

# Trade Note



The  
World Bank  
Group  
www.worldbank.org

## International Trade Department

By Paul Brenton and  
Takako Ikezuki

These notes summarize recent research on global trade issues. They reflect solely the views of the author, and do not necessarily reflect the views of the World Bank Group or its Executive Directors.

## Trade Note 21

## The Value of Trade Preferences for Africa

Improving the ability of the least developed countries (LDCs) to participate fully in world markets can be a powerful way of stimulating growth and poverty reduction. To promote this end, industrial countries offer developing countries preferential access to their markets through lower duties. In this note we discuss the magnitude of the preferences granted by the EU, Japan and the US to sub-Saharan African countries and show that only a small number of countries actually receive substantial preferences.

### The Role of Trade Preferences

Tariffs introduce a wedge between the world price of a product and the price in the domestic market. This price premium normally accrues to the importing country government as tariff revenue. With preferences these rents may go to the developing country beneficiary raising returns to the activity concerned and, depending on the nature of competition in domestic product and factor markets, stimulate expansion of the activity, with implications for wages and employment.

However, if there is little effective competition among buyers/importers in the developed country then the suppliers/exporters in the developing country may be unable to acquire much of the price premium. Ozden and Olareaga (2005) find that only one third of the available rents for African exports of clothing to the US under AGOA actually accrue to the exporters. In addition, as will be discussed below, the costs of satisfying the rules governing preferences reduces the extent to

which they raise actual returns in developing countries.

The arguments underlying trade preferences are that the small scale of industry and the low level of development in developing countries lead to high costs, which reduce their ability to compete in global markets, and to lack of diversification, which increases risks. Developing countries, especially least developed countries, face much higher trade-related costs than other countries in getting their products into international markets. Some of these costs may reflect institutional problems within the countries themselves, such as inefficient practices or corruption, which require a domestic policy response. They also reflect weak transport infrastructure in many countries and firms' lack of access to standard trade facilitating measures such as insurance and trade finance.

Trade preferences may provide the premium over the normal rate of return that is required to encourage investment in these economies. The increase in trade due to preferences leads to more output and, if there are scale economies, to lower costs, which stimulate further trade. It is important, however, that the sectors that receive preferences and investment are those in which the country has a comparative advantage in the long term and that investment not be based on a false comparative advantage due to the margin of preference.

Tariff preferences can, however, lead to several adverse effects. Negotiations under the Doha Round have shown that preferences can be used to bolster external support for highly protectionist policies in industrial countries and to weaken proposals that would substantially reduce such levels of protection. Preferences can also create a



degree of dependence that constrains flexibility and diversification and results in high-cost production of preferred products (Topp 2001). The beneficiaries of trade preferences are not always the poorest constituents in developing countries. When rents do accrue to the developing country, they tend to accrue to the owners of the most intensively used factors. With agricultural preferences the main beneficiaries are typically the owners of land. Preferences will typically only have a strong impact on poverty if the landowners are poor. So, even when preferences create substantial transfers for producers in developing countries, they may not stimulate the long-term growth of exports or reduce poverty, and it can lead to a less diversified export base.

### **The Value of Preferences Offered by the EU, Japan and US**

Table 1 summarizes our calculated value of EU, US and Japanese preferences for sub-Saharan African countries in 2002. We allow for the fact that both the EU and the US have schemes that offer enhanced preferences beyond those of the standard Generalised System of Preferences (GSP). The US has introduced the African Growth and Opportunity Act (AGOA) while the EU has the Cotonou Agreement and Everything But Arms (EBA) for the least developed countries, actually special provision in the EU's GSP scheme. The value of preferences is derived from the value of exports which actually request preferences multiplied by the preference margin and is the implicit transfer of tariff revenue due to the preference scheme, all of which we assume goes to developing country. This is presented in the tables as a share of the total value of exports to each market.

The table shows that the overall value of EU preferences to sub-Saharan African countries under the Cotonou Agreement and under the EBA/GSP amounted to just 4 per cent of the value of those countries exports to the EU in 2002. The value of US preferences for sub-Saharan African

countries under AGOA and the GSP amounted to 1.3 per cent of the value of exports to the US. Japanese preferences to sub-Saharan African exporters amounted to 0.1 per cent of the value of exports. The next columns of the table show that the value of preferences to non-LDCs is higher than that for LDCs in the EU schemes, while this situation is reversed for the US and Japanese schemes.

These benefits are highly concentrated upon a small number of beneficiaries. (Table 1) Under the EU schemes, 60 per cent of the benefits accrue to 5 countries. For the US, the top 5 beneficiaries account for almost three-quarters of the value of preferences, while for Japan nearly 90 per cent of the preferences go to the top 5 countries. For the LDCs, the top 10 beneficiaries account for 100 per cent of the benefits under the US and Japanese schemes and more than 90 per cent of the benefits offered by the EU schemes. Thus, the value of preferences for the remaining 37 countries (although they are not the same countries in each case) is very small.

Preferences are also concentrated upon a small number of sectors, especially for the LDCs. In the EU schemes these are mainly agricultural products (sugar, fruits and processed meat and fish). US preferences are dominated by clothing (knitted and not knitted) and mineral fuels. Fish, Iron and steel and nickel dominate Japanese preferences. Almost one third of the value of EU preferences is derived from sugar, the market for which is highly distorted. These preferences, which will be affected by the domestic reform of this sector in the EU, should be distinguished from general trade preferences that arise only from a tariff preference in otherwise non-distorted sectors.

Table 2 classifies the individual countries in Africa according to the combined magnitude of non-oil preferences in the EU, Japan and US expressed as a proportion of total non-oil exports. For only 5 countries do preferences



	Sub-Saharan Africa (total)			LDCs			Non-LDCs		
	EU	US	Japan	EU	US	Japan	EU	US	Japan
Value of preferences/ total exports (%)	4.0	1.3	0.1	2.3	2.1	0.4	5.1	1.1	0.1
Share of top 5 beneficiaries in total value of preferences requested (%)	59.9	73.9	88.9	73.8	98.8	95.8	76.9	92.9	98.7
Share of top 10 beneficiaries in total value of preferences requested (%)	80.1	95.4	97.7	91.2	100.0	100.0	97.5	99.3	100.0
Share of top sector <sup>a</sup> in total value of preferences (%)	31.3	31.9	41.0	37.1	51.5	70.9	34.5	33.4	31.9
Share of top 3 sectors <sup>a</sup> in total value of preferences requested (%)	56.5	79.6	63.6	68.5	91.3	92.2	65.2	71.3	56.8

<sup>a</sup> defined at the 2 digit level of the harmonised system

Countries for whom the value of preferences is less than 1% of the value of their total exports	Angola, Burundi, CAR, Chad, Congo, Congo Dem, Djibouti, Eq. Guinea, Gabon, Guinea, Liberia, Mali, Níger, Nigeria, Rwanda, S.Tome et Princ., Somalia, South Africa
Countries for whom the value of preferences is between 1% and 5% of the value of their total exports	Benin, Botswana, Burkina Faso, Cameroon, Cape Verde, Comoros, Eritrea, Etiopía, Ghana, Ivory Coast, Mauritania, Sierra Leone, Sudan, Tanzania, Togo, Uganda, Zambia
Countries for whom the value of preferences is greater than 5% and less than 10% of the value of their total exports	Gambia, Guinea Biss., Kenya, Madagascar, Mozambique, Namibia, Senegal, Zimbabwe
Countries for whom the value of preferences is greater than 10% of the value of their total exports	Lesotho, Malawi, Mauritius, Seychelles, Swaziland



amount to more than 10 per cent of the value of total exports. For 35 of the countries, — 73 percent of the total number of sub-Saharan countries — preferences amount to less than 5 per cent of the value of exports. For 18 countries preferences are negligible, amounting to less than 1 per cent of exports.

*So, for most countries in Africa, the preferences that are requested in the EU, US and Japan amount to a very small proportion of the value of exports.* As such the impact of preferences on these countries is likely to be very muted. Only a small number of countries receive substantial transfers under current preference schemes. These are driven mainly by preferences for sugar in the EU and for clothing in the US.

### **Why Do Trade Preferences Fall Short of Their Potential?**

Trade preferences have not transformed the export and growth performance of most developing country beneficiaries, although performance may have been worse without them and a few countries may have benefited substantially. Trade preferences have not enabled beneficiaries as a group to increase their market shares in the main preference-granting markets. Why?

First, many products produced in developing countries are subject to zero MFN duties in industrial countries, and therefore no trade preference can be given. Second, products with high duties are typically excluded from preferences or the preference margin is very small. For a small number of products, however, preference margins are substantial, though usually within strict quantitative limits and only for certain countries. Some countries that have been granted preferential access for sugar and tobacco, for example, have received large transfers due to preferences.

Third, many of the schemes are surrounded by uncertainty concerning their duration and the discretion that the donors have to exclude countries and products. This limits

the incentives to invest in the developing countries to take advantage of preferences. Fourth, exporters in developing countries are often hampered in their ability to take advantage of preferences by the rules of origin. There are two elements of the costs of these rules (i) the additional costs that are incurred in sourcing inputs and designing production structures to ensure compatibility with the requirements stipulated by the rules of origin (ii) the costs, in terms of documentation, maintenance of complex accounting systems and the expenses incurred in obtaining the relevant certificate, in proving conformity with the rules (see Trade Note 4).

Here we have concentrated on the nature of the preferential schemes which limit their impact. But there are important issues relating to the beneficiaries capacity to satisfy other requirements for market access, such as, mandatory standards and quality demands of consumers and broader constraints relating to transportation, energy and so on, all of which constrain the supply response to preferences, and trade opportunities in general, in developing countries.

### **Conclusions**

In principle, trade preferences can assist development if they provide temporary margins of preference to enable industries to adjust and compete more effectively in global markets. Multilateral trade liberalization contributes to this outcome by ensuring that preferences have a short “half-life” and that inefficient, high-cost industries with entrenched lobbies do not constrain flexibility and adjustment. Multilateral liberalization is also important for limiting the long-term trade diverting impact of preferences on other countries (typically these will be other developing countries).

In practice, only a small number of countries receive large transfers as a result of preferences in OECD markets. The values of preferences are largest in the EU



market, driven by a narrow range of products and the very high EU price for sugar. In very few countries, such as Mauritius, preferences appear to have contributed to a relatively strong economic performance and economic diversification (Subrmanian 2003). In some other countries, preferences have led to large transfers, but domestic industries have experienced rising costs and declining output and have accumulated large debts.<sup>1</sup> Nonetheless, *the majority of beneficiaries of U.S., EU, and Japanese preferences have experienced little or no impact*. Preferences have done little to stimulate the export of a broader range of products.

Preference schemes would be enhanced by

- Extending coverage to all products and making schemes permanent (as in the EBA).
- Liberalizing the rules of origin and simplifying the process of certifying compliance. If all schemes had the same simple and easy to apply rules a producer in a least developed country could make production and investment decisions on the basis of equal and predictable access to all industrial markets.

The impact of preferences on developing countries would be facilitated by

- Improving the domestic investment environment.
- Addressing the internal barriers that raise the costs of trade for developing countries—inadequate and high-price transport services, reflecting lack of infrastructure and lack of effective competition in many countries, inadequate and unreliable energy supply, inefficient customs practices, and lack of trade-supporting financial and telecommunications services.

The challenge is to find preference schemes that compliment the domestic reforms that developing countries must undertake to improve the returns to exports without

stifling diversification and multilateral trade liberalization. *Trade preferences are not a panacea for success but rather should be seen as just one part of a strategy for export-led growth.*

In this context, it is crucial that the developed countries do not treat preferences as a substitute for direct development assistance. Such assistance is crucial to progress in alleviating key internal barriers which constrain supply responses in developing countries. Preferences cannot achieve this task. *It is also crucial that allocations of development assistance are not distorted by preferences.* While there is a need to address the difficulties that a small number of countries may face from preference erosion, such needs must not be met by redirecting assistance away from the large number of very low income countries that do not benefit from preferences. At the same time, *developing countries must not view preferences as an alternative to domestic reforms* that are vital to improve investment conditions, to promote effective competition and to facilitate integration into the global economy.

---

<sup>1</sup> For example, Mitchell (2005) concludes that despite substantial preferences most Caribbean sugar producers are not competitive and will need to close or restructure.

**References**

Mitchell, D (2005) 'Sugar in the Caribbean: Adjusting to Eroding Preferences', Policy Research Working Paper, World Bank, forthcoming

Ozden, C and M. Olarreaga (2005) 'AGOA and Apparel: Who Captures the Tariff Rent in the Presence of Preferential Market Access?' *World Economy*, 28, 63-77

Topp, V (2001) 'Trade Preferences: Are they Helpful in Advancing Economic Development in Poor Countries?' ABARE

**Further Reading**

Brenton, P and T. Ikezuki (2005) 'The Impact of Agricultural Trade Preferences, with Particular Attention to the Least Developed Countries', A. Aksoy and J. Beghin (eds) *Global Agricultural Trade and Developing Countries*, World Bank, Washington D.C.

Hoekman, B and C. Ozden (2005) 'Trade Preferences and Differential Treatment of Developing Countries: A Selective Survey', Policy Research Working Paper 3566, World Bank.

Stevens, C and J. Kennan (2005) 'Making Trade Preferences More Effective', Trade Note, IDS, <http://www.ids.ac.uk/IDS/global/pdfs/CSJKTradePreferences.pdf>

This Trade Note was written by Paul Brenton, Senior Economist, and Takako Ikezuki, Junior Professional Associate Economist, of the International Trade Department, The World Bank. Comments from Elke Kreuzwieser and Faezeh Foroutan on the paper underlying this note are gratefully acknowledged. The findings, interpretations, and conclusions expressed in this paper are entirely those of the author and do not necessarily reflect the views of the Board of Executive Directors of the World Bank or the governments they represent. This Trade Note can be downloaded at <http://www.worldbank.org/trade>.