



# TRADE PREFERENCES

ARE THEY HELPFUL IN ADVANCING ECONOMIC DEVELOPMENT IN POOR COUNTRIES?

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## *Trade preferences*

There are many reasons why government and nongovernment agencies around the world provide poorer countries with ‘aid’ of one kind or another. Some are to overcome specific problems, such as with emergency food aid. Some are to assist in development and may involve investments in physical infrastructure, health and nutrition programs, for example. Much of this aid could be described as being relatively ‘direct’ or targeted, although it may not always reach the individuals or groups of people in greatest need.

Running alongside the more direct and targeted forms of foreign aid are so-called ‘trade preference agreements’. These arise from trade policies of industrialised country governments under which imports of selected products are permitted from recipient countries at lower import duty rates than imports from elsewhere. Such trade preferences may increase returns to the exporters who receive them and may indirectly improve the economic and social conditions in recipient countries more broadly. Rich countries generally promote their trade deals with developing countries as though they provide the latter with significant and unequivocal benefits. The announcement of the European Union’s grandly titled ‘Everything but Arms’ scheme in October 2000 and the media statements that accompanied the release of the policy continue to propagate this view.

Extreme poverty persists around the world, however, and there is much evidence that the major trade preference schemes are not that beneficial to very poor countries. And they may provide benefits to only one group of poor countries at the expense of others. Aspects of these schemes are also costly to efficient agricultural producers generally, including many in developing countries, because they displace these efficient producers’ products in the recipient markets.

With the announcement of the ‘Everything but Arms’ scheme for providing preferential access to the least developed countries, it is timely to take a closer look at how trade preference schemes work and at their efficacy as a tool for providing development assistance. The question is: Are trade preferences helpful in advancing economic development in poor countries and, even if they are, might there be other measures that would be more effective and efficient?

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## Background

Poverty and low incomes per person continue to exist on a massive scale around the world. In the early 1990s around 840 million people in the world were undernourished (Foster and Leathers 1999). Poverty problems are particularly acute in the least developed countries, a group of 49 countries classified by the United Nations on the basis of poor economic and social conditions (box 1). (For a formal definition of least developed countries see UNCTAD 2001c.)

There is a general view that the permanent reduction of poverty is best served by policies and programs that lead to higher rates of economic growth and higher per person incomes. At the same time, government policies that influence the way wealth is distributed will have a critical bearing on levels of poverty in any particular country.

## Goals of aid

It was once widely held that simple transfers of capital from richer countries could enhance economic development in poorer countries. Whatever the form of the capital transfers — cash, low interest loans, machinery, physical and human infrastructure etc — the primary goal was to increase output as

### **1** Least developed countries, as classified by the United Nations

Afghanistan	Eritrea	Nepal
Angola	Ethiopia	Niger
Bangladesh	Gambia	Rwanda
Benin	Guinea-Bissau	Samoa
Bhutan	Haiti	Sao Tome and Principe
Burkina Faso	Kiribati	Sierra Leone
Burundi	Lesotho	Solomon Islands
Cambodia	Liberia	Somalia
Cape Verde	Loas	Sudan
Central African Republic	Madagascar	Tanzania
Chad	Malawi	Togo
Comoros	Maldives	Tuvalu
Democratic Republic of	Mali	Uganda
Congo	Mauritania	Vanuatu
Djibouti	Mozambique	Yemen
Equatorial Guinea	Myanmar	Zambia

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measured by, say, gross domestic product. The transfers were seen as important in themselves, as opposed to the way in which they might affect economic and social conditions in poor countries.

This earlier view has now largely given way to an appreciation that foreign assistance is most effective if it is focused on increasing living standards in recipient countries, rather than just increasing gross domestic product. It should improve standards of health and education, as well as contribute to economic expansion. Success of the assistance would be measured against indicators like infant mortality rates, life expectancy and standards of nutrition. The issue of how the benefits are distributed among people is also seen as important by many aid givers, as is consideration of the impact on environmental values and services. According to Stiglitz (1997), aid should be compatible with 'sustainable' development that preserves natural resources and maintains a healthy natural environment.

### *Principles of effective aid*

How to ensure that aid is *effective* is controversial. Some people consider that aid through capital transfers is important for development, irrespective of how the transfers are applied. But there is an increasing belief that much assistance to poor countries is ultimately ineffective, or does not benefit those in greatest need (see examples cited in Raffer and Singer 1996, p. 17; Boone 1994).

In 1997, Joseph Stiglitz, the then senior vice president and chief economist of the World Bank, argued that aid can play a vital role in facilitating development, but only under certain conditions. In particular, it needs to be accompanied by supporting policies in both recipient and donor countries. In the absence of one or the other, the effectiveness of aid may be substantially reduced.

Stiglitz set down four guiding principles for the effectiveness of aid:

- 1 It should continue to take the form of capital transfers, but should be directed toward areas where the private sector is less likely to invest.
- 2 Aid in the form of policy advice should continue to be provided, although citizens in developing countries must be committed to reforms or the reforms will not be sustainable when the current governing elites step down.

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- 3 Aid — whether in the form of capital flows or policy advice — should be complementary to private investment.
  - 4 Aid in the form of knowledge and improved institutions may be just as important as physical and monetary assistance.

### *Whither trade preferences*

Are trade preferences to developing countries consistent with the principles of effective aid outlined above? If not, it is reasonable to ask these interrelated questions:

- Should trade preference arrangements be removed from the suite of policies and programs that industrialised countries currently use to assist development in poorer nations?
- Are there alternative ways of providing assistance to developing countries that better satisfy the principles of effective aid?

These issues are explored later, following a review of trade preference arrangements. This includes a brief history of trade preferences, an examination of how the preferences work, and a review of how much the preferences benefit recipient countries.

### Why trade preferences are popular

When products are traded between countries they usually encounter legal and commercial barriers. For a start, imports are usually taxed through duties or tariffs. They also need to meet safety standards and labeling requirements. In some cases the total quantity of a particular product that is allowed to enter may be administratively fixed or limited. All of these barriers increase the cost of engaging in trade.

Industrialised countries have long recognised that they could assist chosen trading partners by subjecting them to lower trade barriers than others. Reducing tariff rates on selected products for chosen trading partners has been a particularly popular trade policy.

In the infancy of some of the trade agreements that exist today, the countries targeted for assistance were often former colonies of industrialised countries. In the 1960s, however, international efforts were made to entrench general trade preferences for all countries categorised as ‘developing’. These

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efforts culminated in a resolution of the United Nations Conference on Trade and Development (UNCTAD) in 1968 that trade assistance for developing countries should be based on systems of tariff preferences that were ‘generalised, nonreciprocal, and nondiscriminatory’ (UNCTAD 2001b, p. 4). The ‘nondiscriminatory’ characteristic applied to developing countries only, as trade preferences clearly entrenched discrimination against developed countries.

In effect, UNCTAD was arguing for trade preference systems under which donor countries offered similar assistance to all developing countries across all products, without requiring anything in return.

The idea behind trade preferences was that they would assist beneficiary countries by:

- increasing the value of their exports;
- promoting their industrialisation; and
- accelerating their rates of economic growth. (UNCTAD 2001b, p. 4)

If trade preferences do, in fact, increase the volume and value of beneficiary country exports, this will also translate into higher national incomes, and potentially greater aggregate levels of prosperity. The view expressed in the UNCTAD study was that, over the longer term, trade preferences could further expand existing export industries and foster the development of new ones. A general increase in exports and the rising imports that would accompany them should increase the adoption of new technologies, products, management techniques etc. This should ultimately lead to even higher rates of productivity growth and national wealth.

This view of the process by which preferences could improve economic development in poor countries is open to challenge. Where large preferences are given, they can concentrate economic activity in the preference receiving industries. As resources become established in these sheltered uses, the processes of seeking more profitable alternatives and adopting new technologies can be impeded. As a result, these economies tend to lack dynamism and are less able to efficiently match their resources with changing market opportunities. So, while there are short term benefits from receiving these preferences, it is far from certain that they can be translated into long term economic growth. In some instances the preferences can be a beguiling poisoned chalice.



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For a summary of the major trade preference schemes involving developing countries currently in operation around the world, see box 2.

### *Mechanics of trade preferences*

Import duties have two main direct effects: they raise revenue for the government and they increase prices of imports to domestic consumers. In turn, the higher prices for imports reduce import competition for similar products produced domestically, effectively providing domestic producers with a price ‘premium’, a layer of protection.

## 2

### **Preferential trade agreements in operation**

There are now a large number of ‘preferential’ trade agreements between industrialised and developing countries based on the provision of tariff concessions and other forms of preferential market access. Some that have been adopted over the past thirty years follow the broad principles established by UNCTAD in 1968, and some do not.

A number of WTO members offer developing countries trade preferences under what are called generalised system of preferences (GSP) schemes. WTO member countries that operate GSP schemes include Australia, Belarus, Bulgaria, Canada, the Czech Republic, the European Union, Hungary, Japan, New Zealand, Norway, Poland, the Russian Federation, the Slovak Republic, Switzerland, and the United States. Despite sharing a common name, the individual country GSP schemes are all very different in terms of the countries covered, the products covered, the size of the tariff preferences on offer for each product, and many other conditions relating to the granting and operation of preferences.

Apart from these schemes, the four ‘quad’ countries — the United States, Canada, Japan and the European Union — also target some of the poorest developing countries with a number of additional preferential trade agreements and/or extensions to their GSP schemes. These agreements include the ‘Everything but Arms’ scheme, the European Union’s latest initiative in favor of least developed countries, and the ACP–EC Cotonou Partnership Agreement, an EU agreement with developing and least developed countries in Africa, the Caribbean and the Pacific. The latter was previously known as the Lomé Convention.

The United States targets least developed countries in Africa under the African Growth and Opportunity Act, and in the Caribbean under the Caribbean Basin Initiative. Japan and Canada also offer additional tariff benefits to least developed countries under their GSP schemes. For detailed information about these and other schemes see UNCTAD (1999, 2001b).

Trade ‘preference’ schemes typically involve donor countries applying lower rates of duty on imports of particular goods from specific countries than on imports from elsewhere. In essence, they provide favored foreign suppliers with access to either a part or the whole of their domestic price ‘premiums’. Those premiums arise from the differences between domestic prices in the preference giving country and world prices. As import taxes and tariffs vary considerably across different products and from country to country, the size of tariff preferences on offer is highly variable.

**1 European Union producer/ product prices and world market prices, 1999-2000**

	EU price	World price	Difference
	/t	/t	%
Sugar	650	250	160
Sheep meat	3 333	1 476	126
Butter	2 954	1 307	126
Rice	600	300	100
Whole milk powder	2 605	1 384	88
Bananas	660	360	83
Cheese	3 500	2 154	62
Beef	2 780	1 776	57
Maize	140	92	52

Source: European Commission (2000).

Preferential tariffs therefore offer favored foreign suppliers higher returns than would otherwise be the case. A numerical example of how tariff preferences work for products that are not subject to any other trade restrictions is shown in box 3.

The price premiums to favored foreign suppliers can be substantial. For example, in the European Union, producer prices of a number of heavily protected agricultural products are well above the corresponding world market prices (table 1). For an exporter with preferential access to EU markets, returns for some products can be more than twice the world market price, depending on the size of the tariff preference.

*Tariff preferences and the need for quantitative controls*

The provision of tariff preferences can become complicated in instances where internal prices greatly exceed world prices and some countries have big margins of preference. Those countries have an incentive to export large quantities to the preference providing country. If large enough, those imports would undermine the internal supported price, reducing the internal level of protection and, in turn, reducing the margin of preference obtained.

To avoid this problem, authorities in preference giving countries generally choose one of the following approaches:

### 3

### Tariff preferences – an example

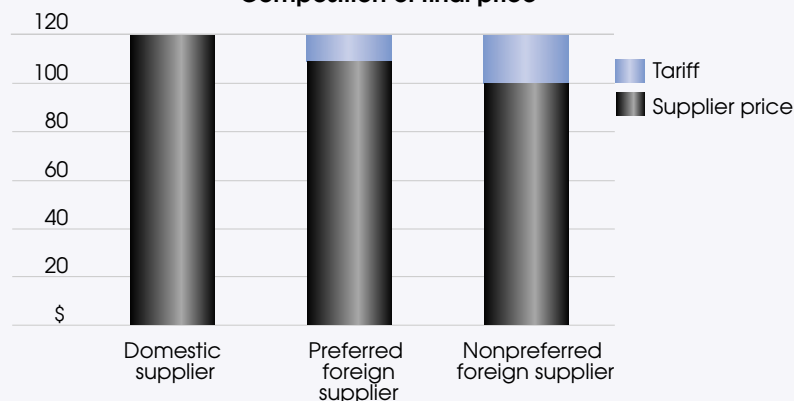
In the figure below it is assumed that the pretax price of imports of a particular good is \$100 per unit, and that any quantity can be imported at this price. Assuming that no domestic production of the good is exported and that there is a common tariff or import tax of 20 per cent (and assuming no other barriers to trade), the domestic price of this good would be \$120 per unit. Imports cost \$100 plus a duty of \$20 per unit, while domestic suppliers would receive \$120 per unit.

Now, if authorities in this country were to offer preferred foreign suppliers a lower rate of import duty — say 10 per cent — and also assuming that the quantity of imports from these countries is not large enough to influence the market price, then preferred foreign suppliers could receive a price of \$109 per unit, with a duty on these imports of around \$11. (The sum of the price of imports plus a duty of 10 per cent of that price equals the market clearing price of \$120 per unit.)

Hence, preferred foreign suppliers could receive a price benefit or premium of around \$9 per unit compared with nonpreferred suppliers to this market. Note that in this example both preferred and nonpreferred suppliers are still worse off compared with domestic producers who would receive \$120 per unit.

It is also important to note that the net benefit of the tariff preference to eligible exporters may be lower than \$9 per unit if these exporters face any additional costs associated with meeting the conditions for preference eligibility. For example, if exporters face any additional administration costs or proof of product origin costs in order to access the lower tariff rates, then the net benefit would fall below \$9 per unit. If the additional costs were large enough they could completely offset the price benefit of the scheme, making it potentially more profitable to export without preferences than with. For any particular good then, the benefit of trade preferences to exporters largely depends on the degree to which preferences result in a higher profit per unit exported, rather than simply a higher price per unit.

Composition of final price



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- they remove highly protected products from their tariff preference schemes to begin with;
  - they reduce the size of the tariff preferences on offer for certain goods; or
  - they use systems of quantitative controls over imports to provide selected beneficiary countries with only limited or restricted access to protected markets — that is, they tie tariff preferences to physical quantities in order to limit the potential impact of imports on their domestic markets.

There is a crucial difference between tariff preferences on relatively freely traded and lightly protected goods and tariff preferences combined with quantity limits on access to heavily protected markets. The former may provide some assistance to beneficiary country exporters, while the latter can offer substantial gains to favored industries and countries. At the same time, high protection in markets in major industrialised countries imposes costs on efficient suppliers in nonfavored countries, including developing countries. These costs can be compounded when trade preferences provide privileged access to other suppliers.

### How large are the benefits from tariff preferences?

The benefit to exporters from having access to a market for a specific product at a preferential rate of tariff include:

- the size of the tariff reduction obtained relative to the price of the good; and
- the extent of any additional costs because of the need to comply with access or eligibility conditions.

Most trade preference schemes involve additional costs for exporters to meet eligibility conditions. Some of these are administration costs to comply with the preferential arrangements. Others arise in proving that the exports are actually from the preference receiving country. Such proof is often required to prevent re-exports of goods produced elsewhere from benefiting from the lower tariffs. Ultimately, the greater the additional costs of compliance — whatever their cause or justification — the smaller will be the net benefits from tariff preferences.

#### *Tariff rate*

If the standard or nonpreferential rate of tariff on a product is small, the benefit of a reduced or zero rate of tariff will also be small. On the other hand, if

the standard tariff rate is relatively large, it is possible but not guaranteed that a reduced or zero rate of tariff will significantly increase the profitability of selling into the market.

For most goods traded on world markets, standard tariff rates in the major preference giving countries are relatively low (table 2). This is partly the result of multilateral trade negotiations over the past twenty years that have led to substantial tariff reductions in most industrialised countries for most goods.

However, a simple average of tariffs across all products hides the fact that many of the major preference giving countries have very high tariff rates on some products, especially agricultural products and clothing, textiles and footwear. These are often the very products that poor countries have the greatest capacity or potential to export.

Tariff peak products are defined as products that face a standard rate of tariff of 15 per cent or more. These products comprise a small but significant share of total tariff lines in quad countries (table 2). The average rate of tariff on tariff peak products is considerably higher than the average rate of tariff across all goods — for example, 20.8 per cent versus 5.0 per cent in the United States in 1999.

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## 2 Tariff lines and rates in quad countries, 1999

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		United States	European Union 15	Japan	Canada
<b>Tariff peak products a</b>					
Number	no.	307	317	233	732
<i>Of which:</i>					
Agricultural products	no.	48	290	178	85
Industrial products	no.	263	27	55	647
Tariff peak products' share					
of all tariff lines b	%	6.1	6.2	4.6	14.3
<b>Standard (MFN) tariff rate (unweighted)</b>					
All products	%	5.0	7.4	4.3	8.3
Tariff peak products	%	20.8	40.3	27.8	30.5

a At HS 6-digit level, a product classification level used by the World Trade Organisation. b Total tariff lines = approximately 5110.

Source: Hoekman, Ng and Olarreaga (2001)

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The types of goods that make up tariff peak products also differ across the quad countries. In the United States and Canada, most are industrial goods, especially clothing, textiles and footwear, while in the European Union and Japan, most are agricultural goods. The importance to developing countries of so-called tariff peak products is explained in more detail in box 4.

Based on tariff rates applying in the major industrialised countries in 1999, the potential benefit to developing countries of preferential tariff rates is relatively small for most products (table 3). Moreover, if average tariff rates in industrialised countries continue to fall over time as a result of multilateral trade reforms, the potential benefits of tariff preferences will be further reduced. That is, as nonpreferential rates fall the potential margin for preferences and the possible benefits from preferential access are eroded.

### 3 Tariff rates applied by quad countries in 1999, by trade agreement

Preferential trade agreement <b>a</b>	Tariff peak products			All products		
	Non-preferential rate <b>b</b>	Preferential rate <b>b</b>	<i>Gain</i>	Non-preferential rate <b>b</b>	Preferential rate <b>b</b>	<i>Gain</i>
<b>United States</b>						
Caribbean community (22)	20.8	13.5	7.3	5.0	1.6	3.4
GSP only beneficiaries (80)	20.8	16.0	4.8	5.0	2.4	2.6
Least developed countries (38)	20.8	14.4	6.4	5.0	1.8	3.2
<b>European Union</b>						
GSP only beneficiaries (42)	40.3	19.8	20.5	7.4	3.6	3.8
Least developed ACP countries (37)	40.3	11.9	28.4	7.4	0.8	6.6
Other ACP countries (32)	40.3	12.4	27.9	7.4	0.9	6.5
Other least developed countries (11)	40.3	12.6	27.7	7.4	0.9	6.5
<b>Japan</b>						
GSP only beneficiaries (127)	27.8	22.7	5.1	4.3	2.3	2.0
Least developed countries (42)	27.8	19.0	8.8	4.3	1.7	2.6
<b>Canada</b>						
Caribbean community (18)	30.5	23.3	7.2	8.3	4.3	4.0
GSP only beneficiaries (108)	30.5	28.2	2.3	8.3	6.2	2.1
Least developed countries (47)	30.5	22.8	7.7	8.3	4.4	3.9

**a** Numbers in parentheses are the numbers of countries receiving preferences. **b** Unweighted average tariff rates across products at the HS-2 level – as specified by the World Trade Organisation.  
*Source:* Hoekman, Ng and Olarreaga (2001).

## 4 Tariff peak products and developing country exports

While average tariff rates in most industrialised countries are relatively low, a small number of products continue to be shielded by exceptionally high tariffs. The table below contains average tariff rates in 1999 across all products in four of the world's major industrialised countries, and individual tariff rates in each country for a number of highly protected products. The intent of tariff peaks is clearly to exclude imports, and to maintain domestic producer prices well above world prices.

### Individual product tariff peaks in industrialised countries, 1999

	Average MFN tariff rate <b>a</b>	Higher tariff products <b>b</b>	Tariff rate
	%		%
Canada	8.3	Butter	340
European Union	7.4	Edible bovine offal	250
		Cereals	76
Japan	4.3	Raw cane sugar	170
		Footwear	36
United States	5.0	Ground nuts in shell	120
		Tobacco	73

**a** Average unweighted most favored nation (MFN) tariff rate across all products. **b** Maximum tariff rate at the 6-digit product classification level used by the World Trade Organisation.  
*Source:* Hoekman, Ng and Olarreaga (2001).

The problem for many developing countries is that tariff peak products tend to be concentrated in agriculture and food products and in labor intensive sectors like clothing and footwear. In general, these are the sorts of products that developing countries have the greatest capacity to produce and export.

Based on work done by the World Bank, developing countries accounted for more than 60 per cent of imports of peak products (products with tariffs above 15 per cent) by the four countries listed in the table in 1999 (Hoekman, Ng and Olarreaga 2001, p. 4). While developing countries are generally eligible for preferential tariff rates on these products, the issue remains that industrialised countries continue to maintain their strongest trade barriers against products of greatest interest to developing countries.

For tariff peak products, however, the potential benefit from tariff preferences — as measured by the difference between the average most favored nation (MFN) tariff rate and the preferential tariff rate applying under each scheme — is much greater. This is particularly so under the EU schemes where the average size of the tariff preference for developing countries in 1999 was between 20 and 28 percentage points. While still significant in percentage point terms, the average size of tariff preferences on ‘peak’ products is lower in the United States, Canada and Japan.

Importantly, however, the extent of nontariff barriers or quantity limits on imports under the various preference schemes are not shown in table 3. In relation to the latter, it is frequently the case that once a designated yearly quota of imports enters at preferential tariff rates, all further imports face the prevailing nonpreferential rate. In the event that significant quantities enter at the nonpreferential rate, a simple comparison of the nonpreferential and preferential rates would overstate the value of the trade preference scheme. For example, while many of the small and relatively poor nations in Africa, the Pacific and the Caribbean receive tariff preferences on their exports of sugar and bananas to the high priced markets for these products in the European Union and the United States, some can only export limited quantities before significantly higher rates of tariff would apply (tables 4 and 5).

For other developing country exporters, the preferential quotas are a large part of their total exports, meaning that the exporters obtain a relatively high average price for their exports overall. A dramatic example of this is the

#### **4 Raw sugar tariff rate quotas, total exports and average export price, 1999**

	<b>Total US and EU quota a</b>	<b>Total exports</b>	<b>Quota share of exports</b>	<b>Average export price</b>
	kt	kt	%	US\$/t
Thailand	14.7	3 379.9	0	163
Brazil	152.7	12 472.0	1	153
Guatemala	50.5	1 137.1	4	165
El Salvador	27.4	222.9	12	208
Zimbabwe	42.8	165.3	26	262
Mauritius	503.6	533.8	94	600
Barbados	57.7	50.0	115	554

a 1999-2000 initial allocation.

Sources: US Department of Agriculture (2001); European Commission (2001); FAO (2001).



sugar industry in Mauritius, where quota access to EU and US sugar markets in 1999 accounted for over 90 per cent of total exports (table 4). As a result, the average price received by Mauritian sugar exporters was around US\$600 a tonne. This was over three times the export price received by sugar producers in Thailand and Brazil, countries that receive only minimal quota access to EU and US markets. Sugar exporters in Barbados also obtained a very high price per tonne in 1999, as virtually all of their exports were quota sales to the European Union.

Similarly, the European Union uses quantitative restrictions to limit the extent to which developing countries can benefit from preferential tariffs on their banana exports (table 5). Once again the impact of the restrictions varies from country to country depending on the quantitative access that they receive relative to total exports, and the export return that they receive. So that, while Costa Rica was able to export some bananas to the European Union in 1999, most of their banana exports were sold elsewhere at a relatively low average price. The relatively small access to the EU market for Costa Rica means that the average returns it receives are dominated by the far lower prices in nonpreferential markets.

In contrast, nearly all banana exports from many small Caribbean nations were to the European Union, leading to a much higher average export price for some of these countries. In this event, the imposition of quantitative limits does not significantly reduce the aggregate net benefit of tariff preferences for bananas to these countries — their complete industries have become geared toward meeting the quantitative access they have to the EU market.

## 5 Banana exports and average export prices, 1999

	Exports to the European Union	Total exports	EU share of exports	Average export price
	kt	kt	%	US\$/t
Philippines	0.1	1 319.6	0	182
Ecuador	698.7	4 056.1	17	235
Costa Rica	664.8	2 557.0	26	221
Colombia	574.9	1 855.7	31	302
Jamaica	51.6	52.2	99	555
Dominica	28.1	28.3	100	542
Saint Vincent / Grenadines	37.9	37.9	100	503
Surinam	39.1	39.1	100	636

Sources: US Department of Agriculture (2001); European Commission (2001); FAO (2001).

## *How significant are the benefits of trade preferences to the least developed countries?*

With the launching of the European Union's 'Everything but Arms' initiative the spotlight is being cast on the implications of trade preferences for this subgroup of developing countries specifically. The extent to which such preferences have so far been provided to these countries and of the benefits that they have received from them are addressed in this section.

The overall impact of trade preferences on the export industries of recipient countries depends on a number of factors. These include the range of goods eligible to obtain preferences (the 'coverage' of each scheme); the extent of the more favorable treatment provided to their products; any limitations on the quantity of goods that can be imported with preferences; costs encountered to comply with the preferential access arrangements and the extent to which available preferences are utilised. Some of these factors are assessed here for the least developed countries in 1999, using the information shown in table 6 which is based on data published by UNCTAD concerning the use of preferences by these countries under the major GSP schemes — with the 'quad' developed countries Canada, the European Union, Japan and the United States.

The three columns on the right hand side of table 6 are indicators of the effects of the preferences. They show respectively the 'potential coverage

### **6 Quad country imports from least developed countries under major GSP schemes, 1999**

	<b>Total imports from LDCs</b>	<b>Dutiable imports</b>	<b>Imports covered by GSP scheme</b>	<b>Imports receiving preferential treatment</b>	<b>Potential coverage rate</b>	<b>Utilisation rate</b>	<b>Utility rate</b>
	(1)	(2)	(3)	(4)	(5)=(3/2)	(6)=(4/3)	(7)=(4/2)
	\$m	\$m	\$m	\$m	%	%	%
Canada	256	92	9.8	5.8	10.6	59.2	6.3
European Union <sup>a</sup>	3 562	3 100	3 075	1 035	99.2	33.7	33.4
Japan	1 248	765	314	229	41.0	73.0	29.9
United States	4 975	4 247	2 282	1 747	53.7	76.5	41.1
– excluding petroleum	2 613	2 078	113	89	5.4	78.6	4.3

<sup>a</sup> Non-ACP (Africa, Caribbean and Pacific) least developed countries only.

Source: UNCTAD (2001a).

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rate' — that is, the proportion of dutiable imports from least developed countries that was eligible to receive preferences (column 5); the 'utilisation rate' — the extent to which the potential preferences were actually used (column 6); and the utility rate — the extent of actual imports entering with preferences in overall imports that were subject to duties (column 7). The utility rate (column 7) is the most important bottom line indicator of the significance of preferences, as it shows the proportion of total dutiable exports from least developed countries to the countries indicated that actually received preferences.

The data in table 6 and the indicators derived from them can help us answer important questions about the extent and effectiveness of the preferences that the least developed countries have received from the major trade preference providers, including:

- Do the major schemes offer preferences to the least developed countries for the types of goods they export?
- Do the least developed countries fully use the preferences on offer?
- Are preferences an important factor in overall exports from least developed countries?

Pertinent conclusions from table 6 include:

- The major schemes do offer preferences to the least developed countries for the types of goods that they export, but the coverage differs markedly between the preference providers. For the European Union in particular, most of the imports from those countries are covered by preferences. A major part of Japan's dutiable imports from the least developed countries is also covered (41 per cent). But the proportions for Canada and the United States are low if petroleum is excluded from the United States.
- The least developed countries use much of the preferences on offer for their exports to some countries but not in the most important case, the European Union, where the potential coverage for preferences is greatest.
- Preferences have not been a very important factor in the overall exports of the least developed countries, having covered only 18 per cent of their total exports to the major developed preference providers in 1999 if preferences on US petroleum imports are excluded.

There would be numerous reasons for the low takeup of preferences under some schemes, the most important instances being with the European Union.

It is likely that one of the most important reasons is that costs to meet conditions set by some preference giving countries, undermine the potential benefits to exporters (International Monetary Fund / World Bank 2001, p. 34). Other impediments include the complexity of the schemes, the limited knowledge of schemes held by some exporters, and a lack of capacity among some exporters to meet conditions such as point of origin requirements. According to an UNCTAD study, a major reason for a low utilisation of preferences is the ‘lack of knowledge of the preferential advantages available under the preferential arrangements on the part of exporters’ (2001b, p. 15).

However, knowledge and information usually come at a cost, so it may be more meaningful to say that the costs of obtaining the information and knowledge required to successfully use the preferences exceed the likely benefits in many cases. This is likely to be a particular problem for those products where the benefits of tariff preferences are relatively small to begin with. Any additional costs associated with preference eligibility would quickly cancel out the potential price gains.

The above analysis suggests that quad group preferences have played only a minor role, on average, in the trade performance of least developed countries. However, aggregate information can hide the fact that not all countries are affected by trade preferences in the same ways. For example, among non-ACP least developed countries (Yemen, Afghanistan, Bangladesh, the Maldives, Nepal, Bhutan, Myanmar, Laos and Cambodia) the utility rate

## 7 Aggregate quad country imports from selected least developed countries under GSP schemes, 1999

	<b>Imports receiving preferential treatment</b> (1) US\$m	<b>Dutiable imports</b> (2) US\$m	<b>Utility rate</b> (1/2) %
Bangladesh	1 125.0	5 535.9	20.3
Bhutan	0.6	3.7	14.8
Cambodia	46.2	365.6	12.6
Laos	42.7	208.3	20.5
Maldives	37.7	72.0	52.3
Myanmar	28.6	208.3	13.7
Nepal	276.8	465.4	59.5
Yemen	37.4	243.6	15.3

Source: UNCTAD (2001a).

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across the four quad GSP schemes in aggregate varies considerably, ranging from around 13 per cent in Cambodia to nearly 60 per cent in Nepal (table 7).

### *Net financial impact of preferences on least developed countries*

It has not been possible to quantify the net financial benefit to least developed countries from trade preferences as the information required is not available. An approximation of the gains to such exporters is given by the amount of import tax revenue that is forgone by preference giving country governments as a result of the tariff preferences they offer — that is, by the difference between the amount of import tax revenue preference giving countries would have earned on imports from least developed countries at non-preferential rates, and the amount of tax revenue actually earned at preferential rates.

In essence, this calculation represents the aggregate of the price ‘premiums’ available to exporters through tariff preferences. It is critical to note, however, that this measure represents the likely maximum or upper bound of the total benefit to exporters. As noted earlier, there are frequently significant costs that must be incurred by exporters in order to be eligible to gain access to lower tariffs, and these costs need be deducted from the forgone revenue measure to derive the ‘net’ benefit. Nevertheless, in the absence of information about the additional costs to exporters, estimates of tariff revenue forgone provide some evidence of the magnitude of the benefits.

Total ‘revenue forgone’ as a result of tariff preferences for least developed countries was calculated by UNCTAD for the major GSP schemes in 1997 (table 8). The absolute value of tariff revenue forgone under the major GSP schemes ranged from US\$0.2 million in Canada to US\$44 million in the European Union (based on a subgroup of least developed countries only).

The ratio of tariff revenue forgone owing to the preferences to the total value of imports from least developed countries ranged from 0.1 per cent in Canada to 1.2 per cent in the European Union. Thus, for the least developed countries exporting to Canada, Japan and the United States, GSP preferences represent only a very small proportion of the gross value of their exports. This is before accounting for the fact that the tariff revenue forgone measure is gross of any costs to least developed countries of meeting GSP conditions. The net benefit of preferences would therefore be even smaller if this adjustment could be made. For the non-ACP least developed countries that are

## 8 Tariff revenue 'forgone' on imports from least developed countries under GSP schemes, 1997

	Tariff revenue forgone on LDC imports <b>a</b>	Total value of LDC imports	Ratio of revenue forgone to total LDC imports
	\$m	\$m	%
Canada	0.2	220	0.1
European Union <b>b</b>	44	3 600	1.2
Japan	8	1 250	0.6
United States	25	5 700	0.4

**a** Revenue forgone gives an estimate of the loss in customs revenue of the importing country from the application of preferential tariff rates. It is calculated by multiplying the preference margin  $\{(MFN \text{ rate} - \text{GSP rate}) / (1 + MFN \text{ rate})\}$  by the value of imports actually receiving preferences. **b** Non-ACP (Africa, Caribbean and Pacific) least developed countries only.

Source: UNCTAD (1999).

exporting to the European Union, GSP preferences also offer relatively small benefits in terms of import tax avoided. Unfortunately the impact of EU trade preferences for ACP countries cannot be assessed in this manner as trade data are not available.

Other studies support the general view that trade preferences provide relatively few net benefits to recipient countries overall, despite the fact that individual producers and industries in some developing countries gain handsomely from access to heavily protected markets in some preference giving countries. In a report by the OECD the authors review a number of studies into the impact of GSP schemes and conclude that, 'in general, these studies suggest modest trade gains attributable to preferences' (OECD 1997, p. 22). The data in table 8 suggest that the least developed countries' share of even the modest gains to developing countries as a whole from the GSP has been very small.

### Characteristics of trade preference schemes as 'aid'

Trade preferences based on tariff differentiation and providing selected foreign suppliers with quota access to heavily protected markets in industrialised countries have few advantages and many disadvantages in assisting economic and social development in poor countries. The most obvious advantage to the preference giving countries is strategic rather than economic. Industrialised countries can use trade preferences to obtain external support for their own protectionist policies.

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For the individuals and industries in poor countries that gain from these arrangements, there is clearly a strong motivation to support the policies of the preference giving nation, and to lobby for the continuation of preferences. This can impede efforts to advance the benefits for trade liberalisation globally through WTO negotiations.

### *Generally limited coverage*

The disadvantages of trade preferences as a means of providing aid include the fact that most trade preference agreements either exclude or severely constrain access for the types of products that many developing countries produce. In general this is done to protect domestic suppliers in preference giving countries that would lose market share in the absence of significant tariff protection. Even the European Union's 'Everything but Arms' scheme quarantines three products — rice, sugar and bananas — from immediate tariff reductions on the basis that they are 'sensitive' to EU producers (box 5).

#### **5** How does the 'Everything but Arms' scheme stack up?

In October 2000 the European Commission announced an amendment to their general system of preferences (GSP) for developing countries. Known as the 'Everything but Arms' initiative, the new scheme grants 48 of the world's poorest countries duty free access to EU markets (European Commission 2000) for all goods except weapons and armaments. Some trade restrictions remain, however, on a group of so-called 'sensitive' products — rice, sugar and bananas. The initiative became a formal element of EU trade policy in March 2001.

Despite the fanfare, however, the 'Everything but Arms' agreement only reduces tariff rates faced by least developed country exporters for a small number of products (Stevens and Keenan 2001). Most EU imports from least developed countries already enter duty free — partly because they are covered by the GSP scheme, and partly because many are tropical climate products for which the European Union maintains relatively low nonpreferential tariff rates.

The results of a recent quantitative assessment of the impact of the 'Everything but Arms' agreement found that most of the benefits to least developed countries would arise from greater preferential access for sugar and rice (UNCTAD 2001d). However, full implementation of tariff cuts for these products under the agreement has been postponed until 1 September 2009, and it is highly likely that there will be further attempts to delay implementation as this date draws nearer. Therefore, in the short to medium term it is unlikely that the agreement will have much of a positive impact on least developed countries.

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However, these are precisely the products that many LDCs are interested in supplying. This is because they are products that many of these countries can produce, and also because the high EU protection for these products means that the price premiums from preferences are large.

Similarly, the effectiveness of trade preference schemes offered by the United States, Japan and other industrialised countries is limited because of the restrictions and limitations applying to agricultural products and clothing, textiles and footwear.

### *Underutilisation*

Most of the major trade preference agreements with developing countries (and least developed countries in particular) are underused in the sense that goods that are eligible for tariff preferences are exported at standard or MFN tariff rates instead (table 6). Whatever the causes, the lack of use of preferences limits the extent to which the arrangements can positively influence general living standards in poor countries.

### *Dependencies*

Perhaps the most damaging aspect of the major trade preference agreements is the extent to which industries and even whole countries have become dependent on preferences. One of the main effects of preferences is that they divert resources in the recipient country away from other activities toward activities receiving a preference. As a result, the industrial base of the country becomes narrower, with a disproportionately large share of land and other productive resources being directed toward producing the preference receiving products. The lack of diversification, and often accompanying failure to capture comparative advantage in nonpreference receiving industries, can render the country's economy vulnerable to external shocks to the preference receiving industries. This includes the risk of preference removal as well as weather and disease risks.

Sometimes the degree of dependence is dramatic, in the sense that a relatively large share of the value of production of particular industries is represented by price premiums obtained in preferential markets. Where these industries are significant employers or export earners in recipient countries — which is sometimes the case in the poorest developing countries — the loss of preferences could adversely affect the local economy, particularly in the short term. In other cases the share of a particular industry's revenue that



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is obtained from trade preferences may be smaller. Nevertheless the price premiums still provide these industries with the resources and incentive to lobby their governments for a continuation of the schemes.

For example, Guyana is a poor country with a relatively large agricultural sector that is dominated by sugar production. EU and US sugar preferences increase Guyana's export earnings for sugar, and the loss or reduction of these preferences would cause serious economic hardship. Similarly, while the share of GDP in Mauritius that is accounted for by agriculture is smaller than in some developing countries, most of the agricultural land in Mauritius is devoted to producing sugar cane. It was noted earlier how preferential quota access to EU and US sugar markets resulted in an average export return for Mauritius's sugar exporters that was around three times the world market price. The loss of trade preferences would have a severe impact on both the agriculture sector in Mauritius as well as the overall economy, at least in the short term.

In Panama, sugar preferences to the United States account for a relatively large share of total sugar exports (around 50 per cent in 1999), with the other half of Panama's sugar exports sold on world markets at significantly lower prices. While the loss of sugar preferences alone would cause major hardship for the sugar industry in Panama, the impact on the overall economy may be smaller compared with countries like Guyana and Mauritius as Panama has a number of alternative and significant agricultural industries, along with a major services sector. Nevertheless, the profitability of the sugar industry in Panama remains highly dependent on US trade preferences.

It is crucial to note that the dependence that results from trade preferences is linked to products that are heavily protected in the preference giving countries, which also limit the quantities on which they allow access to preference recipients. The price premiums generated by domestic support policies in preference giving countries are highly desirable to foreign suppliers that obtain preferential access. In effect, industrialised country trade preference schemes allow their policy makers to expand the umbrella of their protection systems beyond domestic industries to also include favored foreign suppliers. As a result, one layer of inefficiency is being overlaid on another, increasing the costs of these policies to the rest of the world.

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### *Benefits are generally captured by the original owners of capital*

If trade preferences result in exporters in preference receiving countries earning higher profits than otherwise, this will increase their profits in the short term. Over the longer term, however, any price premiums through trade preferences will be reflected in the cost of producing the exports in question — for example, the value of land or other capital used to produce the goods in question typically increases. As this occurs, the rate of return to capital involved in producing these products will typically equate with the rate of return to capital available elsewhere in the economy, including in industries that do not have access to trade preferences. The original owners of land and capital used in preference receiving industries will earn a windfall gain as a result of the introduction of tariff preferences. However, any new entrants to the industry will have to pay a higher price for productive assets on the basis that they expect to receive the higher, preference induced price for their output. For new entrants then, it becomes crucial that preferences continue, at least for a period long enough to allow them to recoup their investment. Otherwise new entrants would suffer a loss in wealth if trade preferences were removed.

In general, there will always be producers with a strong interest in maintaining preferences — just as producers in countries that protect or subsidise their farming industries have a strong interest in maintaining such assistance.

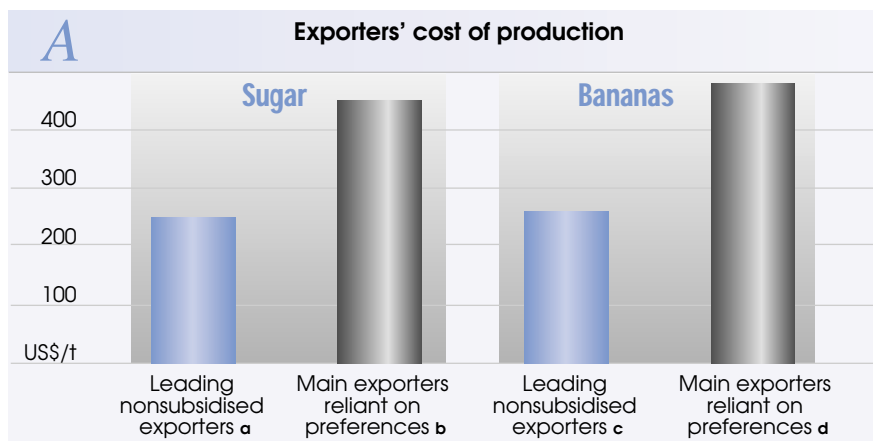
### *High cost industry problem*

An issue that is related to the problem of dependence described above is that producers of goods that benefit substantially from trade preferences frequently end up being high cost producers on a world scale. This is partly because the price premiums they earn on preferential markets are often blended in with returns from other markets, resulting in a higher ‘average’ price paid to producers. This can encourage more resources into the industry than is optimal, and lead to higher average costs of production overall. Some of the price premiums are also likely to be squandered by exporters as a result of lobbying to maintain their individual share of access to preferential markets.

These factors often reduce the competitiveness of industries in preference receiving countries so much that the limited quantities on which they receive preferences become the upper bounds for their production. (Examples for sugar and bananas were shown in tables 4 and 5.)

For sugar and bananas, there are marked differences between average costs of production among exporters that do not have preferential access to heavily protected markets in the European Union and United States, and those that do (figure A).

High cost industries that are uncompetitive on world markets are unable to take advantage of new market opportunities outside of the preference giving countries. This limits the prospects for growth of these industries, with too much emphasis given to convincing policy makers in preference giving countries to grant continued or increased access to preferential markets. The corollary is that too little emphasis is given to implementing industry, social and macroeconomic policies that encourage industries to adopt efficient, low cost production systems. While this might seem only a minor problem in the short term, over the longer term it is likely to be much more significant. For example, if major market opportunities arise over the medium to longer term — say as a result of continued economic growth in populous markets like China, or improved growth in the Asian subcontinent and Latin America — then it will be the countries with efficient, flexible economies and outwardly focused export sectors that are in the strongest position to benefit. Countries with uncompetitive, inefficient industries focused on high priced but restricted preferential markets will find it difficult to participate in new market opportunities. Inefficient and heavily protected industries in quad countries will also be left behind by international developments or become increasingly dependent on subsidies, at an overall cost to their economies.



**a** Australia, Brazil, Thailand. **b** Mauritius, Philippines, Dominican Republic. **c** Ecuador, Costa Rica, Colombia. **d** Cameroon, Caribbean, Canary Islands, Martinique and Guadeloupe.  
 Source: Stoeckel and Borrell (2001, p. 35).

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## *Untargeted*

If the goal of aid is to improve living standards and social conditions in poor countries, then trade preferences are a crude and narrowly focused way of going about it. While trade preferences can sometimes benefit exporters in poor countries, they can also impose burdens on consumers of these products, and producers and consumers of other products. As noted earlier, the major beneficiaries of tariff preferences are generally the individuals that owned productive assets — especially land — prior to the introduction of preferences. As the most distorting and inefficient trade preference arrangements have been in place for many years now, most of the benefits of preferences will have been ‘capitalised’ and returns from the activities receiving the preferences will be much the same as for other activities in the economy.

The benefits of trade preferences rarely flow through to unskilled laborers and the urban poor in developing countries, those people most likely to be in greatest need of assistance.

## Trade preferences and ‘effective’ aid

So, how do trade preferences stack up in relation to the goals of aid, and the principles for effective aid outlined earlier? For aid to achieve an improvement in general living standards in poor countries, many of the benefits must be directed toward individuals and groups in greatest need. However, most of the financial benefits from trade preferences generally accrue to the owners of capital and land used to produce preference receiving exports. Only where the most needy individuals in poor countries are also the owners of the capital and land will trade preferences provide ‘effective’ aid that directly improves their economic conditions. If not, the only way that the poorest individuals will benefit from trade preferences is through the trickle-down effect. That is, as the direct beneficiaries of preferences spend their additional income on goods and services, the increase in economic activity will generally flow through to higher employment and perhaps wages. The trickle-down effect is a poor substitute for more direct intervention to address poverty and economic development in poor countries. Further, where capital assets are also owned by foreign companies or individuals, the trickle-down benefits to the poor from trade preferences may be even smaller.

One of the guiding principles for effective aid outlined by Stiglitz was that aid be directed toward areas where the private sector was less likely to invest. He argued that effective aid should be based on projects and programs that provide goods or services that are valuable to the community as a whole, but

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which would not be supplied efficiently by private companies or businesses. Examples include expenditure on infrastructure and education. In contrast, trade preferences are aimed at directly increasing the profitability of existing private businesses. Moreover, disproportionately large preferences for particular goods or industries provide the beneficiaries with both the incentive and the resources to lobby authorities and policy makers to continue making decisions in their interest.

In a similar vein, trade preferences are inconsistent with the idea that aid should ‘complement’ private investment in poor countries. Efficient private investment — getting businesses to invest in productive and competitive industries — is thwarted by trade preferences, particularly those that lead to export returns that are well above returns available on ‘nonpreferential’ markets. High returns mean that more resources are attracted into preference receiving industries than is optimal, frequently resulting in high cost industries that are uncompetitive in relation to nonpreferential markets.

Further, preferences for industries that are large relative to the size of the overall economy can increase the costs of production in other industries, making it harder for the latter to remain competitive on world markets, and to attract private sector investment. For example, many sugar producing countries with preferential access to EU or US markets have limited land. The preferences become capitalised into the value of land used for sugar. But it also bids up the price of land for alternative activities, increasing costs of other agricultural industries and making them less competitive.

## Improvement or replacement?

Criticism of the effectiveness of existing preferential trade agreements is not meant to imply that the schemes are of no benefit to developing countries, or that they should be removed or revoked immediately. However there are serious underlying flaws and limitations in the existing schemes and these problems should be addressed collectively by industrialised countries before embarking on new preferential trade initiatives for poor countries.

Trade preference schemes typically reduce tax revenue in donor countries. The forgone tax revenue is a representation of the potential transfer to recipient countries arising from preferences. It is important to ask whether the product specific transfers are as effective in advancing the economic development of poor countries as the same aggregate amount of revenue provided as direct development assistance. For example, trade preferences could be

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removed, but with equivalent and offsetting funding paid for well planned and targeted development assistance.

### *Role for developing country policy makers*

The limitations of trade preferences (and other policy initiatives implemented by industrialised countries designed to assist economic and social development in poor countries) do not detract from the fact that the domestic policies implemented by poor countries are ultimately the dominant factors affecting economic conditions and standards of living. Domestic economic and social policies at both the micro and macro levels have an enormous impact on the capacity of poor countries to increase productivity, to engage in trade and to attract investment. In the absence of policies that are conducive to trade and openness, the best designed trade preferences may not be very effective.

### *The way ahead*

The longer term interests of developing countries are best served by comprehensive global trade liberalisation. Trade preferences are inconsistent with this goal. In fact, trade preferences are ultimately a means by which the major industrialised nations have extended and entrenched their protectionist policies — especially for agriculture — and locked in selected or favored developing countries in the process.

The costs to the world economy of protection in industrialised countries is staggering. Previous ABARE research showed that the global gains from liberalisation of both manufacturing and agricultural industries would be around US\$94 billion in 2010 (relative to the reference case), with developing countries benefiting substantially from industrial sector liberalisation in particular (see Freeman et al. 2000, p. 3). If dynamic gains from more open markets are also considered, the global benefits from trade liberalisation increase to around US\$123 billion, with more than half of the additional gains going to developing countries because they have greater scope to gain from the adoption of existing technologies that engaging in trade encourages.

Irrespective of whether or not global trade liberalisation occurs, industrialised countries should focus on providing developing countries — particularly the least developed countries — with assistance designed to directly improve the efficiency and competitiveness of their economies more generally while at the same time helping them to overcome their short term needs.

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Poor countries need to improve their capacity to produce high quality, cost competitive goods in the first place. Capacity building relates to improving the overall efficiency of developing country economies, increasing the competitiveness of all industries and sectors and encouraging higher levels of investment funded from both within and outside these countries. The general areas that need to be addressed include physical and institutional infrastructure, human capital (health, education, research and development etc), legal systems, and market structures — including the provision of information and the implementation and enhancement of property rights.

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