Are Developing Countries 'Losing' Policy Space or not Using New Opportunities?

In this edition of the Trade & Industry Monitor we focus on the impact of the global economy on developing countries, particularly in terms of the measures and responses available to them in the industrial and trade policy arenas.

In our Special Focus article, **Ha-Joon Chang** notes that the changing global environment has put new restrictions on the conduct of industrial policy. Especially for developing countries, the available policy space is constantly under pressure. However, for Chang this does not spell the end of industrial policy; it only means that countries need to be more creative in policy design and implementation. He finds that there is still considerable room for manoeuvre – especially if developing countries realise they have the power to influence the course of events and make full use of new opportunities that are opening up.

Turning to trade, because of a concern that OECD tariff reductions will translate into worsening export performance for the LDCs, trade preferences could be a stumbling block to obtaining broad-based support for deep liberalisation by OECD countries in the Doha Round. In this article, **Joseph Francois**, **Bernard Hoekman** and **Miriam Manchin** examine the magnitude of potential preference erosion and the scope for erosion. They find strong evidence that preferences are underutilised due to administrative burdens. The implication is that the actual value of preferences is reduced quite substantially. In addition, in US dollar terms the primary negative impact of erosion follows from the removal of EU trade barriers. This suggests that the erosion problem is primarily a bilateral, not a WTO-based concern. I

Further focus on the WTO finds **David Fryer**, **Nshalati Hlungwane** and **Nicolette Cattaneo** examining the criticism that the organisation is an instrument that allows rich countries to prise open the markets of middle-income and poor countries. But apart from whether or not developing countries are getting a bad deal, they also look at whether WTO processes appear to be closing the 'development space' for such countries – hindering their ability to follow policies that are substantially non-neoliberal.

The authors find that the WTO has shifted away from its mandate – the regulation of international trade. It argues that this is particularly evident in current efforts (through the proposed 'investment agreement' and the ratcheting up of the GATS) to use the WTO as a tool for liberalising developing country financial markets.

Turning back to the industrial policy space, **Ralitza Dobreva**[1] examines the role of value chain governance in the SA plastics industry. She finds that Sasol, through its governing powers, shapes to a significant degree the development path and the pattern of competitiveness not only of polymer production, but also of the downstream industries which convert polymers into intermediate and final plastic goods.

Is a Strong Industrial Policy Possible in the Current Global Environment?[1]

The changing global environment has put new restrictions on the conduct of industrial policy, and especially for developing countries, the available policy space is constantly under pressure. However, this does not mean the end of industrial policy, says **Ha-Joon Chang**[2], it only means that countries need to be more creative in policy design and implementation. He finds that there is still considerable room for manoeuvre – especially if developing countries realise they have the power to influence the course of events and make full use of new opportunities that are opening up.

Introduction

The debate on industrial policy has a long pedigree, going back at least to Renaissance Italy. However, in its modern form, the debate was started by Alexander Hamilton, the first US Treasury Secretary, when in his 1791 report to the Congress he formulated the theory of infant industry promotion and proposed a plan to promote US industries through protection and subsidies. In doing this, Hamilton was challenging the leading economists of his time, such as Adam Smith and Jean Baptiste Say, who were arguing that the US should specialise in agriculture:

> "Were the Americans, either by combination or by any other sort of violence, to stop the importation of European manufactures, and, by thus giving a monopoly to such of their own countrymen as could manufacture the like goods, divert any considerable part of their capital into this employment, they would retard instead of accelerating the further increase in the value of their annual produce, and would obstruct instead of promoting the progress of their country towards real wealth and greatness" (Adam Smith, *The Wealth of Nations*, 1776, the 1937 Random House edition, pp. 347-8).

Until the American Civil War settled the matter for good in favour of strong industrial policy, there was a constant struggle within the US regarding the direction of its industrial policy.

Similar debates raged in virtually all of today's developed countries, most of which actually used active industrial policy of the kind usually associated with Japan and other East Asian countries, until they became rich.

In the post-Second World War period, most developing countries adopted interventionist trade and industrial policies, typically known as import-substitution industrialisation (ISI) policies. Today, the orthodoxy argues that ISI policies have failed and therefore that developing countries should adopt open trade policy and *laissez faire* industrial policy. However, the reality is the reverse – the developing countries grew much faster during the 'bad old days' of ISI than they have done in the last 20 to 25 years of neo-liberal reform (*tables 1 and 2*).

Is East Asian-style industrial policy valid for developing countries today?

In this post-WWII experience of industrial policy, the East Asian countries stand pre-eminent. While some orthodox economists still try to deny it, most people now accept that active industrial policy played the key role in East Asian economic development, at least up to the 1980s.

As it became increasingly clear that East Asian industrial policy had been a success, the orthodox economists started arguing that, whatever its merits may have been in East Asia up to the 1980s, East Asian-style industrial policy is not applicable to other developing countries today.

Table 1: Per capita GNP growth performance of the developing countries, 1960-1980

	1960-1970 (%)	1970-1980 (%)	1960-1980 (%)
Low-income countries	1.8	1.7	1.8
Sub-Saharan Africa	*1.7*	*0.2*	*1.0*
Asia	*1.8*	*2.0*	*1.9*
Middle-income countries	3.5	3.1	3.3
East Asia and Pacific	*4.9*	*5.7*	*5.3*
Latin America and the Caribbean	*2.9*	*3.2*	*3.1*
Middle East and North Africa	*1.1*	*3.8*	*2.5*
Sub-Saharan Africa	*2.3*	*1.6*	*2.0*
Southern Europe	*5.6*	*3.2*	*4.4*
All developing countries	3.1	2.8	3.0
Industrialised countries	3.9	2.4	3.2

[Source: World Bank (1980), Appendix Table to Part I]

Note: The 1979 and 1980 figures used are not final, but World Bank estimates. Given that the estimates were supposed to be on the optimistic side, the actual growth figures for 1970-1980 and 1960-1980 would have been slightly lower than those reported in this table.

Table 2: Per capita GDP growth rates of the developing countries, 1980-2000

	1980-1990 (%)	1990-2000 (%)	1980-2000 (%)
Developing countries	1.4	2.0	1.7
East Asia and Pacific	*6.4*	*6.0*	*6.2*
Europe and Central Asia	*1.5*	*-1.8*	*-0.2*
Latin America and the Caribbean	*-0.3*	*1.7*	*0.7*
Middle East and North Africa	*-1.1*	*1.2*	*-0.1*
South Asia	*3.5*	*3.7*	*3.6*
Sub-Saharan Africa	*-1.2*	*-0.2*	*-0.7*
Developed countries	2.5	1.7	2.1

[Source: World Bank (2002), table 1 (p. 233) for the population growth figures and table 3 (p. 237) for the GDP growth figures]

Notes: The figures are only approximate, as they were constructed by subtracting the population growth rates from GDP growth rates. This had to be done because the World Bank stopped publishing decade-wise per capita GDP growth rates from its 1998 World Development Report. For country classification, see the table on p.334 of World Bank (2000/1).

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[1] This paper was first presented at the (South African) Department of Trade and Industry's (**the dti**'s) Industrial Policy Seminar in 2005.

[2] Professor Chang is Assistant Director of Development Studies, Faculty of Economics, University of Cambridge and a member of the editorial board of the Cambridge Journal of Economics. Professor Chang has worked as a consultant for numerous international organisations and national governments on development and economic policies. His 2002 book, *Kicking Away the Ladder: Development Strategy in a Historical Perspective*, was awarded the 2003 Myrdal Prize by the European Association for Evolutionary Political Economy.

Table 3: Average tariff rates on manufactured products for selected developed countries in their early stages of development

(Weighted average; in percentages of value)[1]

	1820[2]	1875[2]	1913	1925	1931	1950
Austria[3]	R	15-20	18	16	24	18
Belgium[4]	6-8	9-10	9	15	14	11
Denmark	25-35	15-20	14	10	n.a.	3
France	R	12-15	20	21	30	18
Germany[5]	8-12	4-6	13	20	21	26
Italy	n.a.	8-10	18	22	46	25
Japan[6]	R	5	30	n.a.	n.a.	n.a.
Netherlands[4]	6-8	3-5	4	6	n.a.	11
Russia	R	15-20	84	R	R	R
Spain	R	15-20	41	41	63	n.a.
Sweden	R	3-5	20	16	21	9
Switzerland	8-12	4-6	9	14	19	n.a.
UK	45-55	0	0	5	n.a.	23
US	35-45	40-50	44	37	48	14

[Source: Chang (2002), p. 17, table 2.1, largely based on Bairoch (1993), p. 40, table 3.3]

Notes:

R= Numerous and important restrictions on manufactured imports existed and therefore average tariff rates are not meaningful.

1. World Bank (1991, p. 97, Box table 5.2) provides a similar table, partly drawing on Bairoch's own studies that form the basis of the above table. However, the World Bank figures, although in most cases very similar to Bairoch's figures, are unweighted averages, which are obviously less preferable to weighted average figures that Bairoch provides.

2. These are very approximate rates, and give range of average rates, not extremes.

3. Austria-Hungary before 1925.

4. In 1820, Belgium was united with the Netherlands.

5. The 1820 figure is for Prussia only.

6. Before 1911, Japan was obliged to keep low tariff rates (up to 5%) through a series of 'unequal treaties' with the European countries and the US. The World Bank table cited in note 1 above gives Japan's unweighted average tariff rate for all goods (and not just manufactured goods) for the years 1925, 1930 and 1950 as 13%, 19% and 4%, respectively.

Table 4: Average tariff rates (%) on manufactured products for selected developed countries in the early post-WWII period

	1950	1959	1962	1973	1979
Europe					
Belgium	11	14			
France	18	30			
West Germany	26	7			
Italy	25	18			
Netherlands	11	7			
E.E.C. average[1]		15	13	8	6
Austria	18		20[2]	11	8
Denmark	3				
Finland			20-plus[3]	13	11
Sweden	9		8	6	5
Japan	n.a.		18	10	6
UK	23		16		
US	14		13	12	7

[Sources: 1950 data are from Bairoch (1983, p. 40, table 3.3). 1959 data are from Grubel & Johnson (1967, pp. 766-7, table 1). 1962 data are unweighted averages calculated from the data on 36 2-digit SITC industries in Balassa (1965, p. 580, table 1). The figure for 1960 Austria is from Katzenstein (1985, p. 112). The data for 1973 and 1979 are from the data on the results of the Tokyo Round (1973-79), reported in Greenaway (1983, p. 95, table 5.3).]

Notes:

1. EEC average after 1973 includes Denmark and the UK.

2. 1960.

3. Estimate by the author. The data on Finland's tariff rates are not readily available, but according to the data reported in table 8.2 of Panić (1988, p. 151), in 1965, tariff revenue as a percentage of all imports in Finland was 9.97% – considerably higher than that of Japan (7.55%), which had an 18% average industrial tariff rate, or that of Austria (8.57%), which had a 20% average industrial tariff rate. Given these, it would not be unreasonable to estimate that Finland's average industrial tariff rate in the mid-1960s was well over 20%.

The first variety of this argument is what could be called the 'Do not try this at home' argument. The argument is that East Asian-style industrial policy is too difficult for other countries without the necessary institutions like a competent bureaucracy and therefore is likely to do more harm than good. While it is true that policies need to be calibrated to the capacity of the bureaucracy, the problem with this line of argument is that bureaucratic capabilities are not given but can be built through investment and learning-by-doing.

Another variety of the argument against the adoption of East Asian-style industrial policy in other developing countries today emphasises the recent changes in the global economy. First it is said that nationalistic industrial policies are counter-productive because they will repel foreign investments, which have become vital for economic growth in the new global economy. Second, it is argued that the rules of the global economy have changed (amongst others, World Trade Organisation rules, loan and aid conditionalities, and bilateral and regional agreements on free trade and investment), making many tools of active industrial policies illegal.

But how valid are these arguments?

In arguing that globalisation has made strong industrial policy counter-productive, the orthodox economists are assuming that deregulation leads to greater foreign investment, which then leads to higher growth. However, empirical studies show that it is growth, rather than deregulation, that attracts foreign investment – China and Vietnam are the best examples. Moreover, whether greater foreign investment helps growth or not depends on a number of factors, such as the kind of investment you attract and the kind of economy you are.

Having said that, it is true that the development of the global value chain has opened up new opportunities to develop through closer integration with trans-national corporations (TNCs). However, there is a clear limit to this kind of strategy, as powerfully illustrated by the case of Mexico.

Does the changing global environment spell the end of industrial policy?

How about the changed rules of the global economy, especially the WTO? It is true that under the WTO, rules on the use of tariffs, subsidies and the like have become tighter, but does this mean that developing countries should give up on activist trade (and industrial) policy?

First, it is not as if everything was allowed under the old regime. Secondly, tariff reduction under the WTO does not mean a total abolition of tariffs. Thirdly, infant industry protection is still

allowed (up to eight years). In the fourth place, there is still a provision for 'emergency' tariff increase ('import surcharge') on the grounds of either a sudden surge in sectoral imports or overall Balance of Payments (BoP) problems, for which almost all developing countries qualify. Fifthly, not all subsidies are illegal for everyone. For example, the least developed countries are allowed to use export subsidies, while subsidies for agriculture, regional development, basic research and development, and environment-related technology upgrading are still allowed.

Also, the TRIMS[3] agreement has prohibited certain restrictions on TNCs like local content requirements, but it allows other restrictions such as export requirements. Last but not least, the WTO restrictions only cover 'trade-related' policies, which means that there are many 'domestic' industrial policy measures available.

Of course, the currently available policy space for developing countries is constantly under pressure. There is an ongoing, albeit currently dormant, attempt to restrict foreign investment regulation (the key element in the so-called Singapore issues). If the developed countries have their way in the current NAMA[4] negotiation, average industrial tariffs for the developing countries will come down to between 5% and 15% – a level that is historically unprecedented, with a few exceptions *(see tables 3 and 4)* – and possibly to 0.

However, developing countries are not helpless victims in this but have the power to influence the course of events. If one takes South Africa as an example, its emerging alliance with India, Brazil and Argentina is slowly but surely beginning to change the geometry of international trade negotiations.

Conclusion

The changing global environment has put new restrictions on the conduct of industrial policy. However, this does not mean the end of industrial policy – it only means that countries need to be more creative in policy design and implementation.

There is still considerable room for manoeuvre, and in certain areas such as the global value chain and service outsourcing, new opportunities are opening up. Especially when the developed countries are still using industrial policies under different names, it will be unwise of developing country governments to give up industrial policy.

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[3] Trade-Related Investment Measures

[4] Non-agricultural Market Access

Preference Erosion and Multilateral Trade Liberalisation

Because of a concern that OECD[1] tariff reductions will translate into worsening export performance for least developed countries, trade preferences have proven a stumbling block to developing country support for multilateral liberalisation. In this article, **Joseph Francois**, **Bernard Hoekman** and **Miriam Manchin**[2] examine the actual scope for preference erosion and find that preferences are underutilised due to administrative burden – estimated to be at least 4% on average – reducing the magnitude of erosion costs significantly. They also find that for those products where preferences are used, the primary negative impact follows from erosion of EU preferences, suggesting that the erosion problem is primarily a bilateral concern.

Introduction

Developed countries have long granted non-reciprocal trade preferences to various developing countries. Early in the post-WWII history of the General Agreement on Tariffs and Trade (GATT) system, the pattern of these preferences reflected past colonial trade ties. In 1968, the UN Conference on Trade and Development (UNCTAD) recommended the creation of a Generalised System of Preferences (GSP) under which industrialised countries would grant trade preferences to all developing countries on a non-reciprocal basis. While UNCTAD has addressed a wider spectrum of issues in international economic relations, in the area of international trade its primary goal was to modify the most-favoured nation (MFN) clause underpinning the GATT by (partially) exempting developing countries from this obligation, while at the same time encouraging developed countries to discriminate in favour of imports from developing countries. A key principle was – and is – the idea that such "special and differential treatment" be granted on the basis of "non-reciprocity", reflecting the premise that "treating unequals equally simply exacerbated inequalities" (UNCTAD, 2004).

The jury remains out on whether trade preferences have actually made a substantive difference in terms of enhancing the welfare of recipient countries. The developing countries that were granted the fewest preferences at its inception in the 1960s, those in East Asia, have subsequently grown the fastest. Conversely, those granted the deepest preferences, including sub-Saharan African (SSA) least developed countries (LDCs), have not managed to increase their per capita incomes or diversify their export bundles significantly in the last 40 years. (*see figure 1*). To a large extent both developments – rapid and sustained growth in Asia and the absence thereof in much of Africa – are not due to OECD trade policies, but rather reflect domestic policies and institutions. Most would agree that the major constraint on export diversification and expansion in Africa is on the supply side.

Whatever the intended and actual impacts of trade preferences, they are a central issue in ongoing efforts to negotiate further multilateral trade liberalisation. Middle-income countries are increasingly concerned about the discrimination they confront in OECD markets as a result of the better access granted to other industrialised countries—because of free trade agreements—and to poorer or 'more preferred' developing countries. Conversely, preferences are used as an argument by the LDCs and African countries against a general liberalisation of trade and removal of trade-distorting policies in agriculture. These countries worry about the potential negative effects of an erosion of their preferential access[3].

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[3] They are also concerned about the potential negative terms of trade effects of multilateral liberalisation insofar as this raises the price of their imports, especially of goods that currently benefit from subsidies and protection in OECD markets, by more than the price/quantity of their exports. Both types of fears have been supported by many NGOs, who argue that LDCs have little to gain from the current round of multilateral trade negotiations, and may have more to lose. See Limão (2005) for a theoretical analysis of the incentives for a coalition of preference providers and recipients to seek to limit MFN reforms, and evidence for the EU and US that preferential trade arrangements have a constraining impact on multilateral liberalisation.
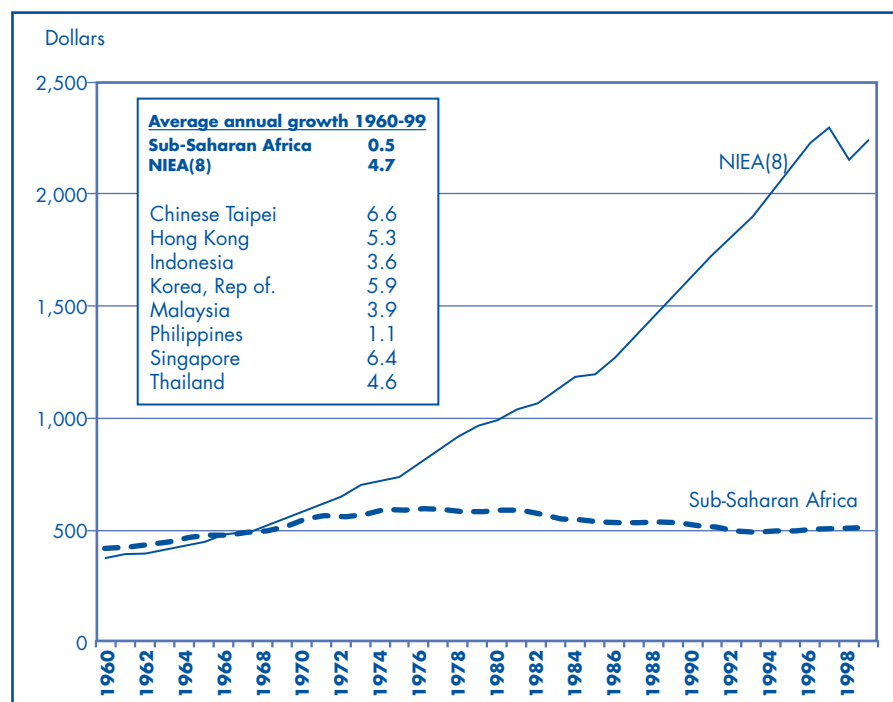
In this article, the economic relevance of trade preferences is explored in the context of WTO-based multilateral liberalisation – the ongoing Doha Round of trade negotiations. This involves both an econometric assessment of the extent to which preference schemes are actually used (*de facto* as opposed to *de jure* preferences), and a numerical assessment of the dollar magnitude of potential preference erosion associated with further WTO-based, non-discriminatory tariff reductions. In this analysis we assume that the principle of non-reciprocity continues to prevail; that is, they model the effects of OECD liberalisation while assuming that the developing countries benefiting from preferential access do not reduce their own protection. Many have argued that non-reciprocity has allowed many developing countries to self-marginalise themselves in GATT/WTO negotiations, as they received market access benefits without having to actually engage in the process of negotiating concessions. Whatever one's views on this question, from the perspective of quantifying the magnitude of potential preference erosion, non-reciprocity is an appropriate constraint to impose, as what matters is to assess the loss of benefits stemming from the removal of an explicit development-motivated policy that has been put in place *by OECD countries.* From this perspective, it is irrelevant that developing countries might also benefit from their own liberalisation or that of other developing countries, or that such potential benefits may be quite substantial.

Reviewing the major existing preference programmes in the GATT/ WTO system

In 1971, the contracting parties to the GATT approved a waiver to the MFN clause to permit GSP scehmes. In 1979 they adopted the so-called 'Enabling Clause', which established the legal framework for the GSP. Although Japan, Canada, Australia and several other countries implemented national GSP programmes in favour of developing countries, the schemes of the EU and the US have been and continue to be the most important, given the size of the two markets concerned.[4]

The first GSP preference scheme of the EU was implemented in 1971 for a 10-year period and has been renewed periodically. The scheme provides non-reciprocal preferences with lower tariffs or completely duty-free access for imports from 178 developing countries and territories into the EU market. GSP preferences are not part of contractual agreements with the recipient countries.[5] The general arrangements cover roughly 7,000 products, of which 3,250 are classified as non-sensitive and 3,750 as

Figure 1: GDP per capita of Sub-Saharan Africa and NIEA(8), 1960-99

(Measured at 1987 prices and exchange rates)

Average annual growth 1960-99	
Sub-Saharan Africa	**0.5**
NIEA(8)	**4.7**
Chinese Taipei	6.6
Hong Kong	5.3
Indonesia	3.6
Korea, Rep of.	5.9
Malaysia	3.9
Philippines	1.1
Singapore	6.4
Thailand	4.6

Note: NIEA(8) (Newly Industrialised Economies in Asia) consist of Chinese Taipei, Hong Kong China, Indonesia, Republic of Korea, Malaysia, Philippines, Singapore and Thailand.

Source: WTO and the World Bank, World Development Indicators 2000.

sensitive products. The tariff preferences offered by the general arrangements differ according to the sensitivity of the products concerned: non-sensitive products enjoy duty-free access to the EU market, while sensitive products benefit from a tariff reduction. These arrangements provide, as a rule, for a reduction of MFN *ad valorem* duties by a flat rate of 3.5 percentage points. These products comprise around 36% of tariff lines (EC Council Regulation No. 2501/01, 10 December 2001). As sensitive products are generally the ones with high MFN rates, the proportionate impact of the preference can be rather small. An important exception to this rule of a flat rate reduction is granted to the textiles and clothing sectors which enjoy a percentage reduction of 20%. For specific duties, a percentage reduction of 30% is the general rule. Where duties include *ad valorem* and specific duties, only the *ad valorem* duties are reduced.

Country eligibility for the EU GSP programme is determined on the basis of 'indices' that combine the development and specialisation level of the country:

$$I = \frac{\ln(Y_i / Y_{EU}) + \ln(X_i / X_{EU})}{2} \qquad (1)$$

where Y_i (Y_{EU}) is the gross domestic product (GDP) per capita in the beneficiary country (EU) and X_i (X_{EU}) is the manufactured exports of the beneficiary country (EU) to the EU (beneficiary country). The index increases in value as the beneficiary country becomes more developed and/or runs a surplus in manufactured goods trade with the EU. It has a value of zero, for example, if the beneficiary country has the same GDP per capita as the EU and has balanced trade. If the country has GDP per capita above US$8,210 and the index has a value greater than -1, it is automatically removed from the GSP programme. South Korea, Singapore and Hong Kong, among others, were removed from the GSP programme on the basis of these criteria.

A second graduation criterion is country/ sector-specific and based on the extent of specialisation – the relationship between the proportion of the imports in a given sector from a given country to the total EU imports in that sector and this country's share of total EU imports. A higher specialisation index indicates that the county's exports to the EU are more concentrated in that category. As a result of this criterion, Brazil, India, China, Argentina and many other countries have lost eligibility for a wide range of product categories.

In 2001, the EU adopted new graduation criteria. All countries designated as high-income by the World Bank lose eligibility for all products automatically. A country can lose sectoral eligibility under two circumstances. First, the country in question has a development index *I* greater than -2 and it supplies more than 25% of EU total imports. Second, the country (i) has a development index *I* larger than -2, (ii) has a sectoral specialisation index higher than a threshold level (depending on the actual development index) and (iii) supplies more than 2% of EU total imports.

The EU GSP programme has a safeguard clause that allows preferences to be suspended for certain products/countries if imports "cause or threaten to cause serious difficulties to a Community producer".[6] The EU has also instituted "special incentive arrangements" that reward compliance with International Labour Organisation (ILO) Conventions, protection of the environment and combating drug production and trafficking. Countries that benefit from these special arrangements receive additional preferences on certain products in the sensitive list. Human rights violations, money laundering, corruption and violation of various international conventions on the environment may result in the withdrawal of preferences.

A special arrangement under the **Everything but Arms** (EBA) initiative, which is incorporated into the GSP preference scheme, is provided for the 49 UN-defined LDCs. The EBA scheme provides duty-free access for all products covered and originating in the beneficiary country, with the exception of imports of fresh bananas, rice, and sugar.[7] Tariffs on these items will be reduced gradually to zero by 2006 for bananas and by 2009 for rice and sugar, with tariff quotas for rice and sugar increased annually during the transition. A key feature of the EBA is that, in contrast to the 'general' GSP, preferences are granted for an unlimited period and are not subject to periodic review.

In addition to the GSP, the EU has another preference programme, limited to African, Caribbean and Pacific (ACP) countries, under what is now the Cotonou convention. This scheme is less generous in terms of duty reduction than the EBA, but in other aspects, such as cumulation rules, it is more generous.

The first agreement between the European Economic Communities (EEC) and the ACP countries dates back to 1963 when the 'Yaoundé Agreements' were signed (which were in effect till 1975). The objective was to foster economic co-operation between the EU and ACP countries, including through development assistance. A significant amount of resources was directed towards francophone Africa to build up infrastructure during the decolonisation period. After the UK joined the EEC, the Lomé I Agreement was signed (in force between 1975 and 1980), covering 46 ACP countries and the EEC Member States. At this time the developing country signatories joined together to form the ACP (in the Georgetown Agreement). The Lomé Agreement introduced trade preferences for most ACP exports to the EEC, including special trade protocols for sugar, bananas, beef and veal.[8] These trade preferences and protocols were extended for further periods under successive Lomé Conventions: Lomé II (1980-1985), Lomé III (1985-1990) and Lomé IV (1990-2000).

After the expiration of Lomé IV, a new Partnership Agreement with the ACP states was signed in Cotonou in 2000. Key objectives included poverty reduction and bringing more stability in the ACP:

> "Focusing on poverty reduction as its principal objective, to be achieved through political dialogue, development aid and closer economic and trade co-operation, this agreement will shape a significant part of the European Union's dealings with the rest of the world."[9]

Cotonou will change the trade relationship between EU and ACP partners. During 2000 to 2007, the prevailing regime with its preferences and protocols on sugar, bananas, beef and veal was to be maintained in a modified form. During this time, non-LDC ACP members were to negotiate economic co-operation agreements under which the one-way EU trade preferences would be replaced by reciprocal market access commitments. These new trade arrangements are to enter into force by 1 January 2008, with the transition to a full implementation of the negotiated agreements to be spread over at least 12 years.

ACP countries are granted preferences that often exceed those available under the GSP. Most industrial products have duty- and quota-free market access, whereas the preferences are less comprehensive for agricultural products. In 2000, duties were still applied to 856 tariff lines (837 of which were agricultural products). Of these, 116 lines were excluded from the Cotonou Agreement. An additional 301 tariff lines were eligible for reduced duties, subject to specific quantitative limits (tariff quotas) set for the ACP countries as a group. The remaining 439 products were eligible for reduced duties without quantitative limits.

Preferences are equally complex in the US, which offers non-reciprocal trade preferences through the GSP as well as through the (amended) Caribbean Basin Initiative (CBI), the Andean Trade Promotion Act (ATPA), and the African Growth and Opportunity Act (AGOA). The US GSP programme was introduced in 1976. It divides eligible countries into two groups based on their income levels – all developing countries and the subset of LDCs. At the time of writing, all eligible countries pay zero tariffs on around 4,650 tariff lines; LDCs have duty-free market access for an additional 1,750 lines. The 1974 Trade Act allows the President to confer GSP eligibility on any country except those that (a) do not offer reasonable and equitable market access for American goods, (b) do not adequately and effectively protect US intellectual property rights, (c) do not reduce trade-distorting investment policies and export practices, (d) harbour international terrorists, (e) nationalise American property without compensation, (f) are members of a commodity export cartel causing "serious disruption to the world economy," or are (g) communist states (except those that have been granted permanent normal trading status). The law stipulates other criteria that may be used in eligibility decisions, such as (a) level of economic development, (b) protection of workers' and human rights and (c) whether the country receives preferences from other countries. Certain articles are prohibited from receiving GSP treatment, including most textiles, watches, footwear, handbags, luggage and certain apparel.

One of the key features of the GSP programme is that a country *may* lose eligibility for a specific product if its exports exceed a certain "competitive need limit" (at the time of writing, $110-million per tariff line). If the country in question has a market share larger than 50% of total US imports in that category, it may also lose GSP eligibility.[10]

GSP eligibility can be removed at the country, product, or country-product level. The President has discretion over when and how to apply these criteria. In practice, an Assistant US Trade Representative chairs an inter-agency committee, which makes eligibility and graduation decisions after reviewing petitions from interested parties (the country in question, import-competing domestic firms, labour unions, other firms, human rights/environmental NGOs, etc.).

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[6] The US programme, in effect, has the same rule in place: any US producer can petition the USTR for GSP privileges to be revoked due to real or potential injury.

[7] For a detailed discussion on the impact of EU preferences for LDCs under EBA, see Brenton (2003).

[8] The banana protocol gives duty-free entry for specific quotas of bananas into the EU market. Under the sugar protocol, the EC annually buys a fixed quantity of sugar from ACP producers at its internal sugar price.

[9] Press release IP/00/640 Brussels, 21 June 2000, "The European Community and its Member States sign a new Partnership Agreement with the African, Caribbean and Pacific states in Cotonou, Benin."

[10] However, there is a *de minimis* waiver. The President has the discretion to waive the Competitive Need Limit if total US imports in that category from all countries (both GSP eligible and ineligible) do not exceed $16.5m (in 2003).

Hudec (1987) concludes that a consequence is that import-competing lobby groups have made GSP a bastion of unregulated protectionism in the US. Since the programme first entered into force in 1976, 36 of the 154 eligible countries have 'graduated' (including Singapore, Hong Kong, Taiwan, Korea, Malaysia, Mexico and Botswana). Countries remaining eligible include Brazil, India, Russia, Indonesia, Turkey, South Africa (SA) and Thailand.

The **AGOA initiative** came into effect in 2000 with the aim to boost US bilateral trade with SSA countries. Currently 37 countries are eligible for preferential treatment under AGOA, which consists of duty- and quota-free access to the US markets for all products covered by GSP, plus 1,800 new items. Furthermore, AGOA entrenches the current preferences available under the GSP by guaranteeing benefits until September 2008. It also eliminates the GSP competitive need limitation for African countries and offers less restrictive rules of origin to eligible African countries, allowing them to import more of their inputs from third countries such as China.[11]

The **ATPA** was enacted in 1991 to combat drug production and trafficking in the Andean countries: Bolivia, Colombia, Ecuador and Peru. The programme offers trade benefits to help these countries to develop and strengthen legitimate industries. ATPA was expanded under the Trade Act of 2002, and is now called the Andean Trade Promotion and Drug Eradication Act. It provides duty-free access to US markets for approximately 5,600 products.

The **CBI** is intended to facilitate the economic development and export diversification of the Caribbean Basin economies. Initially launched in 1983 through the Caribbean Basin Economic Recovery Act (CBERA), and substantially expanded in 2000 through the US-Caribbean Basin Trade Partnership Act (CBTPA), the CBI provides 24 beneficiary countries with duty-free access to the US market for most goods. CBTPA entered into force in 2000 and will be in effect until 2008.

This overview indicates that (i) preference programmes differentiate between developing countries and (ii) that there is significant 'conditionality' associated with eligibility, including in non-trade areas and in terms of criteria that must be satisfied to benefit from preferential access. To assess the magnitude of potential preference erosion associated with further MFN liberalisation, these factors must be taken into account.

Administrative burden and the use of preferences

A key question when evaluating the benefits arising from trade preferences is the costs of obtaining the preferences. When traders request preferences, they have to comply with administrative and technical requirements, the most important of which are related to compliance with rules of origin (RoO). These define the conditions that a product must satisfy to be originating from the exporting country that has been granted the preferential access. The main justification for RoO is to prevent trade deflection, whereby products from non-participating countries destined to the free trade area partner are redirected through the other free trade partners to avoid the payment of customs duties.[12]

When products are produced in a single stage, their origin should be relatively easy to establish. For all other cases, the RoO define the methods by which it can be determined that the product has been sufficiently processed in the free trade partner to qualify for preferential access. The specification of RoO has become especially important in recent years as technological progress and globalisation have led to the increasing fragmentation of the production process into different stages or tasks which are undertaken in different locations. Administration costs reduce effective preference margins.

To assess to what extent preference schemes can deliver gains to the beneficiary countries, we examine the importance of the preference margin on the uptake of preferences.

In an early seminal paper, Herin (1986) argues that the costs of documentation and the administration of origin rules applied by the EEC imposed costs on exporters located in EFTA[13] countries equivalent to some 3% of the value of the goods traded. Carrère and de Melo (2004) provide non-parametric estimates for compliance costs of RoO based on the average rate of tariff preference for NAFTA[14] members. The authors conclude that average total compliance costs for 2001 were 6.2%. When using double-censored tobit estimation techniques, the authors obtain a compliance cost estimate of 3.9% for products where the utilisation rate is below 100%.[15] For developing countries, these costs are expected to be even higher, due to information disadvantages, institutional weaknesses, etc.

The estimating framework

We use a threshold technique to estimate the minimum preference margin (the difference between preferential and non-preferential tariff) needed under which traders have no incentive to ask for preferences because the costs of obtaining these exceed their benefits. We limit the analysis to the preferential trade relations of non-least developed ACP countries and the EU under the Cotonou agreement. Nevertheless, this quantitative assessment can provide a more general proxy for the costs traders from developing countries have to bear when requesting/obtaining preferential access.[16]

Since there may be other factors than preferential margin influencing the decision to ask for preferences, we employ the technique recently developed by Hansen (2000) to endogenously determine any threshold in the relationship of interest, which allows one to control for such other factors. More specifically, this threshold estimation technique is ideal when data need to be split into sub-samples in consideration of some relationship of interest.

$$y_i = \beta_1' x_i + e_i, q_i \leq \gamma \qquad (2)$$

$$y_i = \beta_2' x_i + e_i, q_i > \gamma \qquad (3)$$

In equations (2) and (3), q_i is the threshold variable and γ is the threshold parameter which splits the sample into two sub-samples. In our case, q_i is the difference between preferential and third country tariffs, and γ is the threshold value under which traders have no incentives to request preferences. The threshold parameter can be determined endogenously by allowing the continuously distributed q_i to be an element of x_i. This model allows the regression parameters to differ depending on the value of q_i. The model can be re-written into a single equation.

$$\qquad (4)$$

In equation (4) $\beta = \beta_2$ and $x_i(\gamma) = x_i d_i(\gamma)$, and $d_i(\gamma) = \{q_i \leq \gamma\}$ is a dummy variable. The first step is to identify the threshold value γ and the other coefficients. This is done by using the algorithm provided by Hansen (2000), which searches through the values of γ until the splitting value is found (the value of γ which minimises the concentrated sum of squared errors based on an OLS[17] regression).

Most of the x_i variables included in our threshold regression are typical variables used in gravity models – probably the most robust empirical relationship explaining the volume of

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[11] See further details on AGOA in Brenton and Ikezuki (2004). The African Growth and Opportunity Acceleration Act (AGOA III) extends the general timeframe for AGOA preferences until 2015 and the third-country fabric manufacturing provision for least-developed AGOA beneficiary countries until 2007.

[12] See Brenton and Manchin (2003); more generally on rules of origin, see Hoekman (1993).

[13] European Free Trade Association.

[14] North American Free Trade Agreement.

[15] See also Anson et al (2004).

[16] In the analysis in the "Scope for Preference Erosion" section, we take into account that for a subset of LDCs, AGOA has substantially reduced the costs of RoO.

[17] Ordinary least squares.

bilateral trade flows. To identify the threshold value in the preferential margin we estimate the following equation.

In equation (5), Y_{ijk} is the utilisation rate of Cotonou preferences for product k, in other words, the percentage of country i's imports

$$\ln Y_{ijk} = \alpha + \beta_1 \ln GDP_i + \beta_2 \ln POP_i + \beta_3 \ln GDP_j + \beta_4 \ln POP_j + \beta_5 \ln D_{ij} +$$
$$+ \beta_6 FrenchExcolony + \beta_7 NonFrenchExcolony_{ij} + \beta_7 Freedomindex_j +$$
$$+ \beta_7 SouthAfrica + \beta_{10} dutysmall_k + \beta_{11} dutyhigh_k + \beta_{12} quota_k +$$
$$+ \beta_{13} difference_k + \beta_{14} dutydifference_k + \sum_{ijk} \gamma_{ijk} DUM_{ijk} + e_{ijk}$$

of product k from country j which requested preferential access. The data originate from Eurostat and contain import data at eight-digit level for the year 2001. $Dutydifference_k$ is the difference between MFN and preferential tariffs for product k. This is the variable (q_i) for which we identify a threshold value.

As a proxy for the trading countries' *income* and *size*, the GDP (GDP_i is the level of income in country i) and population (POP_i is the population in country i) of both partner countries are included in the regression. GDP and population data are taken from the World Development Indicators database. D_{ij} is the distance between the partner countries and is a proxy for *trading costs*. Previous empirical results showed that distance had an important negative impact on trade. The further away the trading partners are located from each other the higher the costs will be for transporting the products.

Distance is expected to have a significant and negative impact on preferential trade. The distance data originate from the CEPII distance database and are calculated following the great circle formula, which uses latitudes and longitudes of the capital cities.

To investigate the importance of the quality of economic environment in a given exporting ACP country, an *indicator of economic freedom* was used (*Freedomindex*). The index was obtained from the Freedom House 'Freedom in the World Countries' database,[18] which contains an annual comparative assessment of the state of political rights and civil liberties in 192 countries and 18 related and disputed territories. The lower the index, the more economic freedom the country has. We expect that countries with greater economic freedom are more open and more likely to trade.

To capture *historical linkages* between trading partners, two zero-one type dummy variables were included in the regression. $FrenchExcolony_{ij}$ and $NonFrenchExcolony_{ij}$ take the value of 1 if the exporting country (i) was a colony of France or other partner country (j). Colonial links often reflect not only historical ties but also that the traders of the two partner countries can speak the same language. If a country is an ex-colony of its trading partner, trade between the two countries would probably necessitate lower transaction costs, and thus more trade. A separate dummy is included for non-French ex-colonies and French ex-colonies because we expect that there might be differences in the intensities of the trade links for French ex-colonies.[19]

In many aspects, such as size of the economy or the level of development, SA differs from most of the other countries in our sample. To avoid having specificities of SA drive our results, a dummy taking the value 1 if the exporting country is SA is included in the regressions. DUM_{ijk} is a set of k dummy variables for agriculture, textiles, clothing, footwear, machinery and mineral products.[20]

$Quota_k$ is a dummy which takes the value 1 if the product was eligible for quota preferences and zero otherwise. The dummy for quota is

included in the regression because it is likely that the circumstances for products entering under a preferential quota are different than for products entering without quota preferences (for example, traders using the quota preferences are likely to be better informed). Furthermore, we include a dummy (called *difference*) for agricultural products for which the difference between preferential and MFN tariffs exceeds 30%. These agricultural products benefit from seasonal preferential duty reduction. Since we have yearly data it was not possible to calculate exactly the tariff reduction for these products; we calculated the yearly average tariffs, which might overestimate duty reduction. Although these products only represent 0.8% of all observations, including a dummy for these products avoids that they inflate the threshold estimation.[21]

Estimation results

In employing our threshold estimation, one cut-off value was identified. The 95% confidence interval for the threshold estimates indicates that the threshold obtained is between 48 and 52 percentiles. In terms of tariff difference, it is between 4% and 4.5%.

Figure 2 plots the likelihood ratio sequence for percentiles in the sample ranked by tariff difference, and illustrates the clear break in the sample at this range of tariff differences. Thus, the preferential tariff must be 4 to 4.5 percentage points lower than third country tariffs for traders to request preferences. This confidence interval is plausibly tight, since it has only 341 observations out of 23,685 observations falling within the 48th and 52nd percentiles. To test the robustness of our results, we re-run the threshold regressions,

Figure 2: Likelihood ratio sequence

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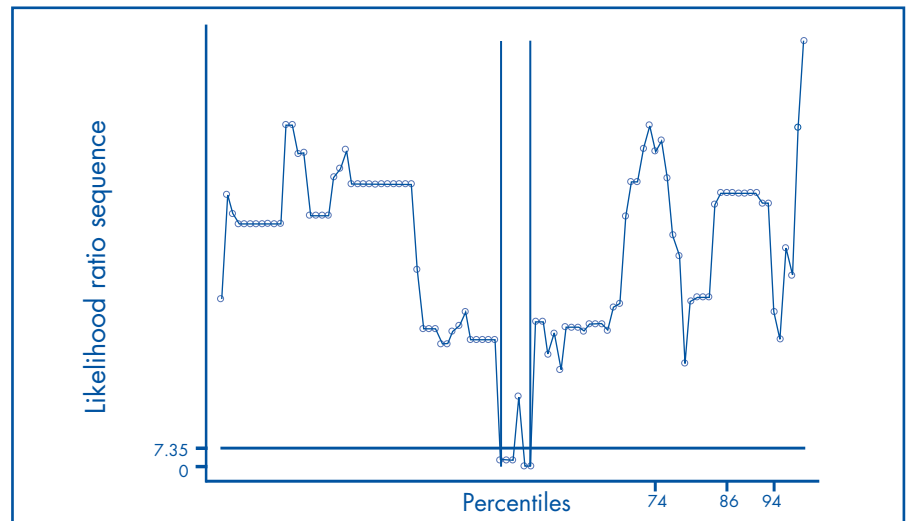
[18] For details on the index see: http://www.freedomhouse.org/research/freeworld/2003/methodology.htm.

[19] Only four countries were not colonies in our sample.

[20] From the 23,685 observations, 9,015 are not covered by any sectoral dummies. These observations belong to sectors such as metals, vehicles, optics, chemicals, plastics, stones and glasses.

[21] The variables *dutysmall* and *dutyhigh* are discussed in the section on "Estimation Results".

Table 1: Results of the endogenous threshold regression

	(1)	(2)
Ldist	0.077	-0.424
	(4.11)**	(6.43)**
lgdp	0.035	
	(12.69)**	
lpop	0.007	
	(2.03)*	
lgdpdecl	-0.215	
	(13.10)**	
lpopdecl	0.279	
	(16.67)**	
freedomindicator	-0.006	
	(2.21)*	
Frenchcolony	0.075	
	(4.14)**	
NONfrenchcolony	0.008	
	(0.92)	
South Africa	-0.316	
	(17.57)**	
DUMagri	0.285	0.331
	(26.87)**	(29.26)**
DUMtext	0.237	0.219
	(13.93)**	(13.04)**
DUMfoot	0.131	0.129
	(5.36)**	(5.35)**
DUMmach	-0.199	-0.163
	(21.56)**	(19.42)**
DUMwood	0.449	0.447
	(22.16)**	(20.05)**
DUMmineral	0.047	0.114
	(0.87)	(2.13)*
DUMcloth	0.243	0.219
	(18.53)**	(16.29)**
dutysmall	-0.455	-0.450
	(1.39)	(1.43)
dutyhigh	0.609	0.479
	(8.46)**	(6.50)**
Hightariff	-0.252	-0.190
	(7.38)**	(4.66)**
Quota		-0.094
		(2.76)**
Country fixed effects		included
LTR	$\chi^2(19)$ =6279.82, Prob>,0.00	$\chi^2(57)$ =9706.34 Prob>,0.00
Psuedo R2	0.2074	0.3209
Log likelihood	-12001.857	-10270.878
Observations	**23684**	**23641**

Notes: Absolute value of z statistics in parenthesis
    * significant at 5%; ** significant at 1%

including country-specific fixed effects instead of the country-specific gravity-type variables. We obtain the same threshold values for this specification as well: the preferential tariff must be lower than the MFN tariff by four percentage points.

To verify that the threshold value identified is correct, a probit regression was undertaken using the identified threshold value. The existence of the threshold implies that the relationship between duty reduction and utilisation rates is constant among sub-sets of products but varies between products. For products for which the duty reduction is small, the utilisation rate might not be significantly influenced by the preferences offered, while higher duty reduction should significantly increase utilisation rates. Thus, if the threshold value is correct, the duty reduction under the threshold should not significantly influence utilisation rate.

Table 1 shows the corresponding results of the probit regression. Two additional variables were included to test if the threshold was correctly identified. The variable *dutysmall* is a dummy variable that takes the value of one if the difference between MFN and preferential duty was smaller than the threshold. Similarly, the dummy variable *dutyhigh* takes the value of 1 if the difference between tariff rates is higher than the threshold. Both the results of equation (2) and (3) confirm the threshold value. The coefficient of the variable measuring duty reduction when it is below 4.5% (*dutysmall*) is negative and insignificant. When the duty reduction is above the threshold (*dutyhigh*), it increases the probability of utilising the preference scheme. These results confirm that the threshold value was correctly identified, in that there is a different relationship between tariff reduction above the threshold and the uptake of preferences.

What does this threshold imply for trade preferences? We continue our focus on EU preferential trade as an example. Table 2 presents, for 2001, EU imports from LDCs. A further breakdown is provided in Tables 3 and 4. The tables provide estimates of the rate of MFN protection that would be applied to LDC exports to the EU, and underlying trade flows, and the share of imports by sector reported as actually entering the EU duty free.

The following points are worth making: For LDCs the most important exports are manufacturing, followed by mining products (which are generally duty-free anyway). This is despite the fact that the highest utilisation of preferences in 2001, as proxied by duty-free-eligible imports, was in agriculture. It is obvious that, in the case of agriculture, rates of protection are generally well above the threshold we have identified.

In addition, it is much easier to prove origin for food (and mining) products.[22] It is therefore in manufacturing that we expect RoO, and related administration burdens, to be harder to overcome.[23]

From Table 4 it is clear that, on average, many EU tariffs in manufacturing are below the threshold we have identified. Yet at the same time, we can also see that there are peak rates that may still make utilisation of preferences worthwhile. Hence, the pattern suggested in Table 4 will be a function of the underlying detailed composition of trade in specific products, and benefits will hinge on the margin of preference at the tariff-line level.[24]

The results presented in this section indicate that there exists a minimum preference margin needed for traders to request preferences. If the difference between preferential and third country tariff rates is less than a certain amount, there are no incentives for traders to request preferences, since the costs of obtaining the preferences are expected to be higher than the benefits from obtaining the preferences. We found this threshold for non-LDC ACP countries in their preferential trade with the EU to be between 4% and 4.5%. Although this figure was found looking at a specific group of developing countries, it provides an approximation of trade costs implied by preferential schemes for other countries as well, as the requirements are similar.

The scope for preference erosion

With the numerical assessment of preference erosion, our goal is to estimate the likely scope for any preference erosion if and when the OECD countries implement further multilateral tariff reductions. This involves the application of a global general equilibrium model, where preferences are included as part of the benchmark data, and where we gauge the impact of OECD tariff reductions on the preference-related gains from trade for the LDCs. We also integrate our assessment of the administration costs in the previous section, to identify how important this is for identifying the overall benefit of preferences, and hence for the impact of preference erosion.

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[22] See Stevens & Kennan (2004). Candau, Fontagné & Jean (2004) find that under-utilisation of preferences is highest in textiles and garments (for EU imports under both the GSP and EBA programmes). In the case of EBA, exporters in principle benefit from 100% duty-free access, but are found to pay up to 6.5% average tariffs.

[23] This is not to say agricultural preferences are not affected by administrative barriers. We would, however, expect these to be related more to prohibitive sanitary and phytosanitary regulations.

[24] Simple regression analysis of the data in Table 3 confirms that the share of duty-free trade, and hence the implicit utilisation of preferences, is indeed significantly, positively correlated with the peak tariff rates in the table.

Table 2: EU imports from the LDCs, 2001

	Total EU15 imports US$'000	Duty free imports US$'000	Sector share of LDC total	Duty free share of sector total	Share subject to specific duties
Agriculture	905,722	611,791	7.6	67.5	14.0
Foresty, Fisheries	258,714	174,782	2.2	67.6	0.0
Mining	3,982,709	3,973,129	33.5	99.8	0.0
Processed foods	1,035,968	32,188	8.7	3.1	4.2
Other manufactures	5,720,632	394,087	48.1	6.9	1.4
Total	**11,903,744**	**5,185,974**	**100.0**	**43.6**	**2.1**

Source: WTO integrated database

Table 3: Composition of EU15 processed food imports from LDCs

	Total EU15 imports US$'000	Free imports (no duty applied) US$'000	Free import share of category total	Share of total processed food imports	EU average rate of protection, all extra-EU trade
Animal products	92	0	0.0	0.0	16.0
Vegetable oils and fats	104,029	26,506	25.5	10.0	37.7
Dairy products	99	0	0.0	0.0	18.4
Processed rice	1,176	0	0.0	0.1	38.6
Sugar	37,818	0	0.0	3.7	36.7
Food products nec	891,547	5,287	0.6	86.1	11.6
Beverages and tobacco	1,208	394	32.6	0.1	20.3
Total	**1,035,968**	**32,188**	**3.1**	**100.0**	**15.2**

Source: WTO integrated database (trade) and GTAP database (protection)

Table 4: Composition of EU15 manufactures imports from LDCs, 2001

	Total EU15 imports US$'000	Free imports (no duty applied) US$'000	Free import share of category	Share of total manu-factures imports	EU MFN tariffs, weighted by LDC trade	Maxi-mum tariff
Textiles	1,838,393	39,012	2.1	32.1	11.5	12.6
Clothing	1,977,100	164	0.0	34.6	12.2	12.6
Leather	325,254	38	0.0	5.7	7.4	17.0
Wood products	104,170	24,665	23.7	1.8	1.7	10.0
Paper products	6,926	2,709	39.1	0.1	1.7	9.8
Petroleum and coal products	27,544	0	0.0	0.5	3.9	4.7
Chemicals, rubber, plastics	84,751	29,399	34.7	1.5	3.7	12.8
Non-metalic minerals	21,430	176	0.8	0.4	9.7	12.0
Iron and steel	6,364	4,218	66.3	0.1	0.7	5.7
Non-ferrous metals	640,473	251,514	39.3	11.2	3.5	10.0
Fabricated metal products	7,671	2,166	28.2	0.1	2.3	8.5
Motor vehicles and parts	3,120	143	4.6	0.1	6.8	22.0
Other transport equipment	587,053	78	0.0	10.3	1.4	15.0
Electrical machinery	16,766	15,003	89.5	0.3	0.6	14.0
Other machinery	41,592	9,546	23.0	0.7	1.6	8.0
Other manufactures	32,025	15,258	47.6	0.6	1.4	9.0
Total	**5,720,632**	**394,087**	**6.9**	**100**	**9.0**	**22.0**

Source: WTO integrated database

The mechanics of erosion

To examine the basic mechanics of preferences, and preference erosion, we start with Figure 3. Here we have an archetype OECD country importing varieties of good X from two suppliers, indicated as S_{LDC} and $S_{non-LDC}$. Trade preferences are represented by a reduction in the tariff applied to imports from the LDC. The result is an increase in exports by the LDC supplier from $X_{LDC,0}$ to $X_{LDC,1}$. The benefit for the LDC exporter is represented by area A. At the same time, there will be a shift in demand away from imports from the non-preferential supplier. This results in a cost represented by area B, which represents the loss in exporter surplus. The magnitude of these costs and benefits depends on underlying supply and demand responsiveness to price changes, as well as the degree of substitution between preferential and non-preferential suppliers. The impact on the importer depends on a mix of effects – terms of trade, trade creation and trade diversion. On net, trade preferences therefore involve a mix of benefits for preferential exporters, costs imposed on third-country exporters, and potential losses for the importer as well (Panagariya, 2000). Basically, trade preferences are a beggar-thy-neighbour type of foreign aid – robbing Peter to pay Paul.[25]

Starting from the picture of preferences in Figure 3, their elimination then involves a reversal of the process shown in the figure. The importer recovers tariff revenue, and potentially realises terms of trade gains. Import demand shifts back to the non-preferential supplier, who recovers the exporter surplus B. The preferential supplier loses exporter surplus gains A.

Preference erosion is a similar process, but one involving the elimination of tariffs on the non-preferential supplier. This is shown in Figure 4. Elimination of the tariff on remaining third country suppliers, given the duty-free access already available for preferential suppliers, means that third country exporters see their exports increase from $X_{non-LDC,1}$ to $X_{non-LDC,2}$. There is a gain in exporter surplus of area E, which may be greater or less than the original loss of exporter surplus resulting from the preferences, area B in Figure 3. The preferential supplier sees a drop in demand for his exports from $D_{LDC,1}$ to $D_{LDC,2}$. This results in a partial, though generally not full, loss of the benefits from the original preference scheme. This is represented by area C, which is shown as being less than area A in Figure 3. The reason the loss is not complete is that preferences include, in part, the benefits relative to the original tariff-ridden equilibrium from a non-discriminatory tariff reduction by the importer. We therefore have preference erosion generally yielding a partial, though not full, loss of the original benefits of the preference scheme. At the same time, third-countries recover some of the costs originally imposed by the preference scheme.

We should add a few caveats to the discussion at his stage. First, to the extent that there is market power on the part of either importers (Francois and Wooton 2005) or the transport and logistics sector (Francois and Wooton 2001), we can expect the benefits of tariff reductions to be captured, at least in part, by those intermediaries with market power rather than the exporters themselves. There is evidence, based on the AGOA preference scheme, that the pass through of preference margins is indeed partial at best.

Olarreaga and Özden (2005) find that the average export price increase for products benefiting from preferences under AGOA was about 6%, whereas the average MFN tariff for these products was some 20%. Thus, on average, exporters received around one-third of the tariff rent. Moreover, poorer and smaller countries tended to obtain lower shares – with estimates ranging from a low of 13% in Malawi to a high of 53% in Mauritius.[26] In addition, based on our analysis in the previous section, we should expect administration costs related to these programmes to also chew up some of the benefits. In the case of market power, the result is a simple redistribution of the benefits of preferences (rents) being transferred to importers. With administration costs, however, the share of the gains that is lost is not redistributed, but is really a deadweight loss. In both cases, the trade effects of preference programmes will be less as well.

A numerical assessment

We now turn to a numerical assessment of the likely magnitudes involved. While there has been a great deal of political weight attached to this issue, this debate has largely been taking place in a vacuum of real information on the costs and benefits involved.

Moreover, the exceptions have focused almost exclusively on the effects of preference erosion on the exports of beneficiary countries.[27] Our assessment uses a global, multi-region general equilibrium model of trade. The model includes
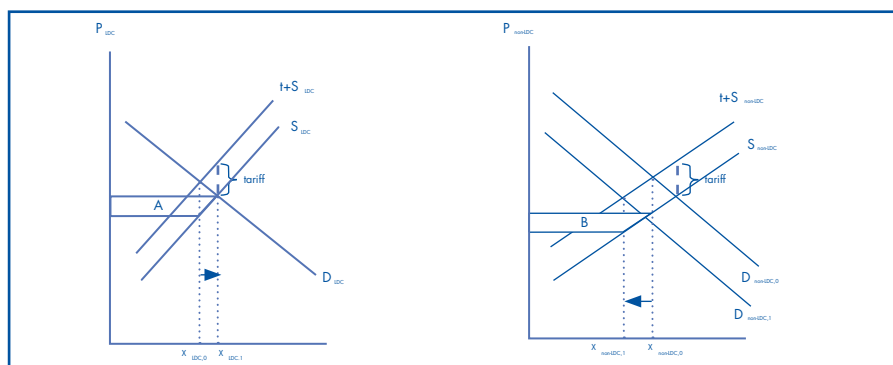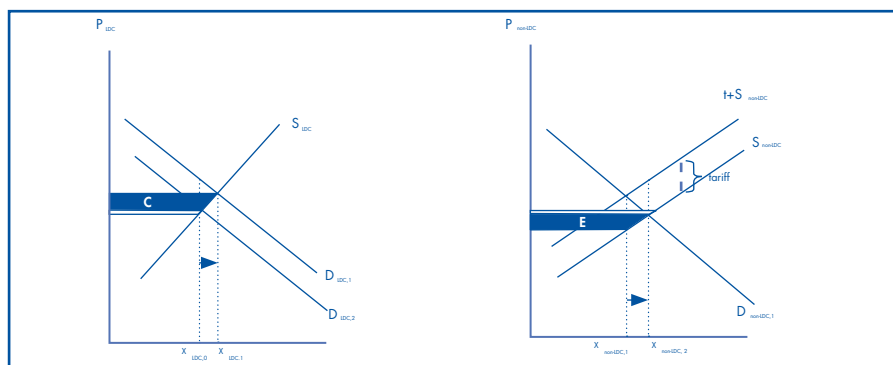
Figure 3

Figure 4

[25] Only if the (more) preferred developing country (countries) is (are) small in the sense of not at all affecting the internal price in the importing nation will there be no detrimental effect on third country competitors. If so, the preference only creates trade (expands imports), to the detriment of local suppliers in the preference granting country, but not to other foreign suppliers, as they continue to confront the same price. See Baldwin and Murray (1977) for an early discussion. Most empirical studies conclude, however, that preference programmes are associated with negative terms of trade effects for excluded (less preferred) countries – there is trade diversion as well as trade creation. Much depends on having good estimates of the elasticities of substitution between foreign and domestic goods and between foreign products of different origin. Early studies assumed these elasticities were identical. General equilibrium studies, including the one undertaken in this paper, by contrast tend to use Armington elasticities. For more discussion, see Brown (1987), Langhammer & Sapir (1987) and the references cited there.

[26] See Ozden and Sharma (2004) for a similar analysis of the CBI programme. Tangermann (2002) also notes that exporters often do not capture all the rents.

[27] See, for example, IMF (2003), Alexandraki & Lankes (2004), Brenton & Ikezuki (2004). Earlier efforts at quantifying the value of preferential access for LDCs such as Ianchovichina et al (2003) did not have access to accurate information on preferences for these countries.

34 regions/countries and 24 sectors (Table 5). The social accounting data come from the GTAP database (www.gtap.org) and are benchmarked to 2001. These data include national production and international trade flows.

The import protection data are based on a thorough and careful effort to include use of preferences in a matrix of global import protection (Bouet *et al.* 2004). These data are the product of a joint effort between the UN International Trade Centre, UNCTAD, the WTO and the Paris-based Centre d'Etudes Prospectives et d'Informations Internationales (CEPII). An important contribution of this project has been an exhaustive coverage of preferential trade arrangements (PTAs) across the world, combined with the calculation of the AVE of specific duties. Combined with differences in the bilateral composition of trade, the result is that protection varies by sector and partner for each importer. These data have in turn been integrated with the GTAP database for 2001. We have modified these data further to assume full utilisation of the 2001 EU EBA initiative, as well as AGOA for those African countries benefiting from more liberal rules of origin, as this has been implemented over a period extending beyond the benchmark year of the original protection data. We have also imposed the elimination of ATC quotas on textiles and clothing on the benchmark, an event which occurred on 1 January 2005. This is of course an important dimension of preference erosion in its own right, insofar as the constraint on the most efficient producers under the ATC implied there was an "implicit" preference for the non- or less-constrained developing country exporters. The impacts of the ATC are assessed in greater detail in Francois, Spinanger & Woertz (2005); we return to the magnitude of the associated erosion in the concluding section.

The model itself is a relatively standard general equilibrium model, with Cobb-Douglas consumer demand over broad categories, and CES-based demand within product categories. For primary sectors, this is Armington-based trade (see the discussion in Francois and Reinert, 1997), while other sectors are modelled as being monopolistically competitive. Scale elasticity estimates are based on Antweiler & Trefler (2002) and Francois (2001).[28] Factor supplies are fixed nationally, and are allocated between sectors through factor markets.

The experiment itself is relatively straightforward. We eliminate, on a multilateral basis, all OECD

Table 5: Country-region and sectoral disaggregation in the model

Basic sectoring scheme

Regions	Sectors
1 EU25	1 Rice
2 Turkey	2 Wheat
3 Russia	3 Other cereals
4 Other Europe	4 Horticulture
5 Middle East	5 Sugar
6 North Africa	6 Meats
7 Botswana	7 Beef
8 Madagascar	8 Dairy
9 Malawi	9 Cotton
10 Mozambique	10 Other agriculture
11 Tanzania	11 Processed foods
12 Uganda	12 Textiles
13 Zambia	13 Clothing
14 South Africa	14 Leather
15 Other SSA	15 Mining
16 Canada	16 Chemicals
17 US	17 Metals
18 Mexico	18 Motor vehicles
19 Centtral America	19 Machinery
20 Caribbean	20 Other industry
21 Argentina	21 Construction
22 Brazil	22 Trade
23 Other South America	23 Transport
24 Japan	24 Business
25 Other high-income Asia	25 Other services
26 China	
27 Vietnam	
28 Other Southeast Asia	
29 Bangladesh	
30 India	
31 Sri Lanka	
32 Other Central Asia	
33 Oceania	
34 Australia & New Zealand	

Sectors 1-10 are Armington sectors (national differentiation).

Others are modelled with firm-level differentiation.

import tariffs on all goods. This includes the ad-valorem equivalents (AVEs) of specific tariffs and tariff-rate quotas, and takes into account the prevailing preference programmes as reported in CEPII. We also conduct a sub-experiment, where we eliminate these tariffs first for the EU alone. This gives us a chance to identify the full magnitude of preference erosion for a sample of least developed and low-income countries (conceptually represented by area C in Figure 3), and also to identify the share of these effects that are due to EU preferences. Finally, we then re-calculate our estimate of EU preference erosion after adjusting for the administrative cost threshold of 4% identified in the previous section. This has a substantial impact on the estimated scope for preference erosion.

Our estimates of the dollar impact of full preference erosion on real national income are shown in Table 6. We have included the impact on the LDCs in SSA, as well as other low-income countries in our sample (using the World Bank classification of countries by income). The tables reveal that EU preferences are very important, as a bilateral measure, for SSA countries. Given the current trade policy landscape, we estimate EU preferences to be potentially worth some $460m annually to African LDCs. Asian countries benefit less, with the exception of Bangladesh ($100m). These are therefore countries that stand to lose – all other things equal – from a move by the EU to lower MFN trade protection. Other developing country groups stand to gain – these are the "less preferred" in the overall hierarchy of preferences.[29] Although we are not convinced that the potential preference rents all actually accrue to the exporting countries (again, see Olarreaga & Özden 2005), our estimates provide a measure of what is at stake.[30]

Our welfare estimates cannot be compared directly to the results obtained in recent partial equilibrium-based analyses such as IMF (2003) and Alexandraki & Lankes (2004) as these focus solely on trade effects. The IMF estimates the potential export revenue loss from preference erosion resulting from a 40% cut in protection by Canada, the EU, Japan and the US at some $530m. This assumes full utilisation of preferences and that developing countries get all of the associated rents. Alexandraki & Lankes (2004), focusing on middle-income countries only, conclude that potential erosion impacts are less than 2% of total exports for the countries that are most "preference dependent".

Limão & Olarreaga (2005) are to our knowledge the only paper to undertake an analysis of the welfare effects of complete preference erosion. They calculate what the income transfer to LDCs would need to be that would be equivalent to the transfer implied by existing preference programmes. They conclude that for LDCs the figure is $266m. This is a one-year, short-run effect; all else equal the net present value is argued to be several times higher. Their results

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[28] See Francois & Roland-Holst (1997) for details. The model is documented in Anderson, Francois & Hoekman and is available for download at www.intereconomics.com/francois.

[29] The income effects are mirrored in the trade effects in Table 4, which reveals that export reductions map to income reductions. This is fully consistent with our earlier discussion centred on Figures 3 and 4.

[30] As discussed further in the concluding section, a case can be made that even if exporters do not get the rents, they *should* get them. In any discussion that focuses on offsetting the loss from preference erosion, one can argue that account should be taken of any 'missing' rents.

Table 6: Income effects of full prefence erosion

	Change in annual national income, US$m		
	Effects of EU MFN trade liberalisation	Effects of other OECD trade liberalisation	Total preference loss
African LDCs	*-458.3*	*347.8*	*-110.5*
Botswana	0.2	16.3	16.4
Madagascar	-7.1	16.9	9.8
Malawi	-22.6	15.6	-7.0
Mozambique	-27.3	13.0	-14.3
Tanzania	4.6	-3.1	1.5
Uganda	-5.9	1.7	-4.3
Zambia	-18.9	-2.4	-21.3
Other SSA LDCs	-381.2	289.9	-91.3
Asia/Other LDCs	*93.4*	*-180.9*	*-87.4*
Bangladesh	-101.0	-37.2	-138.2
Other Central /South Asia LDCs	194.4	-143.6	50.8
Other low-income	*587.4*	*1,463.1*	*2,050.5*
India	174.0	101.8	275.8
Vietnam	413.4	1,361.3	1,774.8
Total	**222.5**	**1,630.1**	**1,852.6**

LDC and low-income classification is based on World Bank designations.

Table 7: Preference erosion with adjustments for compliance costs

	Change in annual national income, US$m			
	Effects of EU MFN trade liberalisation	Effects of EU liberisation, adjusted for compliance costs	Total preference loss, unadjusted	Total preference loss, adjusted
African LDCs	*-458.3*	*-341.5*	*-110.5*	*6.3*
Botswana	0.2	-0.3	16.4	16.0
Madagascar	-7.1	0.1	9.8	17.0
Malawi	-22.6	-18.1	-7.0	-2.5
Mozambique	-27.3	-27.3	-14.3	-14.3
Tanzania	4.6	24.0	1.5	20.9
Uganda	-5.9	0.0	-4.3	1.6
Zambia	-18.9	-18.6	-21.3	-20.9
Other SSA LDCs	-381.2	-301.3	-91.3	-11.4
Asia/Other LDCs	*93.4*	*155.8*	*-87.4*	*-25.1*
Bangladesh	-101.0	-40.0	-138.2	-77.2
Other Central /South Asia LDCs	194.4	195.8	50.8	52.2
Other low-income	*587.4*	*507.3*	*2,050.5*	*1,970.5*
India	174.0	166.1	275.8	267.9
Vietnam	413.4	341.3	1,774.8	1,702.6
Total	**222.5**	**321.6**	**1,852.6**	**1,951.7**

LDC and low-income classification is based on World Bank designations.

Note: Adjustments relate to RoO and other compliance costs for EU preferences.

[31] We can note in passing that this implies that the compliance cost estimate obtained in the "Utilisation of Preferences" section will in fact be higher than 4% on average for manufactures. This also biases upward our calculation of the potential value of erosion.

are in line with ours, assuming away the compliance costs associated with preference programmes (which they do).

If we view the issue of preference erosion in the broader context of potential tariff reduction by all OECD countries, not just EU members, the magnitude of the total losses is reduced. In part this is because the EU has been the most aggressive in using preferences as a tool for development assistance – such programmes in other OECD countries have tended to be subject to greater exceptions (an example has been the non-inclusion of apparel in US GSP programmes). Thus, the gains associated with non-EU MFN tariff reductions will partially offset losses due to EU liberalisation. In the case of SSA, our estimates suggest that overall losses will be reduced by a factor of four – to $110m. In addition, low-income countries in Asia stand to gain a lot from other OECD tariff reductions.

What are the implications of taking into account our threshold estimates of compliance costs? In Table 7 we report a second set of estimates for preference erosion tied to EU preferences. Recall from Table 6 that the EU preferences are the dominant issue at play. The estimates in Table 7 are based on our earlier estimate of the compliance cost for EU trade preferences being some 4% of the value of the goods exported. We eliminate these costs as part of the experiment in Table 7. In other words, we assume that with zero tariffs, the need to enforce RoO becomes moot. Moreover, we make this adjustment for goods that (1) are classified as manufactured goods (reflecting the observation in the literature that utilisation rates are high for non-manufactures in the case of African exports), and (2) offer a potential preference margin of at least four percentage points (Table 4). Another way to view this is that we adjust downward the potential benefit of preferences by the value of the margin, up to four percentage points of the total value of a tariff concession.

We find that the magnitude of preference erosion changes somewhat overall, with the change varying across countries. For Bangladesh, which is specialised in high tariff categories like clothing that are subject to restrictive RoO, the magnitude of potential erosion is cut by half. For Madagascar, potential losses turn into potential gains. The reason for these results is that the compliance costs associated with implementing preference programmes bias upward estimates of the value of preferences.

For countries specialised in agriculture – Malawi and Zambia, for example – the effects of accounting for compliance costs are much smaller due to our assumption, based on other studies (Stevens & Kennan, 2004; Candau *et al*, 2004), that compliance costs are not a big issue.[31] Overall, allowing for compliance costs, we no longer have any real losses for African

LDCs in total, though we do for individual countries. What this says then is that on net, EU preferences do not really offer benefits to African LDCs. To the extent that individual countries benefit, blocking multilateral reductions to maintain these benefits really involves hurting some (neighbouring) countries, with no real net benefits for the region as a whole. It also points to the need for country-by-country analysis and assessments of the potential impacts of preference erosion.[32]

The results from Tables 6 and 7 imply that the magnitude of any transfer needed to offset (or compensate for) the effect of erosion is much smaller in a context where all OECD countries liberalise than in a bilateral EU context. LDCs do stand to lose from tariff reductions in sectors or products where preferences matter. However, they also stand to benefit from improved access to OECD markets; a process that at least partially, and often substantially, offsets the more direct losses on a bilateral basis from erosion of preference margins. We should note that this offset is most likely to be an underestimate, because of the assumption that developing countries themselves do not liberalise.

Independent of the welfare economic implications of this assumption, as noted previously, it is an appropriate constraint to impose given the political economy-cum-negotiating context in which the preference erosion question is placed. The issue at hand is the magnitude of erosion of benefits that stem from removal of an explicit development-motivated policy that has been put in place by OECD countries. From this perspective it is not relevant that there are other sources of offsetting market access and/or terms of trade gains – be it from liberalisation by other developing countries or own liberalisation.

Finally, it is informative to place our estimates in the context of ongoing changes in the trading system. Table 8 compares our estimates of preference erosion to a set of estimates (based on the application of the same basic computational model by Francois, Spinanger & Woerz, 2005), of the impact of the 1 January 2005 elimination of remaining textile and clothing quotas for developing countries. This was the final stage of implementing the 1994 WTO Agreement on Textiles and Clothing (ATC). These restrictions were another form

Table 8: Income effects, MFN liberalisation-based preference erosion and the ATC phase-out

	Change in annual national income, US$m		
	Total preference loss, unadjusted	**Total preference loss, adjusted**	**Total ATC quota elimination**
African LDCs	*-110.5*	*6.3*	*-71.8*
Botswana	16.4	16.0	0.2
Madagascar	9.8	17.0	-7.0
Malawi	-7.0	-2.5	0.0
Mozambique	-14.3	-14.3	-1.7
Tanzania	1.5	20.9	3.2
Uganda	-4.3	1.6	-0.3
Zambia	-21.3	-20.9	1.7
Other SSA LDCs	-91.3	-11.4	-68.0
Asia/Other LDCs	*-87.4*	*-25.1*	*-661.9*
Bangladesh	-138.2	-77.2	-205.1
Other Central /South Asia LDCs	50.8	52.2	-456.8
Other low-income	*2,050.5*	*1,970.5*	*-274.1*
India	275.8	267.9	-478.5
Vietnam	1,774.8	1,702.6	204.4
Total	**1,852.6**	**1,951.7**	**-1,007.9**

Source: Table 7, and Francois, Spinanger & Woerz (2005)

of beggar-thy-neighbour trade preferences, as they (implicitly) favoured smaller, higher-cost developing country suppliers at the expense of exports from China. The reason of course is that by restricting the most competitive suppliers, incentives were created for importers to source from other developing countries. As can be seen in Table 8, for SSA the negative effects of the ATC are significant, although they are smaller than for Asian countries such as India and Vietnam. These losses reflect a combination of greater competition from China and loss of quota rents.

For Africa, the ATC-induced negative impact is smaller than our estimates of the potential magnitude of Doha Round preference erosion if no account is taken of compliance costs. However, if account is taken of compliance costs, the potential trade preference losses are a less important issue than those associated with the lifting of ATC textile and clothing quotas.[33] From a practical perspective this conclusion is bolstered by the fact that the ATC effect is "here

and now," whereas additional Doha Round-based erosion will only occur in the future and thus needs to be discounted appropriately.[34]

As other recent studies of this issue (like the IMF 2003) focus on trade effects, in Table 9 we report on export effects. These map to the income effects reported in Table 8. Again, for some countries like Botswana, Mozambique and Madagascar, there is a significant drop in exports with full preference erosion. However, these preference-based export gains are, in a sense, at the expense of other countries in the region.

Overall, it is clear that the region would benefit overall from MFN-based tariff reductions by the OECD, despite the erosion of preferences.

Concluding remarks

Because of concern that OECD tariff reductions will translate into worsening export performance for the LDCs, trade preferences may be a stumbling block to obtaining broad-based support for deep liberalisation by OECD countries in the Doha Round. In this paper we have examined the magnitude of potential preference erosion, based on an econometric assessment of the actual utilisation of preferences, and the scope for erosion estimated by modelling full elimination of OECD tariffs and hence full erosion.

We find strong evidence that preferences are underutilised due to administrative burdens. This presumably reflects RoO and similar

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[32] IMF (2003) concludes that individual LDCs may suffer more than average due the concentration of their exports in products that enjoy deep preferences. Of the LDCs, Cape Verde, Haiti, Malawi, Mauritania, and São Tomé and Príncipe are found to be the most vulnerable to preference erosion. Alexandraki & Lankes (2004) conclude that six middle-income countries – Belize, Fiji, Guyana, Mauritius, St. Kitts and Nevis and St. Lucia – would also be significantly affected, with predicted export declines ranging from 11.5% for Mauritius to 7.8% for Fiji.

[33] Note that, strictly speaking, this comparison cannot be made as the textiles and clothing erosion MFN estimates assume zero compliance costs. However, as the ATC was based on quotas with associated rents that were equivalent to tariffs well above our threshold value of compliance costs, overall such costs are not likely to have had major effects in relative terms.

[34] As mentioned previously, the ATC effects noted here have been incorporated into the baseline scenario, that is, it is assumed that the associated effects have already played themselves out.

Table 9: Export effects, MFN liberisation-based preference erosion and the ATC phase-out

	Change in exports (%)		
	Total preference loss, unadjusted	Total preference loss, adjusted	Total ATC quota elimination
African LDCs	*3.7*	*4.2*	*-0.1*
Botswana	-4.2	-4.2	-0.2
Madagascar	7.7	11.2	-1.9
Malawi	12.5	16.0	-0.3
Mozambique	-6.0	-7.8	-1.4
Tanzania	2.2	6.3	0.0
Uganda	0.0	1.5	0.0
Zambia	-1.7	-1.6	0.3
Other SSA LDCs	4.4	4.8	-0.1
Asia/Other LDCs	*7.3*	*7.6*	*0.7*
Bangladesh	6.0	10.2	-8.2
Other Central /South Asia LDCs	7.5	7.3	1.8
Other low-income	*6.6*	*6.1*	*1.4*
India	2.5	2.4	1.4
Vietnam	22.9	20.7	1.5
Total	**6.0**	**6.0**	**0.7**

Source: Model estimates, and Francois, Spinanger & Woerz (2005)

hurdles placed in the way of actually using trade preferences. The implication is that the actual value of preferences is reduced quite substantially. In addition, in US dollar terms we find that the primary negative impact of erosion follows from the removal of EU trade barriers. This suggests that the erosion problem is primarily a bilateral, not a WTO-based concern. Indeed, multilateral liberalisation by all OECD countries can serve to reduce the aggregate amount of erosion losses substantially.

What are the policy implications of our analysis?
Preferences can only have an impact if there is a non-zero tariff in the importing market. Two-thirds of the major items Africa exports to Canada, for example, face zero MFN tariffs. 69% of EU imports from Africa (by value) in 2000 were in items facing zero MFN duties (Stevens & Kennan, 2004). Raising trade barriers to increase the value of preferential access would be globally welfare reducing, although it is sometimes suggested. More common is the argument used by vested interests in the OECD that preferred developing countries should not lose any more preferential access to their (highly distorted) markets. The result is the potential for status quo bias reflecting a "bootlegger-Baptist" coalition between protectionist interests and development NGOs in the North and developing country governments in the South.

This would impose a significant opportunity cost from a global efficiency perspective.

One solution would be to agree to compensate developing countries for preference erosion (Page, 2004). Given the systemic downsides, limited benefits and historical inability of many poor countries in Africa and elsewhere to use preferences, a decision to shift away from preferential 'trade as aid' toward more efficient and effective instruments to support poor countries could improve development outcomes and help to strengthen the multilateral trading system (Hoekman, 2004). More effective integration of the poorest countries into the trading system requires instruments aimed at improving the productivity and competitiveness of firms and farmers in these countries.

Supply constraints are the primary factors that have constrained the ability of many African countries to benefit from preferences.[35] This suggests that the main need is to improve trade capacity and facilitate diversification. In part this can be pursued through a shift to more (and more effective) development assistance that targets domestic supply constraints as well as measures to reduce the costs of entering foreign markets.

The additional transfers associated with a decision to compensate countries for lost preferences are not large relative to existing aggregate official development assistance – currently in the US$65-billion range. As noted, the issue is to a large extent a bilateral one, in that most of the prospective loss is generated by MFN liberalisation by the EU. We would argue that the amount needed should be based on our bilateral analysis, as that generates the best measure of the value attached to the preference programme. That is, even though compliance costs are very important determinants of the value of preferences, from a compensation perspective they should be ignored – after all, they imply that recipients are less able to use the programmes.

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[35] Page (2004) and Stevens & Kennan (2004).

SA TRADE @ TIPS A GLANCE

SA Trade Flows to the World

	Q3 2004		Q3 2005		Q2 2005		Q3 2005	
	Rbn	US$bn	Rbn	US$bn	Rbn	US$bn	Rbn	US$bn
Total Exports	72.85	**11.43**	83.56	**12.85**	83.34	**12.99**	83.56	**12.85**
Total Imports	78.69	**12.34**	94.74	**14.58**	89.01	**13.90**	94.74	**14.58**
Trade Balance	-5.84	**-0.91**	-11.19	**-1.73**	-5.67	**-0.91**	-11.19	**-1.73**

SA Trade with the World: Percentage Growth Rate

	Q3 2004 – Q3 2005 (%)	Q2 2005 – Q3 2005 (%)
Total Exports	**14.70**	0.26
Total Imports	**20.41**	6.44

Note: Growth rates have been calculated on the *Rand* values

SA Trade by Region:
Q3 2005 (R-billion)

→ Imports into SA

→ Exports from SA

EU
East Asia
NAFTA
SADC
Middle East
South-East Asia
South America
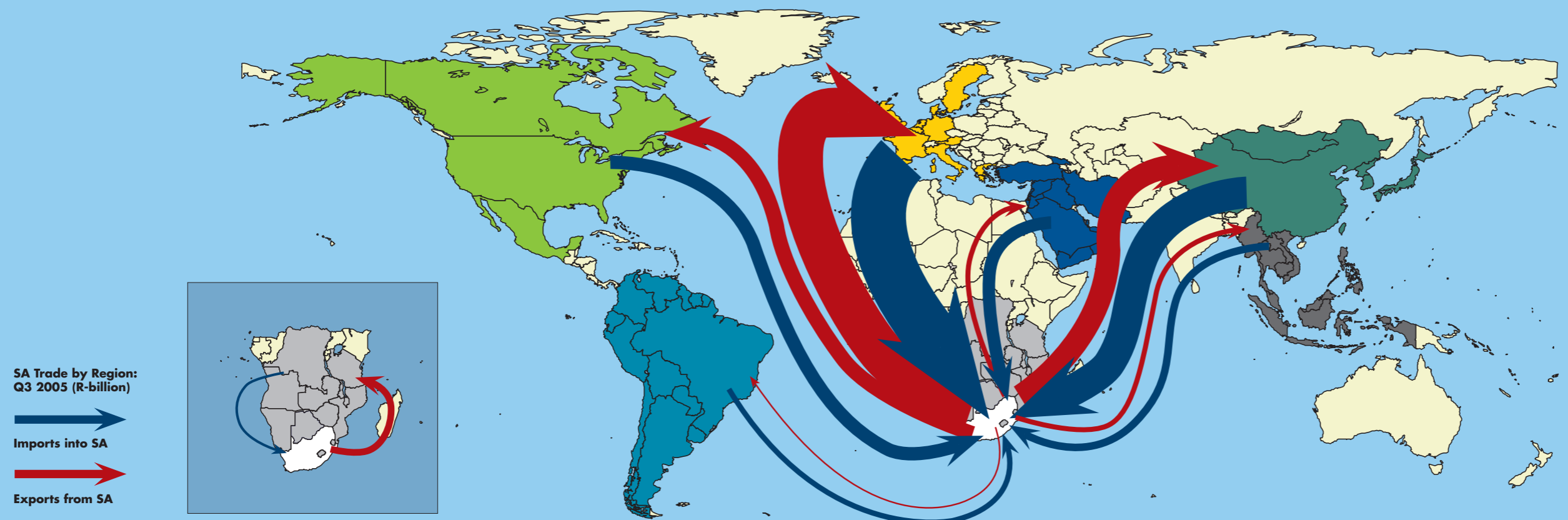
Top Three Non-Mineral Exports from and Imports to SA from Regions (HS4, Q3 2005)

Region	Exports			Imports		
	Products	Value (Rbn)	% Share	Products	Value (Rbn)	% Share
EU	Coal, briquettes, ovoids	3.93	0.16	Original equipment components	4.53	17.79
	Liquid and gas centrifuges	2.26	0.09	Motor vehicles for transport of persons (except buses)	3.66	14.39
	Ferro-alloys	1.57	0.06	Medicaments, therapeutic, prophylactic use	1.12	4.40
East Asia	Motor vehicles for transport of persons (except buses)	2.44	0.17	Original equipment components	2.32	15.46
	Ferro-alloys	1.34	0.10	Motor vehicles for transport of persons (except buses)	1.39	9.30
	Iron ores and concentrates	0.92	0.07	Radio and tv transmitters, television cameras	0.93	6.18
NAFTA	Ferro-alloys	0.58	7.16	Aircraft	0.50	7.66
	Titanium oxides	0.40	4.92	Turbo-jets, turbo-propellers/gas turbine engines	0.29	4.52
	Aluminium plates	0.34	4.19	Original equipment components	0.28	4.30
SADC	Maize	0.29	4.95	Nickel ores and concentrates	0.38	8.04
	Motor vehicles for transport of goods	0.25	4.24	Cotton, not carded or combed	0.10	2.19
	Structures of iron or steel	0.19	3.21	Copper wire	0.10	2.07
Middle East	Coal, briquettes, ovoids	0.58	20.75	Mineral/chemical fertilisers	0.20	2.63
	Citrus fruit, fresh or dried	0.20	7.03	Motor vehicles for transport of persons (except buses)	0.12	1.54
	Hot-rolled products, iron/steel	0.12	4.14	Acyclic hydrocarbons	0.10	1.36
South-East Asia	Hot-rolled products, iron/steel	1.03	35.27	Original equipment components	2.32	15.46
	Chemical wood pulp	0.19	6.62	Motor vehicles for transport of persons (except buses)	1.39	9.30
	Motor vehicles for transport of persons (except buses)	0.16	5.42	Radio and tv transmitters, television cameras	0.93	6.18
South America	Ferro-alloys	0.11	12.48	Original equipment components	0.71	23.85
	Coal, briquettes, ovoids	0.07	7.36	Soya-bean oil, fractions, not chemically modified	0.20	6.75
	Fertiliser	0.05	5.13	Soya-bean oil-cake & other solid residues	0.19	6.25

Note: Share refers to the proportion of total exports/imports from the specified trade partner.

Top 10 Export Markets and Import Sources (Q3 2005), all products

Exports			Imports		
Country	Value (Rbn)	Share (%)	Country	Value (Rbn)	Share (%)
Japan	**9.16**	11.01	Germany	**12.99**	13.72
UK	**8.28**	9.96	China	**8.98**	9.49
US	**7.83**	9.41	US	**7.38**	7.79
Germany	**5.43**	6.52	Japan	**5.80**	6.13
Netherlands	**3.55**	4.26	Saudi Arabia	**5.62**	5.93
Australia	**2.64**	3.18	UK	**4.77**	5.04
Spain	**2.36**	2.83	Iran	**4.00**	4.22
Belgium	**2.08**	2.50	France	**3.19**	3.37
Switzerland	**2.07**	2.49	Italy	**2.51**	2.65
Italy	**2.05**	2.46	Korea	**2.40**	2.54
Total	**45.46**	**54.62**	**Total**	**57.63**	**60.88**

Note: Share refers to the proportion of total exports/imports

SA Trade with the World: Top 10 Products (HS2; Q3 2005)

Products	Total Exports (Rbn)	% of Total Exports	Products	Total Imports (Rbn)	% of Total Imports
Precious metals	**19.78**	23.67	Mineral and fuel oils	**15.53**	16.39
Iron and steel	**9.36**	11.20	Machinery and boilers	**14.31**	15.10
Mineral and fuel oils	**8.60**	10.30	Electrical equipment	**9.32**	9.84
Vehicles	**8.10**	9.70	Vehicles	**9.30**	9.82
Machinery and boilers	**5.83**	6.98	Medical and surgical equipment	**2.86**	3.02
Ores, slag and ash	**3.76**	4.51	Precious metals	**2.38**	2.52
Aluminium	**2.69**	3.22	Plastics	**2.33**	2.46
Citrus fruit	**2.54**	3.04	Pharmaceutical products	**1.98**	2.09
Inorganic chemicals	**1.87**	2.24	Organic chemicals	**1.72**	1.81
Electrical equipment	**1.49**	1.79	Inorganic chemicals	**1.40**	1.48
Total	**64.03**	**76.67**	**Total**	**61.13**	**64.53**

SA Trade by Region (Rbn)

	Q3 2004		Q3 2005		Q2 2005		Q3 2005	
	Exports	Imports	Exports	Imports	Exports	Imports	Exports	Imports
EU	24.30	**31.03**	27.15	**33.47**	27.39	**35.63**	27.15	**33.47**
East Asia	11.90	**14.91**	14.40	**19.36**	15.87	**17.15**	14.40	**19.36**
NAFTA	7.39	**6.81**	8.70	**8.31**	8.47	**7.55**	8.70	**8.31**
SADC	6.19	**1.73**	8.03	**4.81**	7.30	**2.18**	8.03	**4.81**
Middle East	2.50	**6.75**	3.00	**7.66**	2.96	**7.50**	3.00	**7.66**
South-East Asia	2.00	**3.72**	3.03	**4.41**	2.28	**4.07**	3.03	**4.41**
South America	0.70	**2.68**	0.93	**3.22**	0.87	**2.93**	0.93	**3.22**
Rest of Africa	3.03	**2.07**	3.93	**2.32**	3.80	**1.87**	3.93	**2.32**
Rest of the World	14.83	**8.99**	14.39	**11.17**	14.39	**10.14**	14.39	**11.17**

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The IT revolution has allowed techniques that were once the preserve of a handful of leading theoreticians to become part of the practical economist's everyday toolkit. Computable general equilibrium (CGE) modelling is one of a number of approaches to economy-wide analysis that have become accessible and practicable as data- and computer-based techniques have developed. An increasing number of economists use this framework to analyse real-world issues that were previously approached through less appropriate partial equilibrium methods.

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The course integrates theory, real-world data, hands-on computer work and practical applications. Participants will be:
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• Exposed to issues involved in using models for specific applications, such as the analysis of trade, public finance, regulation and environmental economics.

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Is South Africa Kicking Away the Development Ladder?

Neoliberalism in an era of declining American hegemony[1]

The WTO has been extensively criticised as an instrument that allows rich countries to prise open the markets of middle-income and poor countries. However, apart from whether or not developing countries are getting a bad deal, WTO processes appear to be closing the "development space" for such countries – hindering their ability to follow policies that are substantially non-neoliberal – and are therefore "kicking away the development ladder". This article by **David Fryer**, **Nshalati Hlungwane** and **Nicolette Cattaneo**[2] aims to show that not only are WTO processes unfair but also that they are imposing neoliberalism, and as such that the WTO has shifted away from its mandate – the regulation of international trade. It argues that this is particularly evident in current efforts (through the proposed 'investment agreement' and the ratcheting up of the GATS) to use the WTO as a tool for liberalising developing country financial markets.

Introduction

It is a very clever common device that when anyone has attained the summit of greatness, he kicks away the ladder by which he has climbed up, in order to deprive others of the means of climbing up after him… [A]ny nation which by means of protective duties and restrictions… can do nothing wiser than to throw away these ladders of her greatness, to preach to other nations the benefits of free trade, and to declare in penitent tones that she has hitherto wandered in the paths of error, and has now for the first time succeeded in discovering the truth (List, 1966 [1885] in Wade, 2003: 632).

The WTO is the only international organisation dealing with the global rules of trade between nations. Its *raison d'être* is to ensure that trade flows as smoothly, predictably and freely as possible (WTO, 2005: 1). Moreover, it is supposedly tailored to include special 'flexibilities', such as special and differential treatment (SDT) that allow for the 'special needs' of developing countries (Stevens, 2003). Beginning with the Uruguay Round, the WTO has moved beyond the simple trade issues of the GATT to what might collectively be termed the 'new issues'. The GATS and the 'trade-related' issues of TRIPS and TRIMS[3] were introduced in the Uruguay Round. The so-called Singapore issues (investment, competition policy, transparency in government procurement, and 'trade facilitation') are still highly contentious and are not even securely in the negotiating agenda of the current Doha Round (Khor, 2002b).

The WTO has been extensively criticised at two levels. Although these criticisms apply also to the GATT, they are particularly focussed on the 'new issues'. This article focuses mainly on the first set of criticisms.[4]

First, there is the fairness of the process. As Wade (2004: 147) puts it: "Although the agreements are worded to suggest a balance between the rights and obligations of developed and developing countries, closer scrutiny shows that, for the advanced capitalist world, their rights are enforceable but their obligations are more open ended; while for developing countries, the opposite holds." There is significant evidence that WTO processes are skewed towards the business interests of rich countries, that the rich countries have not reciprocally liberalised, and that flexibilities are 'illusory' given the actual modalities of the WTO. Thus the WTO – and particularly the new issues – is to a significant extent an instrument allowing rich countries to prise open the markets of middle-income and poor countries.

The second critique is that the 'new issues'

… list virtually all the industrial and technology policies used by East Asian governments to nurture indigenous firms and industries, and then declare the vast majority of them illegal (2004: 147-8).

Quite apart from whether or not developing countries are getting a bad deal, WTO processes appear to be closing what Wade (2003) calls "development space", and therefore to be "kicking away the development ladder". This highlights an important area of ambiguity in criticisms of the WTO. On the one hand, there is the notion that rich countries are using the WTO to further what such countries believe to be their interests, regardless of the effect this has on developing countries. On the other hand, there is the notion that the WTO is being used to impose a particular ideology (neoliberalism). While it is clear that neoliberal rhetoric is often used to disguise what is straightforward interest politics, it is also clear that the neoliberal agenda commands considerable support as a developmental policy.

The extent to which the critiques of the fairness of WTO processes 'matter' depends on the significance of this development space. Many would argue that even if it is palpably inequitable, the WTO, by assisting (or even forcing) developing countries to liberalise their economies, is an important adjunct to the only viable path to development. Indeed, *closing* this 'development space' (that is, the ability of developing countries to follow policies that are substantially non-neoliberal) is, in this view, perhaps as important as any reciprocal benefits that might flow in terms of disciplining rich countries and opening up their markets.

This view depends on what is argued to be an uncritical acceptance of the notion that 'neoliberalism' is the only viable route to development. However, generalisations that can be drawn both from 'theory' (orthodox *and* heterodox) and from history (development history and the current trajectory of the world economy) strongly support the notion that the closing of development space is indeed a 'kicking away' of the development ladder. Indeed, there is strong evidence that the primary impetus of 'neoliberalism' – the liberalisation of *financial* markets rather than of trade

– is associated with financial fragility and co-ordination failures, and as such is not even in the long-term interests of rich countries. This article does not dispute the notion that the expansion and regularisation of *trade* is generally welfare enhancing, and thus that the WTO has a vital role to play in the world economy. However, the expansion of trade is not the same thing as 'deregulation'. Indeed, it appears that the key factor underlying economic success is the regulation of financial markets.

This article aims to show that the WTO is becoming an instrument for the imposition of this neoliberalism, and as such has shifted away from its mandate, which is the *regulation* of international trade. It also attempts to show that not only are WTO processes unfair but also that they are imposing neoliberalism, and that this is particularly evident in current efforts (through the proposed 'investment agreement' and the ratcheting up of the GATS) to use the WTO as a tool for liberalising developing country financial markets.

The attractions of neoliberalism

Ideas, knowledge, art, hospitality, travel – these are things which should of their nature be international. But let goods be homespun whenever it is reasonably and conveniently possible; and above all, let finance be primarily national." But we now have in place a powerful phalanx of international organizations and multinational corporations devoted to maximizing the freedom of financial capital around the world. The question is what institutional muscle can be brought to bear by those convinced that such untrammelled freedom is even more dangerous for human welfare today than it has been in the past (Wade and Veneroso, 1997: 22, quoting Keynes, 1933: 237).

For the purpose of this discussion it is useful to consider neoliberalism at two levels. It can be defined as a concrete historical entity, namely the ideology and the set of international constraints and incentives set up by Wade and Veneroso's "powerful phalanx". Secondly, neoliberalism can be defined in relation to other epistemologies. It is more or less diametrically opposed to the Keynesian formula expressed in the quotation. Neoliberalism is associated with free capital markets, somewhat 'free' trade in goods, but not very free movement of labour and ideas internationally. There is clear evidence that the WTO is becoming increasingly 'neoliberal' in this sense (*see Box 1*).

Neoliberalism is evidently different to other kinds of 'liberalism' in subtle ways. Classical liberalism (see Ashford & Davies, 1991) posits a much more encompassing economic freedom (the general idea of neoliberalism is laissez-faire sans laissez-passer). What might be called 'social liberalism' (epitomised in practice by the Scandinavian social democracies, and on paper by the constitutions of many countries, including SA) encompasses a freedom that includes a wider set of 'rights' (including statements of basic rights and minimum economic rights) than is found in neoliberalism or classical liberalism.

Most commentators would agree that SA has moved towards, and even embraced, a 'neoliberal' strategy, whether neoliberalism is defined as a particular epistemology or as an association with a particular set of historical institutions. An indicator of the former is SA's movement away from the essentially social democratic Reconstruction and Development Programme (RDP) policy framework towards Growth, Employment and Redistribution (GEAR) (Streak & Van der Westhuizen, 2004; McKinley, 2003; Taylor & Vale, 2000; and Marais, 1997). An indicator that SA is on good terms with the "powerful phalanx" is that it is regarded as belonging to a group called the 'friends of the WTO' (*see Box 2*).

The rationale for accepting a neoliberal strategy is twofold.

First, there is a positive rationale. Economic liberalisation is argued to increase 'transparency' and policy predictability, to reduce the overall cost structure (particularly by lowering the cost of capital and 'disciplining' monopoly elements in labour and product markets), and to improve the allocation of resources (by reducing 'distortions').

Perhaps the central issue is that SA has a low savings rate, implying that development depends on the attraction of capital from overseas. This suggests not only that the capital account of the BoP must be substantially open, but also that SA must adopt the broader policy platform that attracts foreign capital. This platform, it is argued, is neoliberalism.

Furthermore, neoliberal policies do seem to be bearing fruit, in terms of the general soundness of the economy and growth. That they have not yet delivered improvement in terms of employment and redistribution, and indeed may be associated with a poorer set of socio-economic rights, is a matter of concern. However, it is taken that growth will eventually trickle down and translate to better equity outcomes.

Secondly, there is a powerful negative rationale. Taylor & Vale (2000: 400) call it the "there is no alternative" hypothesis. The prospects under neoliberalism seem bleak and uncertain, particularly for the poor. SA has dramatically poor employment, equality, human development indicators and crime statistics *(see Box 3)*, and it is hard to see how neoliberal policies will achieve the growth goals, let alone the equity goals set out in the New Partnership for Africa's Development (NEPAD) and the Millennium Development Goals (see, for example, Sanders & Meeus, 2002).

However, even an admission that there is little chance of rapid growth (let alone rapid trickle down) does not mean that alternative development approaches should not be attempted. There is a strong perception that no other development model seems viable in the long term for countries like SA. Since the Asian financial crisis, the experiences of the Newly Industrialised Countries (NICs) seem to have fallen off the agenda.

'Rich' non-neoliberal exemplars (Sweden, Germany and Japan) are perceived to be faltering, either shedding their heteronymous elements, or paying the price for not doing so.

BOX 1: Neoliberalism and the WTO

Apart from its failure to eliminate subsidies and quotas in agriculture and to eliminate important industrial tariff peaks, and the thrust to liberalise capital markets (which is the main focus of this study), the ethos of restrictions on the movement of ideas and people is clearly evident. TRIPS has been used aggressively to protect developed country patents and copy-rights, even when there is a clear developmental or humanitarian justification.

Even if developed countries are pressured into making humanitarian concessions (as with HIV/Aids drug patents), there seems little chance of development concessions (see Wade, 2003: 626). Although Mode 4 of GATS deals with the international movement of 'natural persons', the neoliberal ethos of restricted movement of people is captured by what Kwa (2005) calls the "completely defensive" attitude of the EU and US towards any liberalisation in this mode. Examples are requests by African countries for more transparent visa requirements, and clarification of the use of economic needs tests (ENTs).


BOX 2: SA and neoliberalism

When it was preparing for Seattle in 1999, SA stood with other developing countries in their resistance towards the round of negotiations because they were still struggling to cope with the outcomes of the Uruguay Round of negotiations. However, SA shifted towards an approach explicitly preparing for a multi-sectoral new round. This was a result of a change in the policy framework within which the key SA economic ministries were functioning (Keet, 2002: 7). See also Kwa (2003) for the important role that Minister Alec Erwin playing in bringing developing countries to accept the 2001 Doha Declaration.

SA ranks very near the bottom of the world list in terms of its unemployment rate and Gini coefficient. It also compares unfavourably (although it is somewhat less of an outlier) in terms of employment as a share of the working age population (15-64). Most surveys show this to be about 40% in SA. Using data given in CIA (2005), SA's employment rate is 43%, compared to an average of 53% for countries with GDP/capita of between US$11,100 (SA's value) and $3,000. For rich countries (with GDP/capita over US$19,000) the average is 68%.

However, where SA really stands out is in health indicators. The only countries with GDP/capita over $3,000 with worse infant mortality rates or life expectancy than SA are its neighbours. As a consequence, SA's Human Development Index ranking is dramatically lower than its GDP/capita ranking. SA is roughly two-thirds down the HDI list, and one-third down the GDP/capita list. Costa Rica and Chile, which were both essentially developing country social democracies before 1973 (Cypher, 2004; DGAP, 1995), have HDIs of about 0.85, whereas SA, which has a slightly higher GDP/capita, has an HDI of 0.65 (see Figure 1). Cuba, which has a GDP/capita of $3,000, has an HDI of over 80. Cuba has virtually identical life expectancy, and lower reported child mortality, than the US.

Figure 1: Human development outliers: lower middle-income countries (2004)
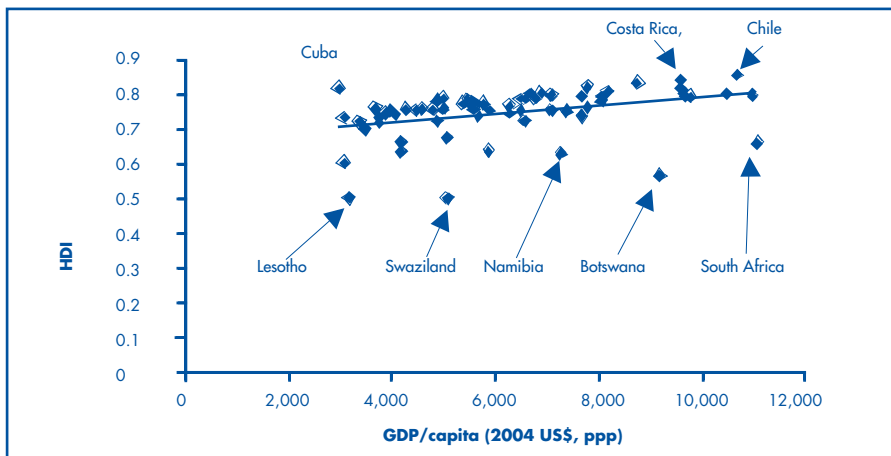
Source: CIA, 2005, UNCTAD, 2005

Figure 2: The waning of alternatives? Convergence^a with (and divergence from) the US
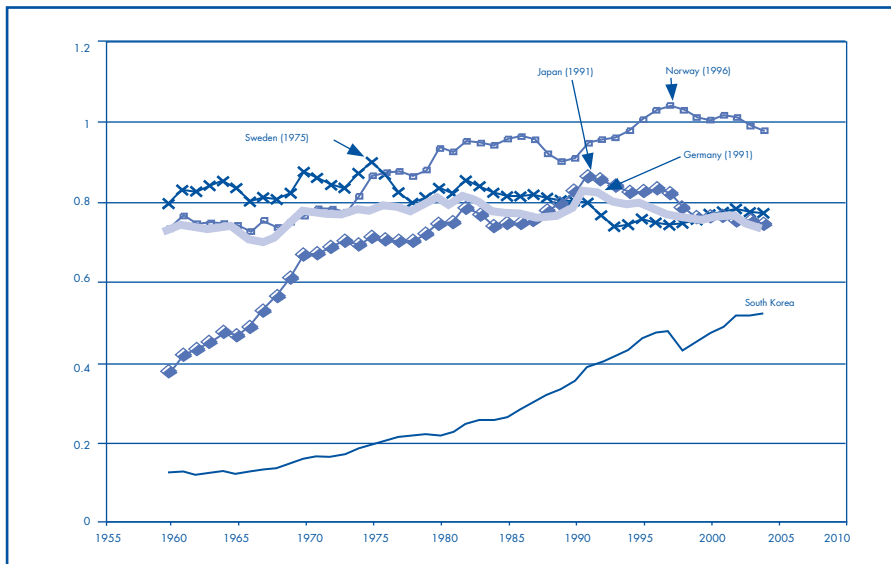
Source: Calculated from BLS (2005).

Note: a) 'Convergence' is measured as GDP/capita (ppp) as a share of US GDP/capita.

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[5] 'Plurilateral' agreements are those which countries theoretically have the right to remain outside.

[6] For example, Articles XXII and XXIII of the GATS provide for dispute resolution. A member that considers another member to have violated its GATS commitments first requests 'consultation' with the other member. If this does not result in satisfaction, the matter is referred to a panel, which then provides a binding ruling. The penalty for a member that fails to abide by such a ruling within the specified period, or to negotiate other concessions with the complainant, is the suspension of 'equivalent commitments'. "In principle, sanctions should be imposed within the sector concerned. If this is not practical or not effective, a different sector under the same agreement may be chosen. As a last resort, action may also be taken under another Agreement" (WTO, Chapter 4).

Indeed, the timing in Figure 2 seems remarkably suggestive: Sweden stopped converging with the US in 1975 (just when the US began to shed its 'New Deal' institutions) and Germany and Japan stopped converging in 1991, just before the 'new economy' surge. More radical ideas about development ('socialism' and 'communism') are no longer even seriously debated in the key international circles that influence policy. In general, there is a sense that all of these alternatives were not really that different, or that they have had their day.

In SA, therefore, there is a wide perception that the taming of 'Leftist tendencies' (and more generally, the ruling out of 'alternative' ideas of development) is an important precondition for any chance of success in a 'globalising' economy. Indeed, a common theme in orthodox diagnoses of SA's poor performance (particularly in terms of labour market inclusivity) is in terms of the residual but stubborn power of the Left. Unions, labour market policy influenced strongly by union pressure (minimum wages, the Bargaining Council and Industrial Conciliation systems) and an 'inappropriate' social democratic model, have, in this argument, retarded SA's ability to adjust to a 'competitive' position, to break into export markets and to attract substantial foreign direct investment (FDI).

The WTO: GATS, modalities and other shenanigans

> These numbers are not even being taken seriously by the EC itself. When questioned on 28 October in the Council for Trade in Services by other Members, it emerges that whilst the EC wants [other countries] to open up the stipulated number of sub-sectors, for itself, the 25 EC members would jointly make up the 139 sub-sectors (as opposed to each country opening up 139 sub-sectors!). As one delegate puts it, the EC will give itself special and differential treatment! (Kwa, 2005).

The WTO is a supposedly a 'rules-based' organisation which is based on the principles of 'flexibility' and voluntary but binding contracts, negotiated at multilateral, bilateral, regional and 'plurilateral' levels.[5] As such, it is supposed to allow a country or group of countries to embark on a course of reform which is sensitive to those countries' level of development (through the 'flexibilities' in the system), but which does not encroach on the rights of other countries, and is backed by a credible assurance that it is not taking this course unilaterally.[6] In other words, the gradual development of the WTO system (with its flexibilities and binding commitments) is seen as the route to a co-operative and mutually beneficial equilibrium, with a set of institutions that rules out individual countries playing the

'dominant strategy' of 'beggar thy neighbour'. The 'new issues' are in this regard an obvious and important extension to the GATT, because they extend the logic of solving collective action problems to 'trade-related' domestic issues (such as subsidies and constraints on capital flows), which could otherwise spoil the process.
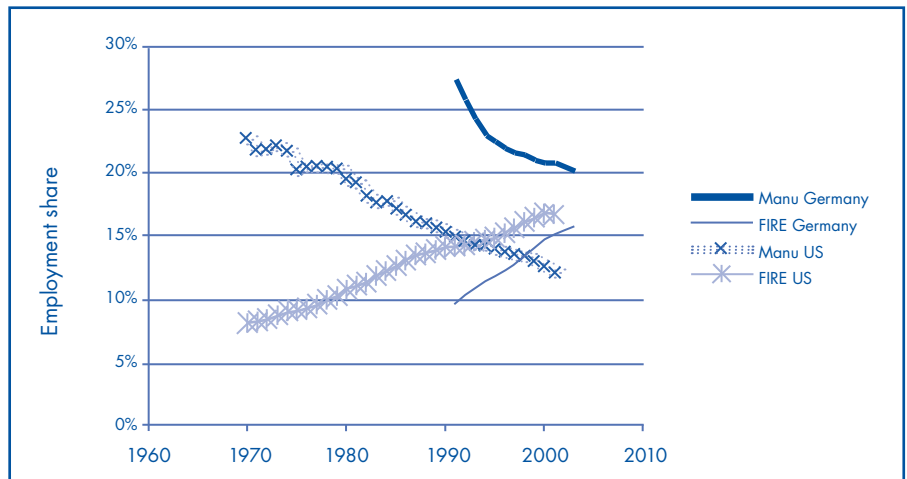
It is important to note that the WTO is not a forum for *deregulation*. On the contrary, it is a forum that seeks to avoid anarchy by making, enforcing and *rationalising* regulation. However, as suggested earlier, the two most significant critiques of the WTO revolve around the extent to which it has become an *instrument* for imposing neoliberal policies, rather than a balanced and ideologically neutral forum for making consensual rules. The first critique is in terms of the WTO processes that have brought about this situation; the second (not discussed further in this article) is in terms of the economic consequences of neoliberalism.

The first critique, that of the fairness of WTO *processes* rather than substantive outcomes, can be organised around two points – the questions of *enforcement* of existing rules and agreements, and the process by which these rules and agreement come into being and evolve. There are obvious problems with the interpretation and enforcement of WTO rules. However, the key point is that this Lockean view of contract, by which autonomous and 'intelligent' agents willingly submit to rules which solve collective action problems, is not approximated at the WTO.[7]

The WTO does appear to offer a tightening up of enforcement in a fairly straightforward fashion through the Dispute Resolution Mechanisms (DRMs), and through the closing of loopholes that existed under earlier GATT rounds. However, although there have been cases of developed countries being disciplined by the DRM (BBC, 2004), the majority of cases has been brought by developed countries.

> The WTO appears to be a more litigious forum than was the GATT. All sorts of policies that had been in existence for years have been placed

in the WTO's dispute settlement spotlight. And the proportion of cases brought by industrial against developing countries has increased: a review of cases brought between 1995 and 2000 found a threefold increase compared with the GATT period in the proportion of cases that were brought by industrialised countries against developing ones (Stevens, 2003: 6).

Figure 3: Structural changes in the US and Germany

Source: Calculated from OECD (2003), total employment by sector, numbers engaged.

Table 1: Employment and GDP composition (%) for four middle-income countries, China and South Korea, 2004

	Agriculture	Industry	Services	Total
Share of GDP				
Korea	3	40	57	100
South Africa	4	31	65	100
Chile	6	38	56	100
Thailand	9	44	47	100
Brazil	10	39	51	100
China	14	53	33	100
Share of employment				
Korea	8	19	73	100
South Africa	30	25	45	100
Chile	14	23	63	100
Thailand	49	14	37	100
Brazil	20	14	66	100
China	42	22	29	100

Source: CIA (2005)

The issues associated with the non-compliance of developed countries to WTO agreements (particularly in agriculture) have received the lion's share of attention and are clearly very important to the LDCs. Agriculture typically accounts for 70% of employment in poor African countries, and the 30 OECD countries spend about $235bn to support their agricultural producers and only about $60bn on aid[8] (Moss & Bannon, 2004: 53).

The irony is that these 'sensitive sectors' like agriculture and low value-added manufacturing account for a tiny share of value added and employment in OECD economies. As Figure 3 shows, manufacturing as a whole makes up a relatively small and rapidly declining share of employment in Germany and the US. It has been exceeded by the rapidly growing FIRE (finance, insurance, real estate and rental, and business) services sectors in the US in employment terms, and in both Germany and US in value-added terms.[9]

In middle-income countries, agriculture may be important in absorbing low-skilled labour. However, it is far less important than

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[7] The general idea is that a just law is "that confinement which hedges us in only from bogs and precipices… For law, in its proper notion, is not so much the limitation as the direction of a free and intelligent agent to his proper interest…" (Locke, 1690: 143).

[8] Worse, USAID has a policy of delivering aid 'in kind', and particularly in the form of food bundles. By law, food for aid must be grown in the US and must be shipped on US-registered vessels. Moreover, more than half of food aid is purchased from four companies. Attempts by the Bush administration to rationalise the system (purchasing food in developing and recipient countries where possible) have been resisted by the 'iron triangle' – the NGOs that distribute aid, agri-business and the shippers (Dugger, 2005). The impression that it is big business rather than 'American farmers' who primarily benefit from protection is mirrored in the case of the EU (Oxfam, 2005).

[9] For example, by 2001, the textile and clothing sectors accounted for less than 1.5% of total US value added, and agriculture less than 0.5% (OECD, 2003). Services accounted for 77%. Apart from the FIRE sectors (which grew from 17% to 31% of total value added), the share of the other broad service sectors (which are much less skill intensive, and have much higher shares of total employment) was virtually unchanged between 1970 and 2001. The shares of Trade (18%) and Transport, Storage & Communication (7%) were unchanged, and Community & Personal Services (22%) were all within one percentage point of their 1970 levels. Although the OECD database does not include series from 1970 for Germany, the pattern in 2001 is virtually identical to that in the US, except that 'Trade' comprises just under 12% of value added.

[10] See Kaplinski (2005) and Goldstein & Lardy (2005).

manufacturing (and manufacturing employment is declining even in China)[10] and particularly, services. Table 1 provides a very rough indicator of this pattern for four middle-income countries with approximately the same GDP/capita as SA, and for South Korea and China, which have GDP/capita about double and about half that of SA respectively.

Apart from their rising importance in both developing and developed country economies, services are becoming increasingly important in trade (Maurer & Chauvet, 2002), particularly given the broad definition of trade in the GATS. According to Wade (2003: 268), half of all FDI is into service sectors. As countries strive to gain advantage in 'services' and other emerging areas such as 'hi-tech', these battles are likely to be waged through the WTO. As Robertson & Dale (2003: 23) put it:

> The particular modality of the GATS was shaped by the strengthening view within the US from the late 1970s onward that it needed to overcome barriers to its international competitiveness presented by national regulatory environments. At the same time the US' assessment of its comparative advantage, recognising the strength of the newly industrialising countries in labour intensive industries and the domination of Germany and Japan in industrial products, saw it as lying in its knowledge-based industries and services. However, its capacity

to expand in this arena was blocked by domestic regulatory regimes. The inclusion of the GATS represents the ascendancy of a new group of service industries and multinational corporations over more traditional groups of producers within the US.

There are signs, particularly in GATS and the Singapore issues, that these 'ascendant interests' will come to dominate the WTO.

What is important to mention here is that the processes revealed by GATS are a very good example of emerging WTO processes in general, in the sense that they reflect the pressures and dominant interests in the world economy. Thus, *part* of the reason that the bulk of WTO litigation is brought by developed countries is that they can devote more resources to litigation (and sustain disputes for protracted periods). However, just as important is that developed countries have, in fact, given so little away that there is relatively little to be enforced (*see box 4*). The key point, as suggested above, is that the distinction between 'enforcement' and the evolution of rules and agreements (which are supposedly arrived at by the power-free process of 'consensus') is becoming blurred.

As defined in the original GATS agreement, GATS is a model of flexibility, which works on the 'positive list' system. Members submit such a list, and inscribe both 'horizontal' concessions (across all sectors) and 'vertical' concessions (in specific sectors). In terms of the

Uruguay Round agreement, countries are free to choose which sectors to include in their list, and even with 'listed' sectors they can include a list of 'exemptions'. Moreover, Articles IV and XI of the GATS contain provision (albeit vague) for differential treatment, with the former supposedly making provision for more rapid liberalisation by rich countries in sectors that will benefit developing countries, and the latter allowing developing countries not to liberalise in areas not yet able to stand competition (Khor, 2002: 28).

However, in an important sense the particular modality of GATS (and other 'flexible' mechanisms such as bilateral and plurilateral agreements) can be thought of as the thin edge of the wedge. The 'positive list' approach was mandated,

> … only because the developing countries did not want a GATS agreement in the first place… [B]y allowing such an agreement, [developing countries] had made a huge concession (Kwa, 2005).

As Kwa suggests, developing countries were pressurised into accepting a bad deal, with illusory benefits and hidden costs. Moreover, it appears that developed countries had pushed for a far less flexible 'formula'-based approach, and subsequent events suggest that this is still their aim.

In terms of the Uruguay Round Agreement itself, and the lists that countries have submitted, several points should be highlighted. First, sectors placed on the 'list' are subject to the core WTO principles of market access and national treatment, unless exemptions are specifically inscribed in the list.[12] This means that, in sectors listed, the innocuous positive list is in fact a *negative* list, whereby anything not on the list is assumed to be fully liberalised. Countries (like SA) are finding that they are

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[11] When making a commitment, a government therefore binds the specified level of market access and national treatment and undertakes not to impose any new measures that would restrict entry into the market or the operation of the service. Specific commitments thus have an effect similar to a tariff binding – they are a guarantee to economic operators in other countries that the conditions of entry and operation in the market will not be changed to their disadvantage. Commitments can only be withdrawn or modified after the agreement of compensatory adjustments with affected countries, and no withdrawals or modifications may be made until three years after the Agreement has entered into force. Such modifications of commitments may not affect the application of MFN treatment. Commitments can, however, be added or improved at any time.

being approached by other countries and asked why such-and-such a 'restrictive' practice or law is not listed.[12] Moreover, exemptions are only valid for 10 years and are currently due for renegotiation (Adlung *et al*, 2002: 259; Lal Das, 1998: 111 and Kwa, 2005). Secondly, as soon as the GATS came into effect, pressure was placed on countries to produce offers and to improve the 'quality' of their offers, and this pressure increased after the Doha Declaration (2001) included a commitment to speed up the GATS process. In particular, the request that SA received was one of 29 sent out by the EU in 2002 (see TWR, 2002). In addition to pointing out where countries were not complying, these requested broad liberalisation. These 'requests/offer' processes were supposed to be confidential[13] (they were leaked). This secrecy is further suggestive of important issues being negotiated by a very narrow set of parties. As TWR (2002: 45) puts it,

> despite the public interest in GATS, [the EU] has conducted negotiations behind closed doors with an unacceptable level of industry involvement.

That the developed countries got the best of the deal is evident in the way that implementation of the GATS has evolved. The GATS classification list has about 160 industries, grouped into 12 sectors,[14] to which a member can make commitments. In their submissions after the Uruguay Round, the majority of developing countries have made specific commitments scheduled for 60 sectors or less. What is interesting is that after tourism, financial and business services are second, with over 100 members making commitments in these sectors. Whereas it is commonly argued that many developing countries have a comparative advantage in tourism, the fact that financial and business services are also heavily scheduled casts doubt on whether it is truly the scheduling preferences of developing countries that are being reflected. Adlung *et al* (2002: 263) explain that the inclusion of financial and business services in so many developing country lists is the result of 'extended negotiations'

in these sectors which were undertaken after 1997. Further, as discussed, the EU has been particularly vigilant in 'checking' on the lists submitted by the developing countries, and 'requesting' that improved offers be made.

Similarly, developing countries stand to gain primarily from liberalisation in 'Mode 4' (presence of natural persons), which would force a rationalisation of rules controlling the flow of and treatment of migrant and guest workers. However, developed countries have made very few commitments in Mode 4 (Hodge, 2005: 5 and Kwa, 2005, quoting UNCTAD). Developed countries stand to gain in Modes 1 to 3, and this is where the primary pressure has been.

Current trends leading up to the Hong Kong Ministerial

The process of getting some concession, then using it as a standard to put pressure on isolated individual countries (or more accurately, the frequently over-burdened country representatives) is a tactic used in plurilateral agreements, and indeed, is the key informal mechanism used in the WTO during supposedly multilateral negotiations. As soon as any agreement, or even negotiating document, exists, the fact that there is no legal obligation on countries to agree to its terms is less important than the precedent set by other countries agreeing and the informal pressure brought to bear on countries that do not meet 'the standard'.[15]

> The practice of Chairs of negotiating committees abusing their authority, and presenting negotiating texts which reflect the positions of the powerful players, but not the majority, has been performed many times in the WTO. Combined with calls, threats and complaints from Washington, and intense lobbying from Brussels, this is one of the most effective ways of sidelining the less powerful players, and silencing them (Kwa, 2005).

The initial acceptance of the GATS, even with its positive lists and MFN exemptions, appears

to be the thin end of the wedge that is designed to prise open developing country markets, not only services, but also in the key area of investment. A particular feature of the WTO is that commitments are irreversible. A country can, of course, pull out of any agreement. However, if it pulls out of the WTO its stands to lose its MFN status, and other countries are entitled to enact measures against it. If a country that wishes to remain a member does not meet a particular commitment, it is obliged either to negotiate with the country or countries that bring a complaint against it, or submit to the DRM.

Although voting is allowed in terms of the WTO constitution, in practice this measure is never used. Rather, the WTO Secretariat seeks 'consensus' on a particularly issue. Although this seems to empower all countries, in practice the opposite effect has emerged. Indeed, the key role played by the Secretariat, and the informality of the process of 'consensus building' are key tools through which the powerful manipulate the process.

First, a 'surprising' amount of WTO business is conducted informally (Kwa, 2003: 38). Attempts to tighten up procedures, particularly made by developing countries during the Doha Ministerial (which launched the current Doha Round, have generally been to no avail. Raghavan (2002: 37) argues that at issue are "principles and procedures so basic to any intergovernmental and international organisation that the very fact that delegations have now to formally propose putting those in place is perhaps the best commentary on the state of the WTO".

Secondly, Raghavan shows that the influence of Chairs, and their partiality towards developed countries and 'liberalisation', contravene Articles VI of the Marrakech Agreement. Chairs have acted as if their brief is to push through an agenda of liberalisation. In 2002, then-Chair of the General Council Sergio Marchi justified the aggressive stance by arguing that the WTO secretariat "was appointed and paid such high salaries 'to promote liberalisation'" (Raghavan). More recently,

> the new element that [current Chair of the Council for Trade in Services (CTS), Mexican Ambassador] Mateo has so flamboyantly added, is the extent to which he has nonchalantly told Members, as if he were the one writing the rules of the WTO, that he cannot remove what he has decided without consensus to put into the text, unless there is complete consensus to take them out (Kwa, 2005).

Under these influences, WTO negotiations in general have developed a familiar but seemingly irresistible form. The EU or US develops a 'negotiating draft', and then gradually extends it to the 'quad' (the US, EU, Canada and Japan), then to other developed

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[12] Two examples from the EC's (2002) request to SA illustrate: "Mode 3: MA [market access] – Foreign banks are restricted to holding 49% of the equity of any seat on the JSE. EC Request: Clarify why this limitation has not been scheduled." Under horizontal commitments: Mode 3 "[L]ending from mother company to subsidiaries, as well as access to loans in local currency for foreign companies is restricted. The basis for this restriction is unknown and they do not appear as a limitation in the SA scheduled commitments. EC request: Clarify the basis for these practices which seem to be discriminatory."

[13] The wording in the request to SA (EC, 2002) is "Member States are requested to ensure that this text is not made publicly available and is only circulated to the officials concerned".

[14] Listed as 1. Business; 2. Communication; 3. Construction and Engineering; 4. Distribution; 5. Education; 6. Environment; 7. Financial; 8. Health; 9. Tourism and Travel; 10. Recreation, Cultural and Sporting; 11. Transport and 12. Other.

[15] At one stage "… the SA delegate has been barred from participation in some small group informals because the country had not submitted [a revised GATS] offer. When she raised complaints in the Council for Trade in Services, the Chair told her that her concern was not on the agenda of the meeting, and cut her off." Pressure therefore comes in the form of exclusion and informally; a prominent developing country Member has described the situation as one where within the WTO, "nobody takes them seriously". The Chilean Chair of the CTS, Jara (in July 2005) even listed the 24 (non-LDC) countries [that had not submitted offers] in his report to the TNC (Kwa, 2005).

countries, then 'friends'. By the time that real opposition is invited to 'negotiate', the text is presented as a virtual *fait accompli*. At Doha, and at the run up to the Hong Kong Ministerial in December 2005, developing country delegates complained of 'magic texts' in which changes appeared unbidden, and reservations and disagreement (supposed to be represented by bracketed text) disappeared without explanation. Key opponents can be bought off[16] or can be isolated and worn down and "made to feel that we are holding up the rescue of the global economy if we don't agree"[17], using the notorious Green Room process (see Kwa, 2003: 27-34) and various other crude but effective tactics.

These matters are of particular concern, because, as suggested earlier, the pressure placed on developing countries to conform, plus the very heavy work programmes caused by the extension of the WTO into so many new areas,[18] plus the tendency of texts to change, means that they may agree to 'issues' that are not well understood. Moreover, even if they are resolutely against a particular issue, it seems that there is a fair chance that the 'process' will manage to extract 'consensus'.

This appears to have become the case in service sector negotiations, and in terms of the proposed investment agreement in the months before the Hong Kong Ministerial. There are signs that developed countries will be pushing for a considerably enhanced GATS, allowing for plurilateral agreement and benchmarking. The investment agreement is a classic example. As Khor (2002b: 32) puts it, the 'watered down' versions (such as the GATS-style proposals for an investment agreement) "are aimed at getting Members to agree to the *concept* that investment rules belong in the mandate of the WTO".[19] These are only "shifts in tactics", and will be followed by "pressure… to liberalise more and more".

> At Doha, industrial country pressure resulted in a vague commitment to initiate negotiations, but on the basis of a decision taken by "explicit consensus". It is transparently clear to most observers that no consensus exists. Yet this has not prevented the EU continuing its crusade for an

investment agreement… Perhaps more than any issue on the agenda, the investment agreement reflects the continued role of Green Room special deals and intrigues, with developing countries being invited to negotiate on an agenda they resolutely oppose (Oxfam, 2003: 2).

Both the GATS and the 'investment' issues are clearly focussed on financial liberalisation at various levels. Given the skill of the 'majors' in driving through what they want, there is a clear risk that developing countries may not be able to resist. The question this raises is whether the tightening up of GATS and 'progress' on the new issues (and particularly an investment agreement) will have a detrimental effect on developing countries.

Conclusion: does it matter?

Few take too seriously the official WTO line, expressed by Michael Moore (Director-General of the WTO from 1999-2002), that its system of consensus-seeking makes it "the most democratic international body in existence today" in which each country – "from the largest to the smallest – has the power of veto" (Moore, 2003 quoted by Wade, 2004: 148).

On the contrary, the outcome at Doha and the way that events unfolded in 2005, suggest that the informality of the modalities for developing consensus means the majors agree to draft texts, and then use 'divide and rule' and attrition to wear down opposition and to force developing countries to accept what is often palpably a "bad deal" (Kwa, 2003).

Nevertheless, as argued earlier, 'liberalisation' is seen as an important policy platform *even if* it occurs unilaterally, and even if it does not produce spectacular reciprocal concessions, because it is important that the temptation to try other policies is ruled out. This 'negative' justification may explain at least part of the enthusiasm of countries like SA. Indeed, Moore himself argues that the increasing resistance to the WTO is a sign that it is achieving a key aim:

> A decade and a half ago the Uruguay Round was launched in the face of public apathy. No one can say that

about Seattle, that's a deliverable. We have gone from apathy to anxiety and even anger, not just from the demonstrators in the streets, but from people around the world who feel that for too long they have been locked out of the benefits of growth… (WTO, 1999).

In neoliberal analysis, WTO commitments are seen as an important, perhaps critical, adjunct to domestic economic reform, because they empower 'pro-trade' and pro-liberalisation interest groups and weaken residual protectionist and Leftist ones. Indeed, Taylor & Vale (2000) argue that 'globalisation' and the decline of the international Left were important factors facilitating and shaping the 'conservative' transition to democracy in SA (see also Adler & Webster, 1999 and Friedman, 2002).

Even if the material losses faced by 'losers' are not compensated or even made up in other sectors, the linking of domestic policy reforms to powerful international elements (particularly, in the case of the WTO, when these have legally binding status and allow domestic reforms to be 'locked' in by international agreements) has important political and ideological effects.

The second set of questions, not discussed in detail here, is whether what is *specifically* being 'given away' (or in danger of being given away) is indeed conducive to development.

Our focus is on financial liberalisation, not because this is the only area of development space that is being eroded, but because it may well be the key area that *defines* development space. It also may be the key factor in the way that development space is used. Again, the ground being contested is not whether there are grounds for a development state of some sort. Even the most right-wing of orthodox economists agree that there is a textbook case for intervention on the 'orthodox' basis that markets would otherwise fail in important ways and yield inefficient outcomes. However, the point is that the orthodox backup argument seems to have muscled its way into the front rank.

This is the negative argument referred to earlier, that policy failures are by far the greater evil, and that 'tampering' in markets has a dismal historical record. However, this is not a position that depends on an *a priori* theoretical case – it is in fact sustained by little more than rhetoric.

Development is usually a matter of cartels and, subtle or not so subtle, government intervention. This analysis suggests that the hypothesis that the current efforts to prise open financial markets through the WTO have very little to do with 'free trade' or development, is at least as plausible as any other. It also suggests that despite the globalisation gloom, SA may still have considerable 'development space'.

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[16] "Just before Doha, ministers from the African countries that are part of AGOA… went to Washington. When they came back, some countries' views… had taken a shift towards US positions" (Kwa, 2003: 24).

[17] Dr Richard Bernal, Jamaican delegate in Doha, quoted by Kwa (2003: 22).

[18] Leading up to the Doha Ministerial, developing countries were arguing that problems, particularly concerning implementation and other modalities, arising from the Uruguay Round needed to be addressed before 'new issues' could be discussed (Khor, 2002a: 24-5). In the Doha Ministerial, the first draft of the text released by the Chairman of the General Council had options 'in brackets' on the 'new issues', indicating disagreement. "Even though Members continued to express the same position of 'no new issues', the second draft on 27 October 2001 was a clean text. That is, the option of no negotiation on new issues was removed" (Kwa, 2003: 24), and the final text does commit members to discussing a range of questions falling within the ambit of each of the Singapore issues (Khor, 2002a: 25). Although objections led to the Chair making a statement of 'clarification' (suggesting that any 'agreement' would be required before such discussions could take place), the signs are that the Singapore issues will be in the text of the forthcoming Hong Kong Ministerial (Kwa, 2005).

[19] Wade (2003: 626) argues that this is also the case with TRIPS which is "merely the starting point for negotiating even tougher 'TRIPSplus' standards of patent protection in bilateral trade and investment treaties" (Wade, 2003: 626).

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Value Chain Governance Revisited: The Case of the SA Plastics Value Chain

The idea of value chain governance is not new, yet the important role it plays in SA industries has not been the subject of much discussion. In this article, **Ralitza Dobreva**[1] reviews the idea of value chain governance and examines the role it plays in the SA plastics industry. She finds that Sasol, through its governing powers, shapes to a significant degree the development path and the pattern of competitiveness not only of polymer production, but also of the downstream industries which convert polymers into intermediate and final plastic goods.

A concise review of value-chain governance

Conventional industry studies confine their attention to within sector boundaries: for example, studies concerning the plastics sector would examine the performance of firms involved in the production of intermediate and final plastic goods, such as builders ware and plastic furniture. This kind of analysis abstracts from the industries supplying downstream producers with raw materials (in this case polymers) and those to which intermediate plastic goods are sold. In contrast, value chain-type studies explore the dynamic linkages between different levels of production of a good or service – from conceptual design through various stages of beneficiation to delivery to the final consumer and disposal after use. Thus the value chain approach reveals the organisation of successive stages of intermediate products, building value added and the mechanisms of control, at each stage and over the chain as a whole (Morris & Kaplinsky, 2001).

The benefit of value chain analysis is that it emphasises the idea that penetrating markets, which brings sustained income growth, entails insight into dynamic factors in the entire value chain, thus generating *systemic* competitiveness (value chain efficiency) in contrast to point efficiency (Kaplinsky, 2000). Even more importantly, value chain analysis considers the factors which determine the way in which producers are connected to final markets and helps to explain the distribution of benefits to various participants (Morris & Kaplinsky, 2001).

The three dimensions which characterise value chains are:

- An input-output structure: a sequence of products and services linked through input-output relationships;

- A territorial structure: geographical distribution of activities and entities in production and distribution activities; and

- A governance structure: a locus of authority and a network of power relationships (Gereffi, 1994).

The centre of governance is determined by the location of key barriers to entry. Governance structures in globally dispersed value chains are usually described as 'producer-driven' or 'buyer-driven'. Producer-driven value chains are dominated by large, often transnational, firms which direct and shape the nature of the backward and forward linkages at different levels of beneficiation. The capital- and technology-intensive manufacturing of cars, aeroplanes and semi-conductors is said to be producer-driven. These production systems are usually distinguished by the control that the administrative headquarters of large transactional corporations exercise.

Buyer-driven value chains refer to industries in which large retailers or brand-named merchandisers set up and co-ordinate decentralised production networks, often with nodes based in developing countries. In these production systems, the core enterprises are not involved in manufacturing, but in 'merchandising': the main function of the core company is to manage a variety of manufacturing and logistical activity and ensure the different parts of the business work together as a whole (Gereffi, 1994).

Thus producer-driven value chains are characterised by significant barriers to entry related to the nature of production, control over resources, design, intellectual property, etc. In contrast, the distinctive features of buyer-driven value chains include the importance of branding and distribution networks, such as in clothing and sports footwear.

A more pressing issue, however, is that the concept of power within value-chain analysis is not well defined. Even though it is recognised that power is contestable as value chains change over time, the distinction between buyer-driven and producer-driven chains has a static nature. The distinction of the different dynamics of 'control achievement' and 'control maintenance' may provide deeper insights. An extension of the value chain framework is necessary to incorporate the foundations of 'market power' and its dynamic nature through insights from microeconomics and industrial organisation (Raikes *et al*, 2000).

Barnes (2000) extends the ideas of power within the value chain by emphasising that differences in connectedness and ownership of firms in the automotive components industry are significant determinants of performance and also have a bearing on their "political economy leverage" – their ability to influence government policy. On their own, efficiency and competitiveness do not decide the growth path of the industry.

The distributional outcomes of production activities are better understood through the lens of value chains for four reasons (Morris and Kaplinsky, 2001).

- First, different forms of rents are identified – rents arising from scarcity and 'Schumpeterian' rents arising from innovation and purposive action. However, most economic rents are dynamic – over time competitive forces transform producer rents into consumer surplus (Kaplinsky, 2000).

- Secondly, the focus on barriers to entry aids in distinguishing the activities which are subject to growing competition from those that are likely to be protected by increasingly difficult access in the future. These barriers also mean that governance may derive from first-mover advantages and/or previous state support and intervention. Where the barriers are entrenched, elements of path dependency are further reinforced.

- Thirdly, the analysis of power within the value chain shows at which points in the value chain changes in behaviour will result in a different income distribution. As value chains become more complex, the rent from governorship also rises. There are often barriers to entry with regard to governance itself, and thus it may provide significant returns.

- In the fourth place, value-chain analysis would provide better insights into the role of vertical integration in competitiveness patterns and hence into distributional outcomes (Kaplinsky, 2000).

In this brief examination of the governance dynamics within the SA plastics value chain, we attempt to answer two questions.

- Where is the power of governance centred within the plastic products value chain and how is it maintained?
- How is governance exercised and what are its consequences in terms of the pattern of industrial development at different levels in the value chain?

Before these questions are addressed, a descriptive overview of the SA basic chemicals and plastics industries is given as a backdrop.

Overview of the SA plastics value chain

Based on the processing of oil, natural gas and coal, a number of distinct levels can be distinguished in the chemicals and plastics production chain *(see Figure 1)*.
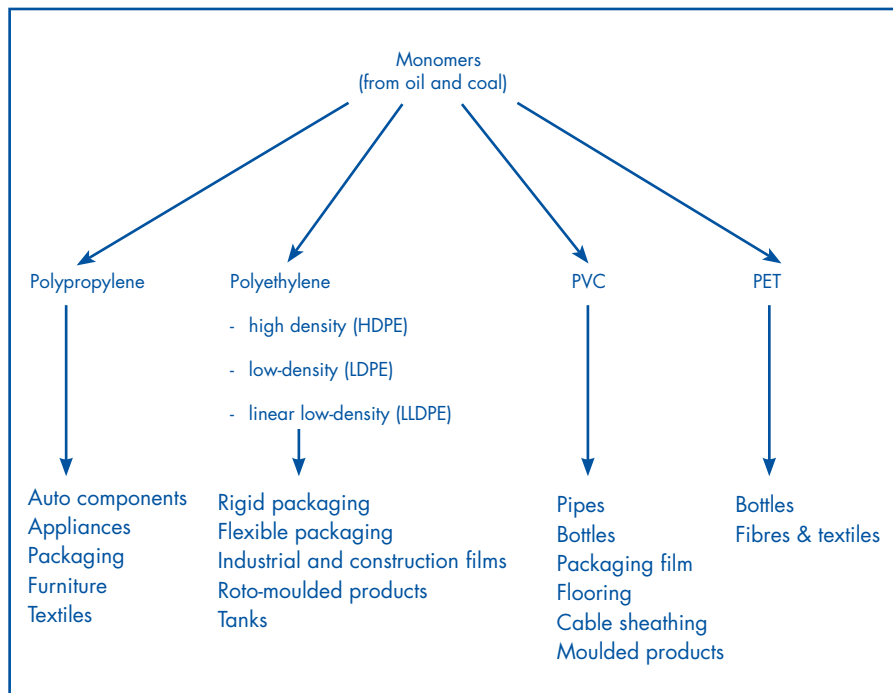
The chain starts from seven main organic chemical groupings comprising the 'building blocks', or monomers, from which various polymers are produced. A few of these polymers then form the main inputs into manufactured plastic products, which can be separated into intermediate and final products.[2]

The plastics industry includes a range of products which are intermediate inputs into other sectors, as well as finished products such as baths and basins. Major markets include packaging, builders ware (such as pipes) and the auto sector.

The inputs to the manufacture of plastics are dominated by primary forms of plastics (polymers), which account for about half of total input costs, and 30% of total output value *(see Table 1)*.

The competitiveness of the sector is therefore closely linked to pricing of polymer inputs. Plastics manufacturing is labour intensive, as the compensation of employees contributes 90% of total value added, in contrast to 35% in the production of primary plastics.

Most plastic products form intermediate inputs for other domestic industries. Only 11% are sold to households, government or the services sector and 7% are exported[3].

As intermediate products, plastics feed into a wide range of sectors, from agriculture and mining to packaging to textile products, effectively placing the industry at the heart of manufacturing. The intermediate nature of

Figure 1: Polymers and plastics production chain

much of plastics output means that it is both a contributing factor to, and reliant on, the performance of manufacturing more broadly.

With regard to industry structure, upstream plastics show significant concentration at various levels of beneficiation, with the four largest firms in the sub-sector accounting for 83% of total output of plastics in primary form and synthetic rubber in 1996 *(see Table 2)*. However, this measure of concentration does not take product differentiation into account.

In effect, only one or possibly two local firms produce the main polymers. This is understandable, given the significant economies of scale in these activities. Indeed, the main polymer producers have been reducing the number of grades they manufacture locally in order to achieve better scale economies, and are importing grades they no longer produce to continue supplying the range demanded by customers.

Sasol is the only domestic producer of monomers, while there is a local monopoly or duopoly in each of the main polymer products. There are four polymer producers in SA.

The largest by far is Sasol Polymers, a division of Sasol Chemicals, followed by Dow Chemicals, a local subsidiary of the multinational Dow.

Sasol Polymers is the largest manufacturer of polypropylene (PP) and is the sole producer of low-density polyethylene (LDPE), linear low-density polyethylene (LLDPE) and polyvinyl chloride (PVC) in SA. It operates plants in

Sasolburg and Secunda, and has partial ownership of two plants in Malaysia.

Dow Chemicals manufactures polypropylene and high-density polyethylene (HDPE). It sources its monomer inputs mainly from Sasol.

The two smaller producers – SANS (a subsidiary of AECI) and Hosaf (originally Hoechst SA) – each make bottle and fibre grades of polyethylene terephthalate (PET).

In contrast with upstream polymer production, downstream plastics do not exhibit signs of imperfect competition, reflecting low economies of scale. The sector comprises a very large number of small or medium-sized firms, with the 10 largest firms accounting for 29% of total output *(see Table 2)*.

In order to find the locus of governance within the plastics value chain, we need to locate the highest barriers to entry. Given the concentrated nature of the upstream industry, the centre of power is likely to be found at the beginning of the beneficiation process. Several further observations confirm this hypothesis.

First, SA is a distinct market for the upstream monomer and polymer products in terms of both supply and demand substitutability. It is a separate geographic market due to the significance of transport costs from foreign suppliers. Any imports are most likely to come from East Asia, with transport costs per tonne of PP, for example, amounting to 5% of the free-on-board (fob) international benchmark price[4]. In addition, different polymers and even

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[2] For a detailed account of the sector, see Crompton (1995).

[3] According to Statistics SA's Final Supply and Use Tables, 2000. The data are at purchasers' prices. The residual item and the change in inventories were not taken into account in the calculation.

[4] Interview with plastic sheeting manufacturer, November 2003.

Table 1: Plastic products: sources of inputs and value added, 2000

Product grouping	R-million
Agriculture & mining	100
Textile products	80
Wood & paper products	237
Petroleum & basic chemicals	465
Primary plastics (polymers)	3,362
Other chemicals	145
Plastic products	1,095
Metal products & machinery	240
Other manufacturing	253
Electricity & water	28
Transport, communication, finance & other services	597
Total inputs at purchasers' prices	*6,611*
Total gross value added (GDP)	*4,479*
Compensation of employees	4,014
Taxes less subsidies	(18)
Gross operating surplus / mixed income	456
Total output at basic prices	*11,090*

Source: Statistics SA, Final Supply and Use Tables, 2000

Table 2: Concentration indices according to output (1996)

	No. of firms	Relative contribution of:	
		4 largest firms	10 largest firms
Plastics in primary form and synthetic rubber	31	0.8265	0.9483
Plastic products	1,027	0.16	0.29

Source: Statistics SA, Manufacturing Census, 1996

different grades of the same polymer are not alternatives as inputs into plastics production, as they generally have quite different properties.

Also, in the cases where there are domestic manufacturers of specific polymers, downstream producers have decided against importing polymers for a number of reasons:

- There are no wholesale traders/importers to serve small or medium-sized firms, which cannot purchase and store large quantities at a time. The option of importing is more feasible for large firms.
- Importing is risky, mainly due to quality concerns.
- Procurement and delivery of imported materials imply additional 'hassle' costs and no credit facilities, the latter being available through domestic suppliers.

This means that the links with domestic suppliers are continually reinforced, and these relationships play a significant role in the competitiveness as well as decision-making of

downstream producers with regard to output and market penetration.

Secondly, the markets are not contestable. The incumbent firms – Sasol and Dow Chemicals in the case of PP and Sasol alone in the case of PVC – enjoy significant economies of scale due to large fixed costs. Thus a potential entrant is faced with higher costs of production because of the enormity of the minimum efficient scale in this market.

Undoubtedly, there are also considerable sunk costs in the capital-intensive production processes involved, where equipment cannot be used for other purposes and a resale market for this kind of capital goods is unlikely to exist.

Thirdly, since the polymer markets are markets for intermediate goods, they are easier to monitor, compared to markets for consumer goods, in which extremely large numbers of buyers are involved. Thus an attempted entry will not go unnoticed, as the incumbent

firms have almost perfect information through established customer networks. Moreover, the domestic polymer suppliers are likely to detect attempts of downstream firms to import polymers.

Maintaining dominance in the SA polymers market is therefore a manageable task for the existing producers. Besides, the existence of excess capacity is a strategic deterrent to entry into the polymers market.

It is therefore clear that upstream producers govern the SA plastics value chain. It is producer-driven, as the large enterprises play a central role in controlling the input-output linkages and development paths.

It also differs somewhat from Gereffi's (1994) definition, as the governing enterprises, which manufacture the relatively unbeneficiated inputs, are generally not vertically integrated into the production of intermediate and final goods. Plastics are made by small and medium-sized firms. The only exception involves Sasol's stake in the plastic pipe manufacturer, DPI Plastics.

A brief historical examination sheds more light on the requirements and path-dependency regarding the acquisition of market power in monomer and polymer production. The SA government's aims of self-sufficiency and import substitution under the *apartheid* regime resulted in massive investment in capital-intensive projects, such as Sasol.

Sasol's dominant position in the SA basic chemicals, plastics, fertiliser, explosives and other chemical-related industries is an outcome of economies of scale in the production of chemicals and significant synergies in the use of by-products from the oil-from-coal process (May & Roberts, 2003; Sasol).

Therefore two observations emerge, both relating to the path-dependency of the pattern of industry governance in plastics.

First, Sasol's position of market power in the SA primary plastics market was a by-product of the State's large investments and support for innovations, which were implemented in pursuit of military and strategic aims rather than profit-maximising objectives.

Hence, Sasol's example does not conform neatly to textbook examples of market power acquisition, which often involve in-depth industry knowledge and foresight, as well as a clear intention to dominate and reap monopoly profits (Hay & Vickers, 1987).

Even though private companies recognised the lucrative commercial opportunities, the capital outlays necessary were prohibitive in the absence of state finance. Hence, in the case of the SA plastics value chain, 'control

achievement' occurred with goals other than profit maximising and innovation initially, and used foreign technology. In 1950, the oil-from-coal project was unlikely to have been implemented with purely commercial motives and private funds.

Secondly, Sasol has been an integral part of the SA plastics value chain since the inception of the industry. Its technological capabilities provide a platform for the technical support and product development discounts it provides to its customers. Together with its thorough knowledge of the market for intermediate and finished products, as well as awareness of foreign markets, these capabilities centre substantial governing powers over the plastics value chain in Sasol's hands.

Governance and development of the plastics value chain

As illustrated above, governance derives from historical investments under state ownership, and the large-scale economies in upstream production. Thus, the way in which governance is exercised has major implications for downstream development. Sasol combines the exercise of market power in pricing with a range of industry support options and rebates.

Polymers are priced at import parity, even for PP and PVC in which SA has had trade surpluses with relative consistency[5]. In the context of a competitive industry where a trade surplus exists, the price is at export parity. This is the case in the SA maize farming industry, where periods of trade surpluses are characterised by lower export prices, but higher import parity prices prevail during times of trade deficits.

Thus, the simultaneous occurrence of trade surpluses and prices at import parity for polymers indicates exertion of market power. Moreover, in the case of polymers, pricing is in fact above import parity, as the *indirect* costs of importing, such as financing, time delay, difficulties with verifying quality and ensuring a regular stream of supply are also included, and their value is said to be equivalent to the service benefits Sasol provides[6].

In addition, adjustments caused by the fluctuation of the exchange rate occur with a two-month lag – the period required to procure a shipment of imported inputs[7].

This pricing strategy combines Sasol's export rebates and product development discounts on polymers[8]. In the case of the export rebate, the polymer sales are invoiced at the SA price and a rebate is granted upon satisfactory proof of the export of finished goods. However, the export rebate does not apply for exports of finished products to the SA Customs Union (SACU)[9], Malawi, Mozambique, Zambia and Zimbabwe.

In addition, the export rebate is conditional upon giving full information about export orders to Sasol. Sasol's stake in the plastic pipe manufacturer, DPI Plastics, would be a cause for concern in this context.

As a separate initiative, a project development discount is offered to selected customers for research into new products. The receiver of the discount is also obliged to supply detailed information about the new products being developed and potential markets for them. It appears that the project development discount is granted on a discretionary basis – no clear criteria seem to exist for firms to qualify[10].

There are three important aspects to Sasol's practice of offering rebates to downstream firms which export or are involved in developing new products.

First, the offer of export and product development rebates allows Sasol to sell greater quantities into the local market without lowering the price on existing units supplied.

Secondly, the export rebates are offered in order to assist local plastics manufacturers to expand their access to foreign markets, thus growing domestic demand for polymers. Similarly, product development rebates would serve to increase both domestic and foreign demand for plastic products and thus the demand for polymers.

Thirdly, the rebates are conditional upon downstream firms' disclosure of detailed information about the products they export, the destinations of their sales and the quantities involved. In addition to the market power in polymers it possesses, these disclosure requirements provide Sasol with the information to exercise governing powers over the SA plastics value chain.

Sasol has the capacity to monitor downstream manufacturers and their markets closely and

direct downstream producers' expansion attempts strategically. For example, in recent years, Sasol lowered its PVC prices to plastic pipes manufacturers for a time, which allowed them to drive asbestos and concrete pipe producers out of business. Once these firms had exited the pipe market, polymer prices were increased once again[11].

Moreover, Sasol's technological capabilities allow it to offer technical support to its customers and so acquire thorough knowledge of their businesses.

Sasol's dominant position therefore extends further than just a position of market power in polymer production. It possesses governing powers over the plastics value chain in exerting considerable influence in shaping and directing its development and competitiveness.

Implications and conclusions

In summary, the SA plastics value chain is geographically confined to the country due to significant transport costs associated with importing and exporting. It is characterised by mass production rather than branding and intricate distribution networks, and is therefore producer-driven.

However, it differs from global producer-driven chains, such as the US and Japanese car manufacturers, since its governing enterprises do not exhibit a high degree of vertical integration. The firms they have influence over are small or medium-sized downstream producers.

Sasol's acquisition of governing powers is due to scale economies, first-mover advantage and path dependency, rooted in state intervention with strategic, rather than profit-maximising, aims during *apartheid*. Governance is exercised through market power, a system of discounts and rebates, and technical assistance.

The pricing at import parity in the domestic market, while exports are priced at lower, internationally competitive prices, implies that it is in polymer producers' interest to grow demand from local downstream plastics firms, but without altering their pricing practices.

The system of rebates and discounts attempts to achieve that, in addition to acquiring information about market conditions at all levels of the value chain. This behaviour implies

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[5] SA recorded trade surpluses for PP from 1995 to 2004, with the exception of 2000. Trade surpluses for PVC were recorded from 1999 to 2003, but a trade deficit was recorded in 2004.

[6] Interview with plastic sheeting manufacturer, November 2003.

[7] Interview with plastic furniture manufacturer, November 2003.

[8] Interviews with plastic pipe manufacturer and plastic furniture manufacturer, November 2003.

[9] SA, Botswana, Lesotho, Namibia and Swaziland

[10] Interview with plastic furniture manufacturer, November 2003.

[11] Interview with plastic pipe manufacturer, November 2003.

that 'Schumpeterian' rents may also accrue to upstream firms. This happens at the expense of the more competitive downstream sector, which is not able to pass higher prices on to consumers.

The consequences of market power and governance located in the upstream industry can be seen in several dimensions.

Upstream producers' economies of scale and advanced technological capabilities imply that these firms are competitive internationally, as evidenced by large and persistent trade surpluses in PP, for example.

At the same time, their market power and influence through authority in governance means that downstream producers do not enjoy the benefits of having domestically produced inputs, as those are priced at import parity.

Thus downstream firms are limited in their international competitiveness and choice of markets into which they can expand.

This results in a lop-sided pattern of development, in which upstream, capital-intensive firms record trade surpluses, while downstream manufacturers, whose techniques require semi-skilled or unskilled labour, which SA has in abundance, serve mainly the domestic market and compete with imports.

Sasol's technical and technological assistance offered to plastics firms, as well as its direct involvement in some downstream sectors such as the production of plastic pipes through DPI Plastics, allow it to obtain detailed information about downstream markets.

Therefore this giant, **through its governing** powers, shapes to a significant degree the development path and the pattern of competitiveness not only of polymer production, but also of the downstream industries, which convert polymers into intermediate and final plastic goods.

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SADC Trade Database

The SADC Trade Database is an online database consisting of the import and export data of 11 Southern African states. The database has been compiled from data provided by member states. The initial dataset includes data for the following countries: Botswana, Lesotho, Malawi, Mauritius, Mozambique, SA, Swaziland, Tanzania, Zambia and Zimbabwe. Data is published for five years; in most cases this covers the period 2000 to 2004, but for three countries – Namibia, Botswana and Lesotho – the period 1999 to 2003 is covered. These will be updated as soon as more recent data is made available. Measures for the data include values in local currency as well as US dollars.

The data is made available via a powerful, yet easy-to-use web-based format that allows the user to configure the report by a number of different variables. The data can be downloaded in a number of formats, including MS Excel.

Also available on the site are MS Excel-based analytical templates that assist in calculating basic trade analysis ratios such as shares and growth rates based on both a partner and commodity view of trade.

Go to http://www.sadctrade.org/tradedata for information and to register for access to the database.