reasons, and automatic licensing used for statistical purposes; no other quantitative restrictions (QRs).
- Low and uniform tariffs. If the tariff is not uniform, it should have little dispersion, with only a small number of bands. A few sectors with high tariffs should be especially avoided.
- If tariffs are important for revenue generation, uniformity implies that the overall level of the tariff should be such as to generate the revenue required. However, some products (such as alcohol and tobacco products) may be subjected to high duties to raise revenue, as long as equivalent excise taxes are imposed on domestic production.
- An efficient customs clearance process with minimum red tape, that ensures tariff-free access to intermediate imports for exporters.
- Only one instrument of contingent protection (a safeguard provision) in place. Antidumping measures should be avoided.
- Efficient markets for service, which may require measures to ensure that competition prevails and that there is no discrimination against foreign suppliers that seek to establish a presence in the market, as well as appropriate regulation.

13.6.2 Is trade reform needed?

A number of questions are relevant in determining whether or not trade reform should be a priority and whether or not it would benefit the majority of the poor.

- **What is the impact of current trade policies on the poor?** It is important to determine the effects on the poor of the existing pattern of protection/subsidization. These may be positive or negative, and may affect particular products consumed by the poor or the incomes of a significant number of the poor, whether country-wide or in a particular region. Taxes or support for important food staples or inputs to agriculture, in particular, should be identified and their incidence examined. In those cases where the structure of protection is not beneficial to the poor there is a prima facie case for reform. In those cases where some of the poor benefit, an assessment should be made of the relative magnitude of the potential losses and the economy-wide gains from reform.
- **Are there nontariff barriers for reasons other than for health, safety, and the environment?** If so, there is again a prima facie case for reform, starting with conversion to tariffs. This reform is likely to benefit the poor more than the nonpoor because license recipients typically collect rents and are unlikely to be poor (almost by definition), and because the competition for licenses wastes resources that could be used more productively.
- **What is the average tariff and how dispersed is it?** Dispersion generated by exemptions and tariff escalation often will lead to high effective rates of protection and is likely to entail significant inef-
ficiencies. Dispersion means differences in the treatment of different sectors and segments of society, and thus increases the urgency for reform.

- **Is there discrimination against agriculture?** This entails an assessment of the effective rate of protection for this sector compared to manufacturing. (See Schiff and Valdes (1992) for a description of a methodology to do this.)

- **How well do critical service markets function?** Do the poor have access to important ancillary services, such as transport? Do policies discriminate against foreign suppliers and lead to high-cost, low-quality domestic supply? Is entry possible in labor-intensive sectors such as tourism? Does competition prevail in key backbone sectors such as transport, finance, and communications? Is appropriate, procompetitive regulation in place?

- **How efficient is customs?** How long does it take to clear a container or air freight shipment? How does this compare to neighboring countries and to best practice? How large are unofficial trade facilitation payments? Is there a functioning drawback and temporary admission mechanism?

The foregoing analysis of the trade regime should yield a preliminary judgment on the desirability of trade reform. Analysis of both the impact of the existing policy and the likely effect of alternative reforms on the poor is important. The tools to undertake such an analysis can be constructed for most economies, with the basic requirements including detailed data on import and export goods, the trade barriers that apply to those goods, household survey information on the consumption pattern of the poor and the sources of their income, and data on the basic structure of the economy (ideally an input–output table or social accounting matrix). The basic elements of a framework for the analysis that is required is laid out in technical note K.1.

This preliminary judgment should be reviewed in the light of the potential short-term effects of trade reform on the poor. It is important to identify any possible negative effects early, so that arrangements for dealing with them and strategies for developing consensus in support of those arrangements may be planned.

### 13.6.3 Complementary policies

Trade policy reform and institutional strengthening must be implemented in the context of a variety of complementary policies. Some of these are general, and some are focused on making the trade policy reform more likely to benefit the poor.

- Are measures in place to promote macroeconomic stability and a competitive exchange rate?
- In agricultural markets, are price changes passed on to farmers, or does government or private intermediaries make large profits in the sale of farm products or farm inputs?
- Is the reform likely to destroy existing markets that are significant for the poor? Will it allow poor consumers to obtain new goods? (See also Winters 2000 and 2001.)
- Are there serious impediments (legal, cultural, transport-related) to labor mobility?
- Are there serious financing obstacles to participation in trade?
- In the short run, are trade-focused instruments such as the use of back-to-back letters of credit available to alleviate the most pressing obstacles to trade?
- Are there serious obstacles in setting up a business?
- Are there transport obstacles to trade?
- Are there serious obstacles to entering major external markets or to meeting competition from abroad?

Most low income countries face relatively low traditional trade barriers in external markets, because of a variety of preference schemes, but there are specific problems related to, for example, sanitary requirements and competition from subsidized exports in third markets.

*Trade-related institutions.* The success of trade policy reforms depends upon a variety of institutions, both public and private. On the government side, an effective and noncorrupt customs authority is
critical to the success of reforms. Other institutions to which particular attention needs to be paid to ensure that trade reforms benefit the poor include marketing and export finance, both of which are necessary for export expansion. For the poor to benefit, it may be useful to establish organizations, such as cooperatives, that can put together large enough shipments from individual producers to supply foreign markets and that are able to obtain financing linked to their exports, neither of which can be achieved by the individual poor farmer. There is substantial international experience on these issues, including through the International Trade Centre and UNCTAD in Geneva. Bilateral donors and multilateral development banks can provide assistance in the design of such programs, as well as financing.

**Agriculture and the rural poor.** Key issues for which complementary actions may be required for poor farmers include the availability and cost of education for children; research and development; and infrastructure, especially transport and communications. Unless the opportunity costs of farm residents can be raised, they will stay trapped in poverty.

### 13.6.4 Political economy of reform

Strong government commitment to the reform is critical. The government also needs to explain the rationale for reform and to win the support of at least some parts of civil society. Obtaining a broad consensus may be difficult, however: the benefits of reform are likely to be dispersed, uncertain, and spread over time; while the costs to sectors that will face increased competition from imports will be obvious, near-term, and likely to be concentrated on powerful political groups.

It can be tempting to design a pro-poor trade reform by identifying sectors that are important to the poor, either on the consumption side or on the income side, and singling out these sectors for preferential treatment when the protection of other sectors is reduced. If, for instance, many poor people produce maize, as in Mexico, it might seem sensible to exclude maize from a tariff reduction. There are at least two problems with this approach, however; one that is fundamental, and one that relates to political economy. The basic problem is that trade policy is a single instrument, and a fundamental principle of economic policy formulation is that a single instrument cannot be expected to address multiple targets. The political economy problem is that, once a highly differentiated trade regime is adopted, it becomes impossible to stop different interest groups building a case that their sector deserves special treatment for one reason or another. Returning to the example of maize, in addition to the poor producers that would benefit from continued protection, there is likely also to be a group of poor people for whom maize is an important expenditure item, and, hence, arguments for additional countervailing policies. Broad trade reforms frequently meet with less political resistance than cuts in protection to individual sectors.

A better approach would be to focus on developing two different sets of instruments: a trade policy focused on providing the incentives appropriate for efficient production and use of goods and services, complemented by policies aimed to redistribute income. The set of distributional instruments will necessarily have a much wider range of dimensions, including investments in expanding access to education, the provision of safety nets, and a range of infrastructure investments needed to give people in poorer regions access to the markets and other amenities enjoyed by relatively advantaged people.

### 13.6.5 Timing and sequencing

Groups benefiting from the status quo may naturally oppose reform and seek to delay adjustment as long as possible. As emphasized above, it is nonetheless extremely important to investigate in advance the potential impact of reforms on different groups of the poor and to design programs to address them. The timing of the implementation of trade reforms needs to be closely linked to the establishment of the programs that deal with their impact on the poor. Some important points about sequencing include the following.

- If a reform is pre-announced to be implemented over several years and is credible, normal market adjustment and labor force attrition can be used to alleviate adjustment costs. However, a gradual approach faces the risk of reversal or nonimplementation, as entrenched interests will have time to mobilize their opposition. A staged reform that is scheduled to take more than five years is not
likely to be credible unless it is anchored in WTO commitments or a far-reaching regional trade agreement.

- It is important to address nontariff barriers and high tariff rates as early as possible.
- Tariffs should be cut across-the-board during each stage of a gradual reform. If instead a target is set based on the tariff average, the temptation will be to cut tariffs only where they cause no immediate difficulty, postponing adjustments to the last.
- Waiting for some important infrastructure project to be completed, such as a port facility or a road, is not usually a good reason to delay reforms.

In conclusion, not everything will be perfect at the start, but at a minimum, macroeconomic stability and a competitive exchange rate should be in place. The best outcomes for the poor can be expected when, as a result of the overall reform process, of which trade reform is a part, growth accelerates in the economy as a whole. That said, it must be recognized that the poor are least able to bear risks, and that in the short run there will be losses for some groups. Analysis of the likely impact of reform on the poor is important. General safety nets may not exist or may be inadequate in many low-income countries; in such situations, reforms should not be postponed indefinitely but should be implemented gradually, following a pre-announced schedule, and complemented by actions to minimize the adverse consequences suffered by the poorest in society. In many cases this can be done by directly targeting reform of trade policies that are clearly detrimental to the interests of the poor, and by ensuring that the reform process also considers the need for action in ancillary areas, such as service markets.

Notes


3. For example, Srinivasan (2000) found that of the 17 percentage point reduction in the population below the poverty line between 1951–55 and 1993–94, 15 percentage points may be attributed to growth and 2 percentage points to redistributive policies.

4. From the 1991 Household Expenditure Survey for Bangladesh.

5. In Mexico, wages from unskilled labor represents 40 percent to 45 percent of the income of the poor. Own consumption is the next largest, representing 15 percent of the income of the poor (Ianovichchina and others, 2000).

6. One view, for example Rodriguez and Rodrik (2000), is that there is a strong association between exports and growth but this association may be a consequence of exports causing output growth or of the two being jointly determined by the strength of a country’s institutions. The latter view implies need for a comprehensive approach to development that would include improvement of a range of institutions along with trade liberalization.

7. More in-depth treatments of trade policy from a development perspective can be found at www.worldbank.org/trade and in McColluch, Winters, and Cirera (2001) and Hoekman, English, and Mattoo (forthcoming). The Bank Web site also offers access to tools that can be used to assist in the design of trade reforms, and cross-country data on trade policies that are useful for benchmarking purposes.

8. Under the WTO, safeguards require compensation to be offered to exporting countries if the action lasts more than three years. This is a useful mechanism to ensure that protection is temporary. See Hoekman and Kostecki (2001) for more detailed discussion.

9. To avoid anti-export bias, duty drawback schemes would also have to be extended to indirect exporters (that is, firms that do not themselves export but which sell to exporters). Administration of such mechanisms is quite complicated in practice for most developing countries.
10. Much cashmere is smuggled out of the country to avoid taxes, but herders nonetheless still lose income as middlemen capture much of the difference between world and domestic prices.

11. The impact of North–South or North–North agreements tends to also involve more efficiently priced imports from partner countries, and thus may be beneficial.

12. For example, if the markets for rice, wheat, sugar, milk products, sugar, and cotton were open in China and India, that would greatly expand the size of the world market for these products and reduce the impact of various exogenous shocks (Tyers and Anderson, 1992).

13. Abstracting from fragmented world markets, commodity price instability is associated with inelastic demand, lags in supply adjustments due to seasonal production, weather conditions, and so on.

14. Prices in domestic commodity markets (for example, for sorghum and maize in inland areas of Africa and South Asia) that are disconnected from world markets by a combination of high domestic and marketing costs and/or restrictive trade policies may fluctuate more than world prices both within and across seasons. Opening up to imports could therefore increase price stability; for example, by cutting off price peaks resulting from crop failures. The use of measures to control imports and exports in ways that do not adjust flexibly to domestic market conditions may also lead to higher domestic price instability than in world markets—or worse, to costly and wasteful accumulations of excess stocks held by government marketing organizations. A significant portion of such stocks often are lost to pests and weather.

15. If agriculture import barriers are not higher than for manufactured goods, there is no rationale for raising them because adjustment will already have taken place.

16. Farmers in middle-income countries may face different incentives, as they will suffer a decline in demand for their products in the EU because of preferential access provided only to the LDCs.

17. In the case of agricultural exportables, increased domestic transport efficiency to the port will typically raise inland farmgate prices. This could worsen the welfare of low-income consumers of that product in inland areas.


19. The relative price of tradable to nontradable (or home) goods (Pt/Ph) is typically referred to as the real exchange rate (RER) and is used as a measure of the competitiveness of the tradable sector. The reason is that several of the determinants of Ph (such as wages) affect the production costs of tradables. For purposes of illustration, suppose a government runs a fiscal deficit and finances it by printing money. The resulting inflation would raise prices in the nontradable sector. If tradable prices do not increase by the same amount, the inflation would lower Pt/Ph and thus the real exchange rate, thereby reducing the competitiveness of the tradable sector (see also the Annex).

20. Trade taxes as a percentage of GDP were 5.3 percent in Africa, 4.4 percent in Asia, and 3.5 percent in the Middle East (Ebrill and others, 1999).


22. A more detailed presentation of these guidelines may be found in Michalopoulos (2001).


References

Note: A number of these papers as well as many others dealing with trade policy issues can be downloaded from www.worldbank.org/trade.


