Chapter 3

Assessing Trade Policy Changes Induced by Graduation

As discussed by Keane and te Velde (2011) there are few studies that specifically look at the potential effects arising from graduation from preferential trade regimes. Instead, most of the literature focuses on changes in preferential tariffs and resultant trade effects. Given this, te Velde and Keane (2011) and Stevens et al. (2011) developed an analytical framework that recognises how firms set their pricing in a given market and consider the actions of other exporters, as well as how a firm's market share, in turn, influences its price-setting policy. This is because the potential for trade shifts to arise as a response to price changes depends on the price elasticities of demand and firms' market shares.

The magnitude of the costs and benefits for exporters affected depends on the responsiveness (elasticity) of export supply and import demand to price changes, as well as on the degree of substitution between preferential and non-preferential suppliers. A product has unit (or unitary) price elasticity if the price change results in a commensurate change in quantity, e.g. a 10 per cent increase in price results in a 10 per cent reduction in demand. If the reduction in the quantity demanded is less than the price decline, the product exhibits a more inelastic demand curve.

Because the methodology developed focused specifically on the potential for trade-related effects to arise from country and product graduation from the EU's GSP, which introduced a number of changes in 2014 and were assessed in detail by Stevens et al. (2013), it is possible to adapt this methodology to analyse the potential for trade shifts to arise as a result of graduation from LDC status.

The data required are mostly trade data. A crucial part of the analysis is understanding the difference – in percentage points – between the MFN tariff rate and the tariff rate applied to LDCs. This major part of the quantitative analysis is a key element within the trade economist's toolkit. Box 3.1 describes the basis of the analysis of preference erosion, adapted from Hoekman et al. (2009). Box 3.2 describes why the focus on the removal of preferences within the European market is justified.

Box 3.1 Basic analytics of preferences[1]

"The simplest measure of the value of preference programs for an exporter is the difference between the applied tariffs facing a country and the MFN tariffs that would apply to the country's exports without

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a preferential agreement. The less close the varieties are as substitutes, the smaller the reduction in demand will be for the non-LDC supplier following the implementation of preferences for the LDC (Hoekman et al. 2009)." The converse would also apply in the case of a removal of a trade preference for LDCs.

According to Hoekman et al. (2009), thee case of horizontal demand curves seems quite appropriate for situations in which small countries are supplying relatively homogeneous products to much larger economies, as in the case of LDCs supplying raw agricultural products to the EU or United States. Therefore, they further note, that in practice, a crude measure of the value of preferences, defined as the product of the preference margin and the quantity exported, provides an upper limit on the potential losses from preference erosion.

However, if buyers or intermediaries in the importing country have market power, they, rather than the exporter, may absorb the cost of the tariff increase (in part because often importers and intermediaries are able to capture large shares of tariff rents).[2] It is precisely for this reason that a GVC perspective has been adopted for the purposes of this handbook.

As Hoekman et al. (2009) described in some detail, the challenges of undertaking an empirical analysis of the effects of trade preferences include:

- the specific impact of preferences as opposed to other factors;
- the observed growth rate of exports from recipients to the preference-granting countries, without controlling for other factors;
- sensitivities regarding trade elasticities;
- and, finally, the use of gravity regressions in which preference status is captured by a dummy variable.

They note that to the extent that exceptions in preferential regime are often defined at a highly disaggregated product level, the absence of elasticity estimates at this level of disaggregation – as well as the difficulty of finding the right controls to include in regressions – adds to the controversy surrounding available studies. These data and methodological problems help explain why the policy-oriented literature has tended to rely heavily on descriptive indicators. Four indicators are particularly common:

- Preference margins – the difference between MFN tariffs and preferential tariffs for products

- Potential coverage – the ratio between products covered by a scheme and the dutiable imports originating in beneficiary countries
- Utilization – the ratio between imports that actually receive preferential treatment and those that are in principle covered (a measure of how effectively beneficiaries are able to use preferences)
- Utility – the ratio of the value of imports that receive preferences to all dutiable imports from that exporter (the lower this ratio, the less generous the preference scheme)

A note of caution is emphasised by Hoekman et al. (2009), since focusing on these variables alone only provides a partial perspective of the economic value of a preferential regime. They describe that in order to get a more precise estimate of the value of preferences, one has to take into account: the extent to which others have preferential access; the costs of compliance in terms of documentation (for example, in proving conformity with rules of origin); the economic costs of sourcing inputs from more expensive sources to comply with origin requirements; the various limitations and constraints embodied in preferential schemes; and the distribution of related rents.

Source: adapted from Hoekman et al. 2009

Box 3.2 Why the focus on the EU?

"The EU GSP program is the most inclusive of its preference schemes for developing countries. However, graduation measures are taken when the country becomes more competitive, with all countries classified as high income by the World Bank losing eligibility. Furthermore, the rules of origin tend to be restrictive, with no cumulation among participants…. The EU (reflecting the magnitude of the preference margins offered, the extensive scope of preferences given and the EU's importance as a destination market for many preference-dependent countries) stands out as the largest provider of preferences and the one where preference erosion is likely to be the most serious problem in the case of MFN liberalization. Although preferences have been instrumental in promoting some developing countries' export diversification into textiles and clothing, the track record of unilateral preferential systems as mechanisms to promote integration of developing economies into the world economy has been mixed at best. In part, this mixed record is because rules of origin and other forms of conditionality remain a major constraint on further expansion in some regimes. More fundamentally, however, it reflects supply capacity constraints in many beneficiary countries."

Source: Hoekman et al. 2009

Strategies related to the loss of trade-related international support measures

Policy-makers must confront competitiveness challenges should the available evidence suggest that these may arise because of the loss of tariff preferences. Some of the strategies that could be adopted are outlined below.

Extension of the transition period: in order to anticipate and adapt to the trade-related effects of preference loss, an extension of the transition period could be sought. This may provide greater flexibility, for example to ensure workers are retrained, and could lead to productivity gains that counteract any adverse effects related to increased competition.

Legal assistance for transition from the EU's EBA regime to GSP+: the loss of tariff preference could be mitigated through seeking to obtain a different trade regime. For example, the EU's GSP offers an additional preference (in some cases, comparable to the EBA) for countries that adhere to particular social and environmental objectives. Legal support may be available upon request from development partners, including the Commonwealth Secretariat.

Transitional arrangement for services waiver: given that the LDC services waiver is a newly available mechanism and has barely been utilised by the next wave of graduates, a particular transitional arrangement may be beneficial.

More targeted aid for trade support: in order to improve the effectiveness of Aid for Trade disbursements, the findings from the application of this guide could be utilised to more effectively advocate support for trade-related adjustment. The buyer's survey (see Annex) could reveal alternative ways in which competitiveness could be harnessed. These could include investments in infrastructure so as to further reduce trade costs in view of heightened competition after graduation.

Notes

1 This is adapted from Hoekman et al. 2009.
2 Olarreaga and Özden (2005) find that on average exporters received around one-third of the tariff rent, with poorer and smaller countries tending to obtain lower shares.

References

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