European Development Cooperation Strengthening Programme (EDCSP)

Trade and Development:

Some Implications for EU Trade Policy

Ken Heydon

EU priorities

The EC Communication of March 2012 on Trade, Growth and Development (henceforth the Communication) contains many elements that have the potential to help to foster economic development in developing countries, in particular:

- Reform of the Generalised System of Preferences (GSP), including by reviewing eligibility criteria and graduation mechanisms, to ensure preferences benefit those countries most in need;
- Better targeted Aid for Trade (AfT), with improved programming and delivery;
- The pursuit of comprehensive Free Trade Agreements (FTAs) via Economic Partnership Agreement (EPA) negotiations, with the option for developing countries to open partially and gradually;
- An absolute priority for getting multilateral trade negotiations to work more effectively for development, including through a package for Least Developed Countries (LDCs) and an agreement on trade facilitation.

The extent to which these objectives translate into an effective stimulus to development will depend on four things: (1) avoiding the pitfalls of departures from the pursuit of open markets; (2) fostering a holistic approach to trade policy in developing countries; (3) improving developing country access to WTO dispute settlement; and (4) addressing particular aspects of EU trade policy that may run counter to its development aspirations.

The pitfalls of departure from open markets

Trade liberalisation – particularly one's own liberalisation – and the strengthening of trade rules help stimulate innovation and hence growth. There are five channels: increased competition resulting from market opening; the transfer of skills and technology embodied in trade; opportunities through economies of scale to better recoup research and development (R&D) investments over a larger quantity of sales; encouraging the global fragmentation of production processes; and the protection of IPRs.

Empirical evidence thus suggests that greater openness is an important element explaining growth performance and that market opening has been a central feature of successful development. No country has developed successfully by closing itself off from the rest of the world.

It follows that, while the flexibilities and 'policy space' offered by special and differential treatment can help developing countries to cope with the structural adjustment associated with trade liberalisation, such provisions need to be handled with care.

The Communication rightly points to the experience of a number of South and Central American countries which have undertaken structural reform as part of agreements with the EU rather than relying on unilateral trade preferences. Undue reliance on preferences risks locking countries into patterns of production that do not necessarily correspond to their underlying comparative advantage. Concern about preference erosion also acts as a brake on multilateral trade liberalisation, recalling that, for all but a handful of countries, the gains from widespread most-favoured nation (MFN) market opening will more than offset the welfare losses arising from preference erosion.[1]

Flexibilities allowing for gradual market opening also need careful application. Policies that seek to impede or delay market opening reduce the opportunities to reap the gains from own liberalisation, while at the same time leading to a two-tier trading system whereby, for example, Organisation for Economic Co-operation and Development (OECD) countries' tariffs on developing country exports are higher than those on advanced country exports.

The provision of financial support for developing countries, including through AfT, is a necessary feature of the trading system, but this too needs to be handled with care if the pursuit of liberalisation and reform is not to be held hostage to the provision of technical and financial assistance.

The EU will thus need to be careful that its trade and development policies do not serve to discourage developing countries from opening their own markets. At the same time, opportunities might be taken to increase the scope of EU preferential benefits in order to reduce the *locking-in risk*.

Putting trade policy in a broader framework

There will, however, be winners and losers from market opening – and the evidence is mixed as to whether trade liberalisation in itself reduces poverty and income inequality. Drawing benefits from greater market openness will work only in a broad policy environment that allows labour and capital to move from declining to expanding areas of activity, and dynamic gains from trade will be stronger when backed by sound policies dealing with competition, education and the regulation of labour and financial markets. As pointed out in the Communication, the ability to graduate from LDC status depends on good macroeconomic management and governance as well as on progressive trade opening and integration into the world economy.

The principle, drawn from Jan Tinbergen, that multiple goals call for multiple policies applies particularly to four acute problems facing many poor and vulnerable developing countries. Reduced reliance on tariffs for revenue calls for fiscal reform and a widening of the tax base. Reduced reliance on trade preferences calls for broad-based economic reform that encourages the diversification of production and exports. Maintaining stable production for exports calls for institution building and the rule of law. And deficiencies in human capital need to be met by sustained programmes of training and education in order to foster a better match between the skills base and labour market needs.

The success of EU trade policy in helping to foster development will depend critically on its ability to help promote a holistic approach to trade policy within developing countries.

Improving developing country access to WTO dispute settlement

The EU is right to give absolute priority to *multilateral* negotiations; Preferential Trade Agreements (PTAs), including EPAs, are inevitably second best. It must be recognised, however, that prospects for the Doha Development Agenda (DDA) – as a Single Undertaking – are at best uncertain and that, for the foreseeable future, the WTO will proceed through litigation rather than legislation. It is therefore a matter of some concern that developing country engagement in WTO dispute settlement is very modest. Only six countries account for 60% of developing country involvement in dispute settlement, the vast majority of developing countries are absent from the process and to date the only LDC to initiate consultations is Bangladesh.

A principal reason for limited developing country participation in dispute settlement is their inability to actually identify the trade barrier that could be the subject of a dispute. EU help in fostering this capacity would greatly enhance the ability of developing countries to benefit from the multilateral trading system.

Addressing some specific aspects of EU trade policy

In terms of the effectiveness of specific aspects of EU trade and development policy:

- Does scope exist for more consistent application of Member States' AfT strategies?
- Is there evidence that the new rules of origin have affected utilisation rates of EU unilateral preferences?
- And is analysis available of the beneficial effects on developing country EPA partners of regulatory harmonisation, or of the potentially negative effects of trade diversion associated with EPA preferences?

And, more broadly, to what extent are EU trade and development policies being frustrated or compromised by persisting dispersion in the EU's MFN tariff, by EU anti-dumping action, by EU regulatory practices or by the European public procurement regime?

All of these questions arise from the EU's latest Trade Policy Review. They suggest EU goals in the area of trade and development may, in certain areas, be frustrated by the actual practice of EU policy. Were that policy to be captured by the pursuit of green protectionism, these internal tensions would become even more acute.

Footnotes

1. As pointed out by the EC Staff Working Paper, loss from preference erosion is also relatively small because preference margins are rather modest and preferences underused.

edcsp@odi.org.uk

www.international-development.eu

EDCSP
Overseas Development Institute
111 Westminster Bridge Road, London, SE1 7JD