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NATIONAL TRADE POLICY FOR EXPORT SUCCESS

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Study presenting a trade policy framework developed by ITC, providing the trade policy instruments that governments can use to support the competitiveness of firms at each stage of the supply chain – outlines how trade policy options can influence national export competitiveness; discusses in detail the trade policy instruments corresponding each of the following objectives: creating competitive infrastructure services; promoting exports and foreign investment; moving goods across borders effectively; addressing export market issues; and improving inputs and capital goods; considers how to tackle the overriding constraints faced by both public and private sectors, related to every stage of production and distribution of goods and services for export.

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FOREWORD

In recent decades, global integration – together with openness to trade – has been a catalyst for strong economic growth for many countries, generating employment and reducing poverty.

Countries that have reaped the most benefits from international trade have focused on national trade policies and regulatory reforms that created a business-friendly environment so that firms could achieve export success. However, because trade policy is a complicated process that demands balancing competing and disparate interests, the process of reform is challenging for both the public and private sectors. Meeting these challenges calls for action on two fronts.

First, governments must take a holistic view of the policies, laws and regulations needed. They must be implemented in the right sequence to create a mutually reinforcing framework that fosters competitiveness and a business-friendly environment. Policies, laws and regulations should work together in synergy to achieve 'export impact for good'. Ministries, departments and government agencies must work in tandem to ensure policy coherence.

Second, for the reform process to strike the right balance among various interests, governments must secure the buy-in of all stakeholders, especially from the private sector.

Reform may be difficult in the short term, which is why stakeholders must understand the issues and be convinced that the benefits of export-led growth will only be realized in the medium and longer term.

This book brings together research, analysis and experience gathered on trade policy, legal and regulatory changes from various countries around the world. It also presents successes and failures through case studies and examples.

We hope entrepreneurs and private sector organizations will be able to use this book to assess the impact of trade policy and regulations on the competitiveness of their businesses. The book attempts to juxtapose the opportunities and the challenges arising out of the reform process to enable all stakeholders to weigh the benefits and costs of different trade policy options. As such, it is a valuable tool for business associations and other interested stakeholders engaging in advocacy campaigns on trade policy issues.

I am confident it will also be of immense use to policymakers in developing and least developed countries that are pursuing export-led economic development strategies.

Above all, we hope this book will promote a culture of informed public-private dialogue, which is an essential component of the democratic process of policy formulation. Only by engaging all stakeholders in an informed dialogue will we be able to achieve the goal of sustainable and inclusive economic growth.



Patricia Francis
Executive Director
International Trade Centre

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Introduction – National trade policy for export success

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ABBREVIATIONS

The following abbreviations are used:

ACP	African, Caribbean and Pacific
ACV	Agreement on Customs Valuation
AEO	Authorized economic operator
AGOA	African Growth and Opportunity Act
ASEAN	Association of Southeast Asian Nations
CBU	Completely built up
CKD	Completely knocked down
CVD	Countervailing duty
DI	Destination inspection
DSL	Digital Subscriber Line
ECOWAS	Economic Community of West African States
EEA	European Economic Area
EPZs	Export processing zones
EU	European Union
FDI	Foreign direct investment
FTAs	Free trade agreements
G20	Group of Twenty
GATS	General Agreement on Trade in Services
GDP	Gross domestic product
GSP	Generalized System of Preferences
IATA	International Air Transport Association
ICT	Information and communications technology
IMF	International Monetary Fund
IPA(s)	Investment promotion agency(ies)
IPO	Initial public offering
ISO	International Organization for Standardization
IT	Information technology
ITC	International Trade Centre
LDCs	Least developed countries
LMIC	Low- and middle-income countries
LPG	Liquefied petroleum gas
LPI	Logistics Performance Index
MFN	Most favoured nation
MNEs	Multinational enterprises
MRL	Maximum residue limit
NAFTA	North American Free Trade Agreement
NTBs	Non-tariff barriers
NTMs	Non-tariff measures
OECD	Organisation for Economic Co-operation and Development
PPP	Public-private partnership
PSI	Pre-shipment inspection
ROOs	Rules of origin
RTAs	Regional trade agreements
S&D	Special and differential treatment
SCION	Standard input-output norms
SEZs	Special economic zones
SMEs	Small and medium-sized enterprises
SPS	Sanitary and phytosanitary
SW	Single window
TBT	Technical barriers to trade
TCMCS	Coding System of Trade Control Measures
TRQs	Tariff rate quotas
TTC	Trade transaction cost
TTFA	Trade and Transport Facilitation Audit
UNCTAD	United Nations Conference on Trade and Development
VAT	Value-added tax
WCO	World Customs Organization
WTO	World Trade Organization

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INTRODUCTION

Export performance has been critical for the economic development of many developing countries in recent years. It has contributed to faster growth and poverty reduction. Exporting has produced economic benefits deriving from efficiency gains associated with exploiting comparative advantages and improved allocation of scarce resources. There are also dynamic gains in the export sector driven by greater competition, greater economies of scale, better use of capacity, dissemination of knowledge and know-how, and technological progress.

TRADE-LED GROWTH

There are now many examples of developing countries that have been able to develop competitive export industries and have been rewarded with remarkable economic growth: the Republic of Korea and Chinese Taipei in the 1960s; Southeast Asian countries such as Thailand, Malaysia and Singapore in the 1970s; China in the 1980s; and Central and South American countries in 1990s, such as Chile. These countries were also able to tap into the phenomenal growth in international trade. Between 1950 and 2005 the volume of world trade increased 27 times, from US\$ 296 billion to over US\$ 8 trillion.¹ Despite international trade experiencing a contraction of 12.2% in 2009² in the wake of the financial crisis, trade is again on the upswing. This is evidenced by a record-breaking 14.5% surge in the volume of exports in 2010.³

But what trade policies and regulations are needed to achieve export success? This book attempts to answer this question by promoting a better understanding of trade policy, which can enable countries to achieve export success. It is now widely recognized that to tackle the myriad constraints faced by exporters, trade policy can no longer be limited to so-called 'border measures'.⁴ Policymakers must address a wide range of national issues, including creating an enabling business environment (competition, investment, institutions, etc.); providing competitive access to infrastructure (energy, communications, transport, etc.); facilitating reliable and efficient movement of goods to destination markets; and ensuring product compliance with quality and sanitary and phytosanitary standards.

Because of the success of forerunners of export-led economic growth, since the mid-1980s many other developing and least developed countries (LDCs) have tried to emulate this model. There has been a fundamental shift in development policy. The import substitution model encouraged countries to build up their own domestic agricultural and manufacturing capacity and substitute domestically produced goods for imports. This may have been important at an earlier stage of development in some countries, but also led to a number of failures and slow growth, and a number of countries that had earlier followed an import-substitution model have become more outward oriented. Today, the focus is on improving international competitiveness, allowing the exploitation of dynamic export markets.

DOMESTIC POLICY PRECONDITIONS

To be export competitive among countries with similar resource endowments, a range of supporting domestic policies is required. Many countries are unable to realize the full potential of export-led growth because

1 'The GATT/WTO at 60: WTO World Trade Report examines six decades of multilateralism in trade', WTO Press Release 502, 4 December 2007. Available at: www.wto.org/english/news_e/pres07_e/pr502_e.htm

2 'Trade to expand by 9.5% in 2010 after a dismal 2009', WTO reports, WTO Press Release 598, 26 March 2010. Available at: www.wto.org/english/news_e/pres10_e/pr598_e.htm

3 'Trade growth to ease in 2011 but despite 2010 record surge, crisis hangover persists', WTO Press Release 628, 7 April 2011. Available at: www.wto.org/english/news_e/pres11_e/pr628_e.htm

4 Kaukab, R., 'Inclusiveness of trade policy-making: Challenges and possible responses for better stakeholder participation', Commonwealth Trade Hot Topics, Issue 70, February 2010.

domestic preconditions remain largely unfulfilled. For example, LDCs still contribute just 1% to global trade. Partial efforts have been made by many countries, but anything short of a comprehensive approach fails to overcome the full range of constraints inhibiting export development.

A comprehensive and clearly articulated approach to trade policy and regulatory practices, with buy-in by all stakeholders, is vital to the success of an export strategy. When different government departments handle trade-related policies in isolation rather than in an integrated manner, it is difficult to develop and implement a coherent policy framework to support an export strategy. A coherent trade policy framework bridges government departments, public and private sector trade-related programmes, and private-sector actors. The result is an overarching set of prioritized objectives prepared in a holistic fashion by bringing together all relevant stakeholders and driven by the common goal of export impact for good.

This book aims to address these concerns by advancing a coherent trade policy framework. To address the need to unleash the export potential of firms through trade policy 'at the border', 'behind the border' and 'beyond the border', this book advances prioritized objectives to tackle the overriding constraints faced by both the public and private sectors.

This introduction explains how the International Trade Centre (ITC) prioritized the objectives discussed in each chapter. It gives an overview of how trade policy options can influence national export competitiveness and trade policy options. It goes on to present a framework, created specifically for this book, to explain the interface between trade policy and export competitiveness (see figure 1). The framework captures at a glance the scope for trade policy to influence export competitiveness. It illustrates the need for specific trade policy instruments to address constraints exporters face behind the border, at the border and beyond the border, related to every stage of production and distribution of manufactured goods, agricultural products and services for export. Some of these trade policy instruments that have multiple purposes in addressing common, overlapping issues. Finally, this introduction provides a further explanation of how these objectives are addressed in each chapter of the book.

TRADE POLICY OPTIONS FOR NATIONAL EXPORT COMPETITIVENESS

Export competitiveness refers to 'the capacity to produce, distribute and sell products and services as or more effectively and efficiently than is done by the relevant competitors'.⁵ In the current globalized trading environment, the notion of competitiveness has taken on added importance and emerged as a key indicator and determinant of 'successful' nations. Christian Ketels, an economist specialized in competitiveness strategy, suggests: 'Exports are an important diagnostic tool that can help signal whether more fundamental conditions in the economy are right. The overall success on global export markets as well as the particular pattern of industries that successfully export provides valuable 'revealed' information on underlying competitiveness conditions.'⁶ He further adds that poor export performance is 'an indication that there are weaknesses that either limit the productivity of companies or negatively affect their ability to project their capabilities on global markets. Exports in particular sectors give an indication that the location has a particular set of strengths in its competitiveness fundamentals that are conducive to their success.'

National trade policy that promotes export competitiveness must find ways to increase the ability to sell domestically produced goods and services on global markets. Finding such ways requires the analysis of factor endowments, institutional strengths and market opportunities. Strategies may then be shaped to take account of overall national development and socio-economic ambitions, typically involving multiple government departments, ministries and agencies, as well as the effective participation and collaboration of the private sector. Often a strategy aimed solely at attaining export success may be politically unfeasible due to incompatible competing interests that impact on the process of trade policy decision-making. Strategies

5 Ministry for Foreign Affairs of Finland. Available at: formin.finland.fi/public/default.aspx?nodeid=15265&contentlan=2&culture=en-US

6 Ketels, C., 'Export competitiveness: Reversing the logic', paper prepared for World Bank's Development Debate, 'What do we mean by Export Competitiveness and How do Countries Achieve it in an Uncertain World?', Harvard Institute for Strategy and Competitiveness, 2010.

also need to be formulated within the international trading context to ensure compliance with commitments under the World Trade Organization (WTO) and other regional and bilateral agreements. The main priority is to ensure domestic policies and partners work in tandem to achieve export competitiveness.

IDENTIFYING DRIVERS FOR EXPORT SUCCESS

Consensus is emerging concerning the fundamental drivers of exports. Increasingly, it is understood that broad reforms at the national level can have positive results for exporters. Global competitiveness frameworks and firm-level value chain analyses that have emerged have been helpful in this respect.

Global competitiveness frameworks

The emergence of international competitiveness frameworks has been influential in pinpointing a wide range of stumbling blocks to trade. Frameworks most relevant for trade policy include the following::

- The World Economic Forum's Global Competitiveness Index outlines 12 pillars for global competitiveness:
 - Institutions, infrastructure, the macro-economic environment and health and primary education are basic requirements for competitiveness.
 - Higher education and training, goods market efficiency, labour market efficiency, financial market development, technological readiness and market size are essential to enhance efficiency.
 - Business sophistication and innovation are indicators of innovation-driven economies.
- The World Economic Forum's Enabling Trade Index is also relevant. The index measures how economies have developed institutions, policies and services to facilitate trade, and groups its indices around:
 - Market access
 - Border administration
 - Transport and communications infrastructure
 - Business environment.
- The World Bank's *Doing Business Report* has also emerged as a recognized framework to measure progress related to trade policy and export competitiveness. Its 11 indices measure ease with:
 - Starting a business
 - Dealing with construction permits
 - Getting electricity
 - Registering property
 - Getting credit
 - Protecting investors
 - Paying taxes
 - Trading across borders
 - Enforcing contracts
 - Resolving insolvency.

These frameworks help trade policy reformers to assess the trading and business environment of their country against international best practices. This enables them to focus on specific areas to reform that will improve their country's ranking on international indices and, at the same time, strengthen competitiveness and increase exports.

However, while international frameworks are useful to assess competitiveness, their effectiveness is limited for the following reasons:⁷

- They focus on broad economic competitiveness rather than export competitiveness. As such, they cover some issues that may be less critical for the export environment (or too far upstream) and fail to go into sufficient detail on some issues that are particularly critical for exports.

⁷ *Ibid.*

- Most analyses of export competitiveness uncover a series of issues that a country would need to address to achieve more success in export markets. This is to be expected, as the factors that constrain exports are generally multiple and simultaneous. But it is seldom financially feasible, operationally practical, or politically possible to address all these issues concurrently. In short, there is a need to turn an assessment into practical and actionable policy.

The value chain approach

International frameworks generally assess and expose constraints rather than propose ‘remedies’ or policy recommendations. Further analytical work is required at the country level to devise more targeted policy responses. Value chain analysis can be used as a framework to complement global competitiveness benchmarking.

The value chain approach analyses each link in the ‘chain of activity’ at the sector level. A value chain for any product or service extends across research and development, raw materials supply and production, delivery to international buyers, and ultimately to disposal and recycling.⁸

By ‘analysing the costs of doing business through a specific product or industry lens, value chain analysis facilitates the identification of binding constraints to growth and competitiveness and the effective targeting of institutional and policy-related issues, at the sector and economy-wide levels alike’.⁹

How is value chain analysis for national reforms to trade policy? The findings of a report from the World Bank Group suggest that the reform agenda that typically emerges from the value chain analysis relates to three broad core areas:¹⁰

- **Product or services market issues** – trade policy, competition policy, price distortions, subsidies, licensing, standards for products and services, customs, logistics, property rights, and the regulatory framework.
- **Factor market issues** – wages, capital charges, utility market issues, labour market rigidities, land price and zoning.
- **Market-related issues** – market diversification, research and development, product or service diversification and supplier linkages.

Importantly, the findings suggest that the obstacles to trading are typically not unique to one particular sector, but affect exporters from diverse sectors. These common factors suggest that firm productivity greatly depends upon public inputs to production and well-functioning markets in which firms operate. Government policies either contribute to or constrain the creation of a business-friendly environment in which firms can efficiently obtain and sell their inputs.

The multifaceted nature of export competitiveness requires a clear understanding of the wide range of contributing and constraining factors. Constraints are likely to be multiple and intertwined, tied to cross-cutting issues such as good governance; infrastructure; product standards, certification and corresponding regulatory requirements for the provision of services; access to finance; and firm linkages.

THE TRADE POLICY AND EXPORT COMPETITIVENESS INTERFACE

The list of constraints that prevent a country from expanding trade is very long. Most developing countries are unable to make wholesale reform changes simultaneously. First, this is due to a failure to create the necessary constituency for reform. Because policymaking requires buy-in from a diverse range of stakeholders with competing views, they need to be convinced of the rationale for reform. Second, many countries are constrained by a lack of financial resources to carry out often-expensive reforms.

8 ‘Value Chain Analysis: A Strategy to Increase Export Earnings’, *International Trade Forum* – Issue 1, ITC, 2003.

9 ‘Moving toward competitiveness: A value-chain approach’, World Bank, 2007.

Available at: [www.ifc.org/ifcext/fias.nsf/AttachmentsByTitle/MovingTowardCompetitiveness/\\$FILE/Value+Chain+Manual.pdf](http://www.ifc.org/ifcext/fias.nsf/AttachmentsByTitle/MovingTowardCompetitiveness/$FILE/Value+Chain+Manual.pdf)

10 *Ibid.*

As a result, it is critical to galvanize stakeholders around overarching constraints, which if addressed would have the greatest impact on expanding trade and promoting economic growth. Because country situations are so diverse, there is no singular trade policy framework that can be advocated globally. However, there are some similar, fundamental components.

The ITC trade policy and export competitiveness framework developed for this book and detailed in figure 1 is intended to assist readers in identifying overriding objectives and suitable trade policy instruments to address constraints. The framework is intended to enable policymakers, private sector organizations and entrepreneurs to take a holistic approach to national trade policy reforms. Reforms should be implemented with a wide range of instruments aligned to support enterprises in achieving export competitiveness and success. The framework is the analytical basis for this book.

THE PRODUCTION SUPPLY CHAIN

The top half of figure 1 shows the most typical inputs firms require across the entire supply chain:

- It begins with the need for firms to access raw materials and intermediate goods for production. Here the most cost competitive and reliable source of supplies is sought, either domestically or abroad.
- Next, inputs are transported to the firm via customs, distribution warehouses and overland (road, railway, etc.). Some inputs may be 'transported' via telecommunication or other modes of cross-border trade (outsourcing services).
- Inputs are then processed into agricultural or industrial products or services.
- Finally, the products or services are 'transported' to destination markets. To transport goods to the border firms are increasingly reliant upon efficient logistics functions, for which there is a need for good communication systems (telecommunications and Internet). Good communications systems are also necessary for the export of services typically characterized as 'business process outsourcing'. All products, whether agricultural or manufactured, must conform to technical barriers to trade (TBT) requirements. Agricultural products must conform to sanitary and phytosanitary (SPS) requirements. Services may need to meet regulatory requirements.

Firms must compete with both domestic and foreign firms as providers of goods or services to destination markets. Cost, access and reliability of inputs is inevitably a main concern of firms endeavouring to be competitively priced and reliable providers of goods. At the same time, non-competitiveness in any of the four areas discussed earlier can make exporting an unrealistic option for firms.

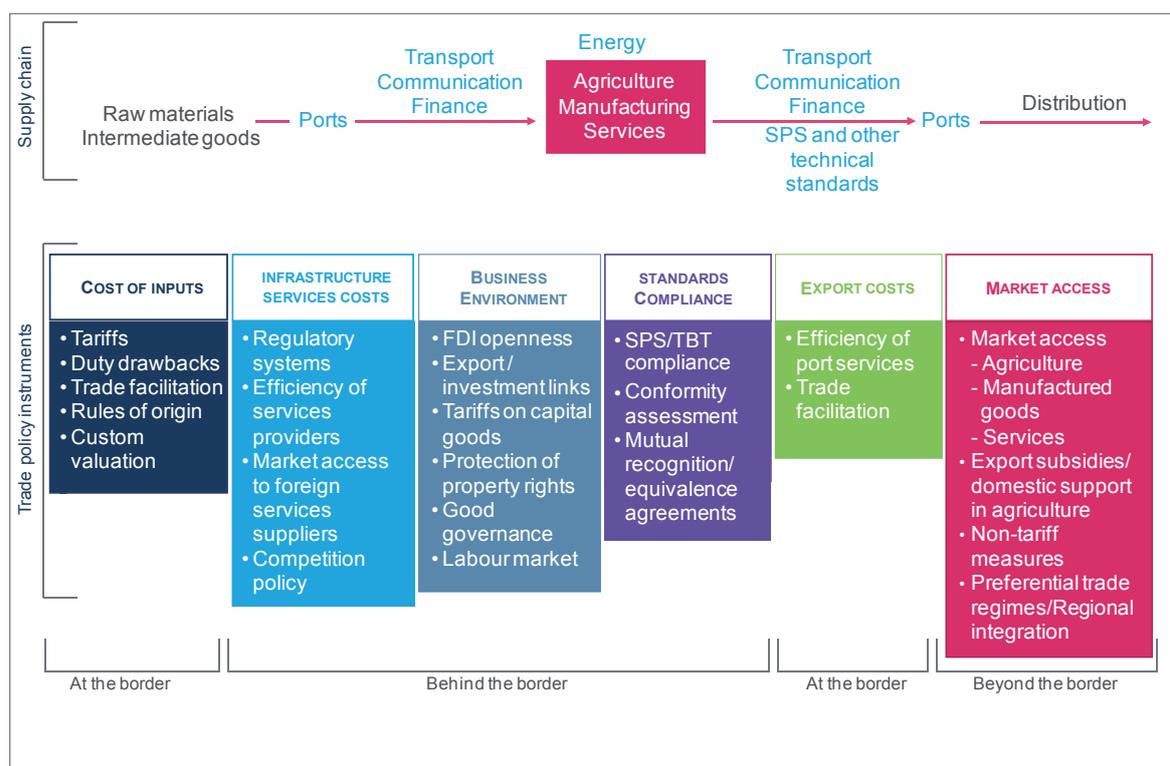
TRADE POLICY INSTRUMENTS

The bottom half of figure 1 details typical trade policy instruments that governments can use to support the competitiveness of firms at each stage of the supply chain. These instruments encompass a broader understanding of trade policy responses 'at the border', 'behind the border' and 'beyond the border'. Governments can use some instruments to target specific areas of the supply chain that would boost firm competitiveness. Other instruments are cross-cutting and affect multiple areas of the supply chain through policies that shape the country's trading and economic landscape.

An example of the former is the use of duty drawback schemes to 'provide exporters of manufactured goods with imported inputs at world prices and thus increasing their profitability, while maintaining the protection for domestic industries that compete with imports'.¹¹ Such policies are specifically intended to achieve access to inputs at competitive prices. Similarly, mutual recognition of academic qualifications is an important determinant of export of professional services (under the broader area of trade in services).

¹¹ Export Competitiveness and Duty Drawback, World Bank: web.worldbank.org/WBSITE/EXTERNAL/TOPICS/TRADE/0,,contentMDK:20540524~pagePK:148956~piPK:216618~theSitePK:239071,00.html

Figure 1: The trade policy/export competitiveness interface



Source: ITC.

Here governments – ideally working in close cooperation with professional bodies – can negotiate mutual recognition agreements with their trading partners with foreign professional credentials so as to enable greater exporting of these services.

In terms of cross-cutting policy instruments, overall improvements in transport, communications, port services and distribution can have an impact at various stages of the supply chain. For example, transport brings goods to the border or to the port, but also affects production costs.

By mapping the trade policy instruments that impact each stage of the supply chain it becomes clear that the same trade policy instruments regularly affect different stages. Accordingly, trade policy instruments can be classified into a set of overarching objectives. These objectives are the subject of the five chapters of this book.

- Create competitive infrastructure services
- Promote exports and foreign investment
- Move goods across borders effectively
- Address export market issues
- Improve inputs and capital goods.

DESIGNING TRADE POLICY FOR EXPORT COMPETITIVENESS

CREATE COMPETITIVE INFRASTRUCTURE SERVICES

Chapter 1 discusses the positive effects that competitive infrastructure services can provide for businesses. It focuses on issues concerning the competitive structure and behaviour of firms involved in the delivery of infrastructure services. It also reviews the role of public initiatives to enhance competition of infrastructure services through restructuring and applying related rules.

Numerous examples illustrate the impact of state monopolies and abuses of a dominant position in raising the input costs in developing countries, thereby making it more difficult for them to export. The chapter explains how inefficient monopolies can be restructured and competition rules applied to revitalize the performance of infrastructure sectors. Attention is also given to the role that business associations and individual businesses can play in guiding policy innovation and implementation.

PROMOTE EXPORTS AND FOREIGN INVESTMENT

Chapter 2 explores how foreign direct investment drives the global economy and how it may enhance a country's export performance. A discussion follows on the policy implications of linkages between export performance and foreign direct investment, as well as recommendations to promote export growth by adopting the 'right' policies concerning foreign investment.

MOVE GOODS ACROSS BORDERS EFFECTIVELY

The importance of effective trade facilitation for promoting exports is stressed in chapter 3. Effective trade facilitation increases exporter competitiveness by allowing exporters to trade goods and services on time and with low transaction costs. Key components of a 'broadened approach' to trade facilitation are discussed, including customs (clearance, risk management, coordination among border agencies, etc.), competency of private and public logistics services providers, and logistics and competitiveness.

Also presented are best practices to achieve the main objectives of trade facilitation, which are to minimize the transaction costs and complexity of international trade for businesses while maintaining efficient and effective levels of compliance with national and international requirements.

ADDRESS EXPORT MARKET ISSUES

Chapter 4 emphasizes that the roadmap to a successful export effort requires identifying market opportunities and conditions of access, followed by developing a programme at the government and private-sector levels to take advantage of the opportunities. The chapter focuses on what exporters need to know about overseas markets, how to obtain that information, and how to exploit the opportunities that are identified.

Advice is also provided on how exporters can develop a strategy to address these various, changing situations to win markets. There is also a discussion on technical barriers to trade, which have been identified in recent surveys as a key concern of exporters.

IMPROVE INPUTS AND CAPITAL GOODS

Given equal terms of access, competitiveness in a foreign market depends on being able to deliver at a final price that is lower than that of competitors, taking into account conditions of sale, quality, delivery times and, where appropriate, after-sales services.

This final price of the good or service is itself a composite of production costs as well as delivery costs, which in some instances may be even higher than the costs of production. Chapter 5 explores strategies and policy options to ensure that firms are able to access inputs and capital goods at competitive prices.



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CHAPTER 1

CREATE COMPETITIVE INFRASTRUCTURE SERVICES

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CREATE COMPETITIVE INFRASTRUCTURE SERVICES

INTRODUCTION

Infrastructure services – including transportation, energy and telecommunications – account for a large proportion of the costs of export-oriented and other developing and transition economy businesses. The term 'infrastructure' typically refers to 'the basic physical and organizational structures and facilities (e.g. buildings, roads, power supplies) needed for the operation of a society or enterprise'.¹ The efficient organization and delivery of infrastructure services is vital to the export competitiveness and success of businesses. For this reason, infrastructure investment is seen as a key to enhance development prospects of low-income and middle-income countries.

DEVELOPMENT ASSISTANCE FOR INFRASTRUCTURE

As a result, providing infrastructure services has emerged as a primary focus of development assistance. Infrastructure now accounts for about 40% of the World Bank's commitments.² Sound infrastructure investments can make a big difference to countries' growth prospects. For example, in recent years, enhanced public investment in infrastructure has been a key factor underpinning rapid growth and a decrease in trade costs in the emerging economies of Asia.³

Several issues are critical to successful infrastructure.

- **Finance.** Because infrastructure is often provided through public investment and expenditure, the adequacy of public finances and the efficiency of their allocation is an important factor. Frequently, access to private financing – including foreign direct investment – as a supplement or alternative to public funds is also a concern.
- **Public procurement.** A related factor is the efficiency and competitiveness of public procurement methods and institutions.⁴
- **Technology.** Access to the best available technology, whether sourced from home or abroad and whether financed by public or private capital, is another crucial factor.

FOCUS ON FIRMS DELIVERING INFRASTRUCTURE SERVICES

This chapter focuses on issues concerning the competitive structure and behaviour of firms involved in the delivery of public and business infrastructure services. Also discussed is the role of public initiatives to enhance competition in providing these services through restructuring and application of related rules. Attention is given to the role that business associations and individual businesses can play in guiding policy innovation and implementation in this area.

The structure and behaviour of firms involved in infrastructure supply, related rules and public policies and their implications for developing country businesses is just one aspect of the discussion on public infrastructure as a development tool. Historically, in both developed and developing economies, monopolies often

¹ As defined by the Online Compact Oxford Dictionary. Available at: www.askoxford.com/concise_oed/infrastructure

² For further information on the World Bank's infrastructure-related activities: web.worldbank.org/WBSITE/EXTERNAL/TOPICS/EXTSDNET/0,,contentMDK:22493665~menuPK:6395187~pagePK:64885161~piPK:64884432~theSitePK:5929282,00.html

³ Brooks, D.H. and D. Hummels. Infrastructure's role in lowering Asia's trade costs: Building for trade, Cheltenham, Edward Elgar, 2009.

⁴ Anderson, R.D., W.E. Kovacic and A.C. Müller, 'Ensuring integrity and competition in public procurement markets: a dual challenge for good governance'. In Arrowsmith, S., R.D. Anderson, The WTO Regime on Government Procurement: Challenge and Reform, Chapter 22, pp. 3-58, Cambridge University Press, 2011.

provided key infrastructure services, whether in the fields of transportation, energy or telecommunications. Occasionally these monopolies have emerged through monopolistic or predatory behaviour by the firms themselves, but most often they have been established through legislation or by government grant.

Frequently, the combination of monopoly power and public ownership has resulted in less-than-satisfactory performance, as manifested by:

- Higher-than-competitive rates;
- Lack of adequate service offerings;
- Lack of innovation or readiness to adapt to improvements in technology as they become available.

This has directly undermined the competitiveness of developing country business users. Consequently, there has been a trend to 'de-monopolize' such industries and ensure fair competition to the benefit of users, as illustrated by the various examples in this chapter.⁵

PRIVATIZING IS NOT ENOUGH

In many cases, first recourse of governments has been to privatize the relevant entities, seeking thereby to invigorate and infuse them with the dynamism that is often associated with private ownership. This has been particularly true in the transition economies of Central and Eastern Europe, as well as in developing economies in Africa, Asia and Latin America. However, experience has shown that this can be a trap. Merely privatizing state-owned monopolies typically will not yield improved performance if measures are not also taken to expose such enterprises to competitive market forces.⁶

Experts increasingly believe that exposing infrastructure service providers to competition is at least as important to improving performance as the injection of private capital financing, and should, where possible, precede rather than follow privatization. It may be easy to make such a recommendation, but it is harder to follow it in practice. Even in developed economies, reforms have tended to proceed in an incremental fashion, seeking practical solutions to particular problems that have presented themselves, and with much 'learning by doing', rather than following an overall 'rational plan'.

Where privatization has already occurred, measures to introduce competition remain important and should still be pursued. However, they may be more difficult to implement as the private monopoly will have a clear interest in lobbying the government to delay or avoid measures that may jeopardize its market position.

An important element of the policy response to a lack of competition in public infrastructure sectors is either adopting or maintaining a competition or antitrust statute. Such a statute is essential to prevent and remedy common in anti-competitive practices, such as abuses of a dominant position or the establishment of price fixing cartels that raise costs for infrastructure customers. In a number of instances, competition laws, typically through the application of their provisions regarding abuses of a dominant position, can be used as a platform to impose necessary restructuring and establish competitive access regimes.⁷

However, in some cases the remedies available through competition law enforcement may be insufficient and other measures may be needed to effectively address monopoly issues in infrastructure industries. An example is repealing or reforming statutes or regulations that unnecessarily limit entry to particular markets. Another is enacting new legislation to restructure – break up – established monopoly enterprises to enable

5 Beato, P and J. Laffont. 'Competition in public utilities in developing countries', Inter-American Development Bank, Washington, D.C., Sustainable Development Department, *Technical Papers Series*, 2002. Available at: cdi.mecon.gov.ar/biblio/docelec/MU2007.pdf

Kessides, I., *Reforming Infrastructure; Privatization, Regulation, and Competition*, World Bank, Washington, D.C., 2004.

François, J. and M. Manchin, 'Institutions, Infrastructure, and Trade,' Policy Research Working Paper No. 4152, World Bank, Washington, D.C., 2007.

6 *Ibid.* and Anderson, D. Robert, F. Jenny, 'Competition Policy, Economic Development and the Role of a Possible Multilateral Framework on Competition Policy: Insights from the WTO Working Group on Trade and Competition Policy', in Medalla, E., ed., *Competition Policy in East Asia*, Chapter 4, Routledge, 2005.

7 Kovacic, W.E., 'Designing Antitrust Remedies for Dominant Firm Misconduct', vol. 31, *Connecticut Law Review*, pp. 1285-1319, 1999.

Anderson, R.D. and A. Heimler, 'Abuse of Dominant Position: Enforcement Issues and Approaches for Developing Countries', in Dhall, V. (ed.), *Competition Law Today: Concepts, Issues and the Law in Practice*, Chapter 2, pp. 59-92, New Delhi, Oxford University Press, 2007.

competition, for example by establishing industry-specific competitive access regimes. Such measures may be adopted either as an alternative to, in conjunction with, or as a follow-up to competition law enforcement proceedings.

For example, the far-reaching reform of the United States telecommunication services was to a large extent put in motion by the 1982 consent settlement in an antitrust case, *United States versus AT&T*. Nevertheless, extensive legislative action was required to complete the process. This issue is discussed further in this chapter, in the section on telecommunications. A complementary relationship between competition law enforcement actions and legislative reforms in the reform of public infrastructure sectors has also been evident in the European Union (EU).⁸

While measures to inject competition into moribund infrastructure monopolies have most often been implemented at the national level, in many cases there is also an interface with international trade agreements and cooperation. For example, in Africa, the creation of common regional markets may be a necessary step to establish effective competition in some elements of the transportation sector, due in part to a lack of adequate demand to support multiple service providers in some individual countries. Similarly, regional cooperation can be a key factor in facilitating competition in energy markets. Trade commitments, including in the 1997 World Trade Organization (WTO) negotiations on Basic Telecommunications Services, have played an important role in reinforcing the effectiveness of pro-competitive reforms in the telecommunications sector.

Using this chapter

The specific sectors examined in this chapter include:

- Transportation, including port facilities, railways, air and road transport;
- Energy, including electricity and natural gas;
- Telecommunications.

This chapter explores infrastructure competitiveness issues from the vantage of developing and transition economy infrastructure-user firms, with particular attention to the interests of export-oriented firms. It provides numerous examples of the impact of state monopolies and abuses of a dominant position – whether by private or publicly owned companies – in raising the input costs of developing country businesses, thereby making it more difficult for them to participate in export markets. The chapter also explains and provides examples of how inefficient monopolies can be restructured and competition rules applied to revitalize and enhance the performance of infrastructure sectors.

The aim of the chapter is not to provide a textbook for legal, economic or judicial experts to develop particular cases within competition authorities or adjudicatory bodies, but rather to show policymakers the importance of policy for infrastructure issues related to the competitiveness of developing and transition economy businesses. Another aim is to encourage businesses, their associations, and other relevant bodies, such as consumer and public interest organizations, to provide appropriate input to the policy solutions adopted.

This chapter presents background for approaches to competitive restructuring and competitive access to remaining monopolies that cut across the various sectors. A key related point concerns the need for input from developing country businesses and their associations in the design and application of relevant policies and initiatives.

Concerning the relationship between the infrastructure issues in this chapter and the domain of trade policy, for the most part, the measures and initiatives are not legally mandated by trade agreements. Rather, they fall into the category of measures that countries may take to ensure that their participation in trade-liberalizing agreements and arrangements is not only legally compliant, but also successful in generating benefits for citizens.

There are exceptions. As discussed in this chapter, maintaining ‘competitive safeguards’ in relation to basic telecommunications services is a requirement of the Reference Paper on regulatory principles that has

⁸ Canada’s experience with these issues is discussed in: Anderson, R. D., A. Hollander and J. Monteiro, W.T. Stanbury, ‘Competition Policy and Regulatory Reform in Canada, 1986-1997’, *Review of Industrial Organization* 13, pp. 177-204, 1998.

been adopted by most WTO members. Sometimes the most effective tool to enhance competition, whether in infrastructure or other sectors, is trade liberalization, which entails removing legal or other barriers to participation in goods or services markets by 'foreign' firms.

In many cases, trade liberalization alone fails to generate sustained development and growth. This can be traced to a failure to introduce complementary domestic policy reforms.⁹ Countries and their businesses are best positioned to take advantage of the potential benefits of trade liberalization when steps are taken to:

- Reduce costs and enhance the efficiency of infrastructure sectors such as telecommunications, energy and transportation
- Promote flexibility by eliminating artificial restrictions on entry, exit and pricing in manufacturing and other industries
- Establish and strengthen incentives for investment and innovation
- Create efficient management structures
- Improve productivity.

The views and suggestions set out in this chapter are offered in this spirit.

RESTRUCTURING STATE MONOPOLIES TO IMPROVE PERFORMANCE

Addressing sub-optimal performance in infrastructure sectors due to lack of competition can require a variety of remedial measures. The privatization of relevant entities can be part of the solution. But the mere privatization of relevant entities will not yield improved performance if measures are not taken to expose former monopoly enterprises to competitive market forces. The result could be to substitute private monopolies for public ones, often with no improvement or even a worsening of performance from the standpoint of users.

USING COMPETITION LAW AND POLICY

In this context, competition law and policy have vital roles to play. A competition law is essential to prevent common anti-competitive practices, such as abuses of a dominant position or establishing price-fixing cartels that raise costs to consumers and business users. This is no less important in public infrastructure than in other sectors; arguably it is more so, because the effects of excessive prices or poor quality service in infrastructure sectors will be felt across the national economy.

Beyond applying competition law to harmful practices such as cartels, it may be necessary to consider the comprehensive restructuring of established monopoly enterprises/dominant firms. It may also be necessary to enact competitive access regimes that, for example, authorize competing electrical energy suppliers to connect to a power grid, enable trains operated by different enterprises to run on the same sets of rails, or grant competing transportation service providers equal access to port or airport facilities. The repeal of legislation limiting entry or granting legal monopoly status may also need to be considered.

Essential information is provided on the topic of competitive restructuring, particularly the forced separation of monopoly and competitive business segments in a particular sector. Information is provided on the closely related topic of access pricing. Also discussed is the continuing need for effective enforcement of general provisions of competition law, even after appropriate restructuring has taken place. Finally, this section explains the important role that businesses and other associations, such as consumer organizations and public interest groups, can play in reinforcing the case for user-friendly reforms and in the ongoing application of relevant rules in ways that benefit export-oriented businesses.

⁹ This is discussed further by Osakwe, C., *Poverty Reduction and Development: the interaction of trade, macroeconomic and regulatory policies*, Tenth Joseph Mubiru Memorial Lecture, organized by the Bank of Uganda, 14 December 2001.

ISSUES IN COMPETITIVE RESTRUCTURING

Over the past two to three decades, governments in developed and developing countries have progressively implemented extensive reforms aimed at improving the performance of public infrastructure sectors. A common strategy for improvement has been the introduction of private sector participation in formerly state-owned infrastructure markets, such as the transportation, energy, telecommunications and other sectors. However, for private sector participation to result in improved performance, creating competition is an essential complement to other reforms.

A necessary basis for reforms implemented in many countries to create new possibilities for competition has been the realization that the majority of infrastructure sectors, even if they have some monopoly elements, normally are not 'monolithic natural monopolies'.¹⁰ Rather, such sectors typically comprise distinct activities, some with natural monopoly characteristics, but others that may be perfectly capable of supporting competition. A good example is the electricity sector, which in the past was widely assumed to be a natural monopoly. It is now recognized that although building and operating power transmission facilities may be most efficiently done by a single firm, in general there is no technical barrier that prevents power for the grid from being supplied by multiple electricity generating companies operating in competition with each other. However, as discussed later in this chapter, introducing competition into previously monopolized electricity sectors is a complex and challenging process.

Another example is that while decades ago it was believed that the then-telephone industry was best served by a single, vertically integrated enterprise supplying most or all related services, today most segments of the industry in most countries have to one degree or another been exposed to competition between multiple service providers. At the same time, there are continuing issues regarding the terms of access to common facilities, for example, the 'local loop' that may still have natural monopoly characteristics.

POLICY OPTIONS

Table 1 summarizes information on competition possibilities in five infrastructure sectors. If implemented successfully, these options can generate major savings for businesses and other users.

The challenge for policymakers is to decide, on the basis of the best available information, which of these possibilities for competition can be realized most practically in the context of their national geographical, institutional and practical constraints. This is a challenge that calls for substantial input from business users, on the basis of their practical experience and knowledge, in addition to public interest organizations and any advisory bodies with specialized knowledge of the sectors concerned. In some cases, authorities may wish to draw upon the services of consulting firms having specialized knowledge of issues and technical constraints in the relevant sectors.

Table 1: Non-competitive and competitive components of key infrastructure industries

Industry	Activities that are usually not competitive	Activities that can be or are sometimes are competitive
Electricity	High-voltage transmission and local distribution	Generation and supply to final customers
Gas	High-pressure transmission and local distribution	Production, supply to final customers and storage
Telecommunications	Local residential telephony or local loop	Long-distance, mobile and value-added services
Railways	Short-haul track and signalling infrastructure	Train operations and maintenance facilities
Air transport services	Airport facilities	Aircraft operations, maintenance facilities, and commercial activities

Source: Table adapted from Kessides, I., *Reforming Infrastructure: Privatization, Regulation, and Competition*, World Bank, Washington, D.C., 2004. Table 1.2. See also: Gönenç, R., M. Maher, G. Nicoletti, 'The Implementation and the Effects of Regulatory Reform: Past Experience and Current Issues', OECD Economic Studies 32(11), Organisation for Economic Co-operation and Development, 2001.

¹⁰ A natural monopoly is an industry that is most efficiently served by a single firm (i.e. a monopoly) due to the cost structure of the industry.

In 2001, the Organisation for Economic Co-operation and Development (OECD) Council adopted a recommendation concerning structural separation in regulated industries (see box 1 below).¹¹ The recommendation recognizes the potential usefulness of the following:

- **Structural reforms**, for example separation of potentially competitive segments of a particular sector (e.g. train operation or power generation) from other segments that constitute genuine natural monopolies, like railroad track facilities or power transmission lines.
- **Behavioural measures**, such as regulation, can be tools to stimulate competition for the purpose of controlling costs, promoting innovation and enhancing the quality of the service, to the benefit of users.

At the same time, the OECD recommends that neither structural reforms nor regulation are without attendant costs. Rather than recommending a blanket approach to the implementation of such reforms across countries, it recommends a careful case-by-case approach, involving the weighing of potential benefits and costs. Different countries – both developed and developing – have employed a variety of approaches at different times and across different sectors, for example energy as opposed to transportation or telecommunications. This is an important factor highlighting the need for input from business and other advisory bodies to implement solutions in particular cases.

In 2006, the OECD Recommendation on Structural Separation was extensively reviewed. The review found that structural separation, as the stronger means of introducing competition, has important general advantages over behavioural measures:

- 'Separation limits the need for certain regulations that are difficult, costly and only partially effective
- Separation may stimulate innovation and efficiency in the competitive services, and
- Separation helps to eliminate cross-subsidization.'

However, the review also found that these advantages must be balanced against possible disadvantages, in particular:

- 'Separation [sometimes] forces a loss of economies of scale from integrated operation
- Transaction costs for consumers [may] increase
- Direct costs of separation can be high
- System reliability may fall when investments are not made jointly, and
- Accountability for interface problems may be difficult to assign.'

Overall, the OECD study finds that 'costs and benefits differ from sector to sector and from country to country, so uniform recommendations are not possible'.

There is an important qualification to the discussion on structural separation of competitive and non-competitive business segments. In some cases it may not be necessary to undertake such a 'vertical' separation of functions if all components of the industry are potentially subject to competition. For example, as discussed in the context of the rail transport sector, rather than separating the ownership and management of track facilities and trains, some countries have chosen the path of allowing separate integrated train networks to compete with each other, known as 'horizontal competition'.

In yet other cases, the relevant authorities may consider that the costs involved in either vertical or horizontal restructuring of incumbent firms may be excessive in relation to the benefits to be achieved; they may decide to continue to allow the dominance of key infrastructure sectors by vertically integrated monopolies. However, this choice precludes the achievement of the significant gains in efficiency that experience has shown can be achieved by introducing well-tailored pro-competition reforms.

Again, the context-specific nature of the choices to be made highlights the importance of specialized knowledge of conditions prevailing in particular markets and direct input from end users (i.e. developing and transition economy businesses) in the development and implementation of the solutions to be adopted in particular cases.

¹¹ Recommendation of the OECD Council concerning Structural Separation in Regulated Industries, 26 April 2001 – C(2001)78. Available at: acts.oecd.org/Instruments/ShowInstrumentView.aspx?InstrumentID=194&InstrumentPID=190&Lang=en&Book=False

Box 1: OECD recommendation on separating competitive and natural monopoly functions

In its recommendation, the OECD Council identified two types of measures that may be taken to introduce or enhance competition in regulated sectors: (i) structural measures and (ii) behavioural measures. While structural measures 'primarily address the incentives of the regulated firm (such as vertical ownership separation or club or joint ownership)', behavioural measures 'primarily address the ability of the regulated firm to deny access (such as access regulation)'.

The OECD recommends the careful consideration of the balance of benefits and of the different types of measures in choosing which should be implemented. The main part of the recommendation reads as follows:

"When faced with a situation in which a regulated firm is or may in the future be operating simultaneously in a non-competitive activity and a potentially competitive complementary activity, Member countries should carefully balance the benefits and costs of structural measures against the benefits and costs of behavioural measures.

The benefits and costs to be balanced include the effects on competition, effects on the quality and cost of regulation, the transition costs of structural modifications and the economic and public benefits of vertical integration, based on the economic characteristics of the industry in the country under review.

The benefits and costs to be balanced should be those recognized by the relevant agency(ies) including the competition authority, based on principles defined by the member country. This balancing should occur especially in the context of privatization, liberalization or regulatory reform."

Source: Recommendation of the OECD Council concerning Structural Separation in Regulated Industries, 26 April 2001 – C(2001)78. Available at: acts.oecd.org/Instruments/ShowInstrumentView.aspx?InstrumentID=194&InstrumentPID=190&Lang=en&Book=False

ACCESS TO MONOPOLY FACILITIES

An issue closely related to structural separation that complicates the implementation of this approach concerns the pricing of access by the competitive segments of an industry to monopoly facilities that remain even after appropriate restructuring has taken place. A 'competitive access regime' may be needed, for example to authorize competing electrical energy suppliers to connect to a power grid, enable trains operated by different enterprises to run on the same sets of rails, or grant competing transportation service providers equal access to port or airport facilities. However, setting appropriate price levels for this purpose is by no means an easy task.

A vexing task for regulators is to design terms and conditions of access to bottleneck infrastructure facilities by competing service providers. These facilities are essential inputs in the production or delivery of final products, and cannot be economically duplicated.

Examples include the local loop ('final mile') in telecommunications, the transmission grid in electricity, the network of pipelines in natural gas, and the track in railroads. Access policy is the keystone of the contemporary response to the problem of residual monopoly in infrastructure. Indeed, it is at the core of discussions of ways to facilitate competitive entry into activities that have traditionally been run by franchised monopolies.

The access issue is especially difficult in situations where several firms compete in the sale of a final product, but one is the monopoly owner of an input that is indispensable in the supply of that product.¹²

The pricing of access to essential monopoly facilities is a technical issue that will not be discussed in detail here. In brief, economic literature and competition law enforcement and regulatory experience offer two main

¹² Kessides, I., *Reforming Infrastructure; Privatization, Regulation, and Competition*, World Bank, Washington, D.C., 2004.

approaches to the efficient pricing of such essential input facilities: (i) the 'efficient component pricing rule'; and (ii) 'Ramsey pricing' – a form of price discrimination where different classes of users are charged different prices according to their respective demand elasticity.

Each of these approaches seeks to specify prices for access that prevent monopolistic service providers from appropriating excessive rents for themselves, while properly reflecting the economic costs of access and maintaining incentives for efficient investments in common (monopoly) facilities. Variations on these two main approaches have also been proposed, and issues concerning the use of 'price caps' – ceilings that are placed on particular prices or charges – can also arise.¹³

Access pricing is a matter on which user businesses and their associations, in addition to public interest organizations, should seek to involve themselves and provide appropriate input. Consulting firms specializing in access issues may also be employed to help illuminate conditions in particular markets. Active monitoring by users and participation in regulatory proceedings by a broad range of public interest bodies can help broaden the perspective of sectoral regulators.

A CONTINUING NEED FOR ENFORCEMENT

Even following the implementation of any appropriate restructuring measures and, where appropriate, the introduction of competitive access regimes, the need for continuing applicability of general competition laws remains. Such laws are important to dealing with three main sets of business practices:

- Cartels – price fixing or market sharing arrangements between firms that should be in competition with each other;
- Mergers between competing firms;
- Abuses of a dominant position, sometimes referred to as monopolization.¹⁴

All of these practices have the potential to undermine or completely eliminate the potential gains from pro-competitive reforms, including structural separation. For example, suppose train operating companies are split off from the ownership of railroad tracks in the hope of enabling effective competition to take place, but the train operators meet secretly to establish a rate-setting cartel. In this case, all of the potential gains for consumers generally and export-oriented businesses in particular may be lost.

THE ROLE OF BUSINESS ORGANIZATIONS AND ASSOCIATIONS

Individual developing and transition economy businesses and their associations can play an important role in these issues. There are at least three types of input they can provide.

- **Political support.** First, at a broad level, they can play a crucial role in building political support for necessary restructuring initiatives and reforms.
- **Designing specific restructuring initiatives.** Second, they can provide essential input to the design of specific restructuring initiatives, most importantly because they are typically situation-specific. For

¹³ Readers seeking technical information concerning these issues are referred to: Access Pricing, Organisation for Economic Co-operation and Development (OECD), Competition Committee, 2004. Available at: www.oecd.org/dataoecd/26/6/27767944.pdf

Armstrong, M., 'The Theory of Access Pricing and Interconnection', in M.E. Cave, S.K. Majumdar, I. Vogelsang, *Handbook of Telecommunications Economics: Volume 1*, Chapter 8, pp. 297-381, 2002.

Laffont, J., I. Gremaq, Jean Tirole and Idei Geras, 'Creating Competition through Interconnection: Theory and practice' *Journal of Regulatory Economics*, vol. 10, No. 3, pp. 227-256, 1996.

¹⁴ Formally speaking, the terms 'abuse of dominant position' and 'monopolization' are not identical. The former deals with abusive conduct by a firm already enjoying a dominant position in a market. The latter concerns the process by which a dominant position or monopoly is established. However, in practice the kinds of conduct covered by these two labels overlap substantially.

Anderson, R.D. and A. Heimler, 'Abuse of Dominant Position: Enforcement Issues and Approaches for Developing Countries', in Dhall, V. (ed.), *Competition Law Today: Concepts, Issues and the Law in Practice*, Chapter 2, pp. 59-92, New Delhi, Oxford University Press, 2007.

example, whether separating the ownership of railroad tracks and train operators is a useful step in helping export-oriented businesses compete will depend on the size and geographic configuration of the particular country considering such measures and particularly on the extent of other options, such as low-cost trucking services or air freight, that are available to individual users. This is information that user businesses and their associations are best-suited to provide.

- **Referring business complaints to authorities.** Third, user businesses and their associations can play a role in referring complaints to the appropriate authorities, for example national competition agencies, looking at apparent competition law violations by infrastructure service providers and other input suppliers.

Businesses and their associations are not the only bodies that can potentially make valuable contributions to issues concerning implementing competition-oriented structural reforms and related rules. It is very important that consumer and other public interest-oriented bodies play their roles.

To facilitate providing input, the following examples illustrate the harm to international competitiveness that can be caused by inefficient infrastructure monopolies as well as the benefits that can be achieved through pro-competitive restructuring. They also illustrate the continuing need for the application of competition rules, for example to enforce competitive access to genuine 'natural monopolies' and to guard against continuing abuses of a dominant position.

THE TRANSPORTATION SECTOR

Transportation is a critical infrastructure sector. Its performance is of paramount importance for the competitiveness and success of export-oriented businesses. For this reason, it has been an early and continuing target of competition-oriented structural reforms in both developed and developing countries. Following are examples of reforms implemented and related issues concerning the application of competition rules in the specific sub-sectors of this important field: ports, railways, airlines, and bus and road transport services.

PORTS

Within the transportation sector, ports are one of the most important infrastructure elements for international trade. Almost 85% of the world's trade distribution relies on sea transportation.¹⁵ For a majority of goods, other methods of transportation, such as land and air, are significantly less viable alternatives. Therefore, efficient port services and infrastructure are essential to the competitiveness of export-oriented businesses in developing countries.

Measures to introduce and safeguard competition in port services can play a vital role in creating efficiency in port-related services, thereby reducing costs for business users exporting and distributing goods via sea transportation. This section provides an overview of competition issues related to ports, as well as examples illustrating how competition law can contribute to preventing anti-competitive practices.

In general, port-related competition can be observed at two levels:

- **Competition between ports.** To the extent that several different ports can be reached by producers at a comparable cost level, there will be competition among those ports. Inter-port competition can, in some circumstances, be enhanced by improvements in inland freight transport, which means that customers can switch more easily from using one port to using another.¹⁶
- **Competition among port service providers** can be created at the intra-port level. For example, this can be achieved by breaking down relevant concessions and creating multiple terminal facilities with different operators for different terminals within a single port.

¹⁵ Brooks, D.H., D. Hummels, *Infrastructure's Role in Lowering Asia's Trade Costs*, Cheltenham, Edward Elgar, 2009.

¹⁶ Pittman, R. and V. Yanhua Zhang, 'Electricity Restructuring in China: The Elusive Quest for Competition', Economic Analysis Group Discussion Paper 08-5, April 2008, 2008. Available at: www.justice.gov/atr/public/eag/232668.pdf.

While both forms of competition improve efficiency and business competitiveness in a given country or region, the specific geographical, economic and overall situation determine which measures can be implemented and will yield the best results. An important task for business users is to actively reflect on their needs and where possible establish channels of communication with the relevant regulatory authorities.

Structural measures alone may not be sufficient to fully address all competition-related concerns regarding ports. An Economic Analysis Group Discussion Paper¹⁷ describes two trends that threaten competition.

The first trend is the appearance of a few but large multinational terminal operating firms worldwide. As this leads to a consolidation of terminal operating firms, there are fewer potential bidders for particular concessions or privatizations in ports, thereby reducing competition. This development can be harmful to local developing country businesses in two ways. First, large multinationals may replace individual, local port operating firms. Second, prices for business port users may rise due to reduced competition, thereby reducing local business competitiveness in export markets.

The second trend is that ocean shipping lines have been vertically integrating into the ownership and operation of container terminals. At the same time, bulk producers of iron ore, coal and petroleum have been vertically integrating into the ownership and operation of the specialized bulk terminals used for their products. This trend affects competitors of vertically integrated firms in the primary markets served. Other ocean shipping lines or producers may be excluded from using the terminals, thereby creating competition issues despite the enhanced economic efficiency of the operations of the vertically integrated firm.

Therefore, even where basic inter-port and/or intra-port competition exists, competition/anti-trust statutes, efficient monitoring and law enforcement by competition authorities are of crucial importance to ensure competition in ports.

The boxes on port restructuring in Argentina and Indonesia illustrate cases of actual or potential abuse found and countermeasures taken by different governments in different regions of the world.

The Argentine example highlights threats to competition caused by vertical integration of port operators with shipping lines or export-oriented producers of goods.

The example of Argentina in box 2 shows that vertical integration does not necessarily lead to violations of competition law, but that close monitoring can be an effective deterrent. Monitoring may be carried out by public competition authorities. However, the business community must also take an active role. Competitors as well as business users of port services can make important contributions to monitoring activities by notifying authorities of any indications of anti-competitive behaviour. This is in their interest as they suffer the negative consequences of anti-competitive behaviour, as seen in the Indonesian case in box 3.

Box 2: Argentina: monitoring competition in restructured ports

The Argentine Government, seeking to create intra-port competition in the port of Buenos Aires, its largest and busiest port, created a six-terminal authority within the port, Puerto Nuevo, and limited awards to only one terminal per company. One of the terminals was acquired by Maersk Sea Land, one of the world's largest ocean shipping companies. The company was closely monitored by the Argentine Comisión Nacional de Defensa de la Competencia to avoid possible vertical foreclosure – in other words, to ensure that Maersk Sea Land did not discriminate against its ocean shipping competitors by denying them access to its own terminals, or providing access under inferior terms.

Source: Pittman, R., 'Competition Issues in Restructuring Ports and Railways', Economic Analysis Group Discussion Paper 09-6, November 2009. Available at: www.justice.gov/atr/public/eag/251856.htm.

¹⁷ Pittman, R., 'Competition Issues in Restructuring Ports and Railways', Economic Analysis Group Discussion Paper 09-6, November 2009. Available at: www.justice.gov/atr/public/eag/251856.htm.

Box 3: Indonesia: using competition law for restructuring ports

In Indonesia, the Commission for the Supervision of Business Competition found the public company controlling the ports of the provinces of Aceh, North Sumatra and Riau to be in violation of competition law. It had monopolized the market for palm kernel and copra exports from the major North Sumatran port of Belawan, and had sought to impose exclusive dealing requirements on seven major customers. (Decision, Case No. 01/KPPUL/2004)

Source: Ray, David, *Indonesian Port Sector Reform and the 2008 Shipping Law*, Jakarta: Indonesia Competitiveness Program, Report prepared for USAID, August 2008.

When it comes to infrastructure services, businesses often find themselves in the role of being a customer of the relevant infrastructure business. Therefore, abuses of dominance, such as the imposition of exclusive dealing requirements as described in box 3, can directly impact their ability to make economically beneficial business decisions and can negatively affect their competitiveness.

The Jamaican case in box 4 is a good example of the role of regulation and competition law where competitors are forced to rely on open access to essential facilities controlled by a dominant player. While it may not be necessary to impose full vertical separation by preventing port operators from also being active in ancillary markets such as stevedoring, open access regimes must be actively monitored and enforced to counteract the strong economic incentive for dominant players to exclude competitors from using essential facilities.

Box 4: Jamaica: stopping abuse of dominance in port management

The facts

Port Kingston/Bustamante (hereafter referred to as Kingston Wharves) is a multi-purpose facility also used for stevedoring. Kingston Wharves (KW) is one of only two public ports in Jamaica located at a distance of 170 km of each other. Kingston Wharves Limited (KWL), a Jamaican company that owns KW and also operates a stevedoring company, issued a notice on 11 December 2001 that effectively denied independent stevedoring companies access to the port facilities they needed to carry out their commercial interest.

The law

Section 20(1) of the Jamaican Fair Competition Act (FCA) states, 'an enterprise abuses a dominant position if it impedes the maintenance or development of effective competition in a market'. Under Section 20(2)(a), 'an enterprise shall not be treated as abusing a dominant position if it is shown, [inter alia], that (i) its behaviour was exclusively directed to improving the production or distribution of goods or to promoting technical or economic progress; and (ii) consumers were allowed a fair share of the resulting benefit'.

Analysis

Given that KW handled all the non-containerized cargo in the Port of Kingston/Bustamante, and thus had a dominant position, KWL had the ability to engage in practices aimed at excluding competition in stevedoring and other ancillary markets. This was not necessary to ensure the operability of the port facilities and therefore could be identified as an attempt by KWL to engage in anti-competitive practices. KWL was found to be in violation of Jamaican competition laws.

Impact on local businesses and exporters

If not prevented from barring independent service providers from using its facilities by regulation, KWL could have extended its dominant position from providing the port facilities as sole owner to all related services by driving out its existing or potential competitors in ancillary markets, such as the stevedoring and towage markets. Furthermore, KWL would have been in a position to charge port users, such as shipping operators, exporters and importers, excessive prices for ancillary port-related services.

Source: OECD, DAF/COMP/GF/WD(2005)15 of 14 January 2005, Global Forum on Competition, Abuse of Dominance in Regulated Sectors. Case submitted by Jamaica, Session III.

Box 5: Zambia: abuse of dominance in port management led to tariff increases

The facts

Zambia is a landlocked country. The only significant port is Mpulungu Port, located on Lake Tanganyika in northern Zambia. Mpulungu Port is vital for the export of goods to neighbouring countries grouped around the lake. It was formerly managed by the Zambian Government through a state-owned enterprise. To increase the productivity and efficiency of the harbour by privatization, Mpulungu Harbour Management Limited (MHML) received a concession for the management of Mpulungu Harbour Estate, Harbour and Port Operations and Assets in 2000 after a competitive bidding process.

However, MHML not only became the port's operator, but also acted as the holding company of Agro-Fuel Investments Limited (Agro-Fuel), a port user with a 50.1% market share. This led to MHML securing preferential shipping space for Agro-Fuel by passing on information exclusively available to the port operator, favouring Agro-Fuel to charter vessels and allocate profitable cargo. This practice created obstacles that made it impossible for other port users to store cargo, and forced cargo owners to clear and transport their cargo exclusively through Agro-Fuel. The final result was a 46% tariff increase for other port users.

The law

The Concession Agreement provided the following terms: 'The Concessionaire warrants and undertakes that it shall procure that Harbour and Port Services are available to the public and other commercial users on Arms Length Terms, provided however, that such use shall not unduly prejudice or interfere with the Concessionaire's operations hereunder, in doing so the Concessionaire shall procure that the public or other commercial users are not prejudiced.' (Article 62.1.)

Analysis

Despite privatization, efficiency gains could not be reaped due to vertical integration. MHML was able to transfer its position of dominance provided by the concession agreement to the market of its subsidiary, thereby abusing its position. Adequate access-regulating clauses in the Concession Agreement proved vital. MHML was found to be in violation of the Concession Agreement as Mpulungu Port had the potential and capacity to handle both the port operator's (i.e. MHML's), services and the competitors' services without affecting the port operators' business.

Impact on local businesses and exporters

Denial of access to this facility meant that other port users were unable to compete effectively. As a consequence of MHML's abuse of dominance, competitor port users ran into liquidity problems and some subsequently collapsed. This situation could only be remedied by virtue of the sound legal framework addressing potential competition concerns provided by the Concession Agreement.

Source: OECD Global Forum on Competition, DAF/COMP/GF/WD(2005)21 of 14 January 2005, Abuse of Dominance in Regulated Sectors. Case submitted by Zambia, Session III.

The Zambian case described in box 5 provides an example of a more subtle, but equally detrimental, abuse of dominance. In Zambia, other businesses were not formally excluded from using the port. However, over the long term, preferential treatment of a particular port user can have serious consequences for the competitiveness of other port users, resulting in bankruptcy and an eventual eradication of competitors.

RAILWAYS

Railways are another extremely important element in the infrastructure of most countries. Resource commodities like grains and other agricultural products, minerals, fertilizers, coal, potash, sulphur, ores and concentrates, chemicals, forest and petroleum products – commodities essential to developing country producers and exporters as inputs for production – are typically transported in bulk and over long distances. Where road transport is not a viable alternative, for example due to the size of shipments or the lack of good roads, commodity shipments are often captive to the railroad industries.¹⁸ As a result, railway transport efficiency is important for the competitiveness of developing country firms using such commodities.

¹⁸ Kessides, I., *Reforming Infrastructure; Privatization, Regulation, and Competition*, World Bank, Washington, D.C., 2004.

Even countries with long-established railway networks have observed poor performance of state-owned, monopolist railway companies. International institutions have identified competition as necessary to enhance railway services and infrastructure markets generally. At the end of the twentieth century, many countries adopted sometimes radical reforms to achieve this.¹⁹

Investment in rail infrastructure is a high 'sunk cost',²⁰ which poses significant barriers to the market entry of new competitors. Competition in the form of duplicating railway infrastructure cannot be expected to occur even after the privatization of a formerly state-owned company.²¹ Therefore, measures to reform railways must integrate novel strategies to avoid the 'natural monopoly' created by railway infrastructure owned and operated by a single railway company.

Several 'modes' of creating competition have been implemented by countries in reforming the railway sector. Researchers, having assessed evidence from the experiences or reform efforts across countries and continents, conclude that 'no one approach has proven to be the best across a wide variety of circumstances'.²²

Private sector feedback is essential to any reform process. This is particularly relevant where complex systems and structures, like in the railway sectors, are regulated to favour private sector participation and market entry.

Often, the status quo is a vertically integrated state-owned enterprise that owns and operates all railway facilities and vehicles.²³ While this structure may allow maximum economy of scale benefits and seamlessly integrates different rail transport sub-sectors, it is not conducive to competition. The result is a lack of incentive to operate efficiently. As pointed out above, even privatization of a vertically integrated state-owned enterprise may not lead to the desired benefits.

As a result, some countries have created railway systems where several private companies operate on different sectors of their territory – spatial separation – based on concessions or franchises. At the same time, vertical integration is maintained within each of the sectors; one company owns and operates all railway facilities and vehicles within the relevant sector. The basic idea behind this approach is that the benefits of vertical integration are preserved to some extent within each sector. At the same time, some competition occurs when concessions and/or franchises are tendered and where alternative routes to destinations through different sectors or common points are available to users.

Countries that have implemented this 'spatial separation model' include Argentina, Brazil, Mexico, Peru and Bolivia (Plurinational State of). These countries have divided their formerly monopolistic railway systems into separate railway enterprises, controlled by private companies under long-term franchise agreements. These companies compete with each other mostly at common points, but occasionally over parallel routes as well.²⁴

The Mexican case in box 6 explains conditions and regulatory choices conducive to effective competition through the spatial separation model. Whether similar strategies can be deployed in other countries will depend on country circumstances.

Another way to introduce competition in the railway sector is through competitive access, as discussed earlier in the chapter. Competing railway companies have exclusive control over some track and exchange access rights with other companies or 'interline' – handing off traffic between companies. While this mode is conducive to enhanced competition and preserves efficiency gains resulting from vertical integration, close monitoring may be necessary to ensure that access rights are provided on a non-discriminatory basis. This is because different railway companies can be considered as having a 'dominant position' through control of essential facilities for 'their' tracks.

19 Gómez-Ibáñez, J.A. and G. De Rus, *Competition in the Railway Industry: An International Comparative Analysis*, Cheltenham, Edgar Elgar, 2006.

20 A 'sunk cost' is a cost that has been incurred and cannot be reversed.

21 Pittman, R., 'Competition Issues in Restructuring Ports and Railways', Economic Analysis Group Discussion Paper 09-6, November 2009. Available at: www.justice.gov/atr/public/eag/251856.htm.

22 Gómez-Ibáñez, J.A. and G. De Rus, *Competition in the Railway Industry: An International Comparative Analysis*, Cheltenham, Edgar Elgar, 2006.

23 Kessides, I., *Reforming Infrastructure; Privatization, Regulation, and Competition*, World Bank, Washington, D.C., 2004.

24 *Ibid.* and

Pittman, R., 'Competition Issues in Restructuring Ports and Railways', Economic Analysis Group Discussion Paper 09-6, November 2009. Available at: www.justice.gov/atr/public/eag/251856.htm

Box 6: Mexico: encouraging competition – the spatial separation model

Mexico was able to create a spatial separation model conducive to direct competition in freight transport services among different privately-owned railways. Three different railways each serve a major port on the Pacific and the Caribbean. Two railroads serve industrial hubs such as Monterrey and Guadalajara and connect to different railways at the United States border. As a result, businesses have a choice between at least two competing railways when serving their main markets.

Source: Gómez-Ibáñez, J. A., G. De Rus, *Competition in the Railway Industry: An International Comparative Analysis*, Cheltenham, Edgar Elgar, 2006.

A third option consists of vertically separating different components of the railway sector; separating ownership and maintenance of the railway tracks from ownership of vehicles and provision of transport services. While this option may appear to create the most robust environment for high levels of competition, there is a price to pay. Vertical separation requires coordination among a multitude of different actors, which may prove difficult to achieve where economic interests are not aligned. Furthermore, efficiency gains from competition may be counteracted by a lack of economies of scale. Box 7 describes how Sweden successfully implemented a 'vertical separation model' and combined it with adequate oversight to ensure competition.

AIR TRANSPORT

Air transport, like other transport services, is a key input to international trade and the competitive success of user businesses. This is separate from the role of air transport services in meeting consumer demand for tourism-related services. Numerous studies have highlighted the importance of an efficient, effective and reliable air transport infrastructure, especially in developing countries, to ensure the materialization of the gains from trade.²⁵ These studies also highlight the role of international civil aviation in contributing to the development process and its role in many people's commercial decisions. The importance of air transport has increased as a result of technological innovation, deregulation and enhanced market access for foreign companies, which have made air transport more accessible to a wider set of customers in a broader range of countries.

Box 7: Sweden: encouraging competition – the vertical separation model

Sweden decided to vertically separate infrastructure and operations while maintaining public ownership of the infrastructure company and some operating companies. Rail operators are charged low short-run marginal costs for using the infrastructure; the taxpayer bears the remaining burden. Publicly-owned operating companies are subject to private-sector competition, especially in the freight sector, where there is open access. Other services are subject to competitive tenders.

The example of Sweden shows that continued oversight and competition legislation are needed despite regulatory measures to enhance competition. When a state-owned operator won back a contract over a private operator in 1993, it was found guilty of using predatory pricing methods: it used its dominant position to put in an unprofitable bid and was thus able to eliminate competition.

Sources: Gómez-Ibáñez, J. A., De Rus, G., *Competition in the Railway Industry: An International Comparative Analysis*, Cheltenham, Edgar Elgar, 2006. Alexandersson, G., S. Hultén, 'The problem of predatory bidding in competitive tenders – a Swedish case study,' *Thredbo papers*, 8, 24, 2003. Available at: www.idei.fr/doc/conf/rai/papers_2003/alexandersson.pdf

²⁵ This section of the chapter draws on material from World Trade Organization. Source: 'International Trade in Air Transport: Recent Developments and Policy Issues', *World Trade Report 2005*, World Trade Organization, 2005. Available at: www.wto.org/english/res_e/publications_e/wtr05_e.htm

- In the past few decades, far-reaching changes have occurred in government policy in the national and international air transport sectors. Diverse policies have been introduced to facilitate entry, increase foreign ownership and investment, liberalize access to markets and, importantly, alleviate restrictions on access to and use of airports. The success of these policies has varied. No unique formula exists to satisfy the sometimes conflicting goals of ensuring adequate delivery of international air transport services and airline profitability. Nonetheless, a number of jurisdictions have found the following approaches to be useful and relevant. The removal of unnecessary restrictions on entry to and pricing of providing airline services – ‘deregulation’ – is one approach. It is important to note that the relaxation of regulation, which has received broad support, relates to these economic variables of entry and pricing, not to safety or environmental issues.
- Another approach is relaxing or, in some cases, eliminating restrictions on foreign ownership and investment.
- Some policymakers choose to promote competition in international routes through negotiating ‘Open Skies’ and similar agreements.²⁶
- Vigorous application of competition (antitrust) laws to instances of collusive and predatory conduct and airline mergers that are likely to lessen competition is another approach.

The pursuit of such policies in the international air transport sector and the national air transport sectors of many countries built initially upon the experience gained in one jurisdiction – the United States. Key findings are explained in box 8.

In continental Europe, deregulation started later than in the United States and moved at a slower pace. The 1992 Single Market Initiative played a key role in implementing greater freedom of entry and pricing. Subsequently, various regulations issued by the European Council, reinforced by relevant enforcement actions and policy advocacy by the European Commission, further promoted freedom of pricing and operational flexibility across the EU. Since then, extensive competition from low-cost carriers has triggered significant fare reductions for consumers in many intra-EU city-pair markets for passenger air service. Most recently, intra-EU deregulation has been complemented by major external market-opening initiatives.

The state of competition in the international air transport sector is a function of many variables, some of which have already been described in previous sections of this chapter. These include changing technology and demand conditions, the availability of necessary infrastructure and, importantly, the conditions governing access to markets. As described above, for many years, the degree of competition in the international air transport sector has been limited by constraints on entry and in some cases pricing that are embodied in bilateral air service agreements. These, in turn, derive from the ‘piecemeal bilateralism’ approach to international regulation of this sector that was adopted at the Chicago Convention in 1944.²⁷

The state of competition in air transport also depends on firm strategies and behaviour, as well as on public policies in relation to such strategies and behaviour, for example on the application of competition law and policy. The following issues have been noted as meriting particular attention:²⁸

- Mergers, joint ventures and strategic alliances (including code-sharing arrangements) in the airline sector, their implications for competition and their treatment by competition authorities;
- The implications of antitrust immunity for the International Air Transport Association (IATA) and individual code-sharing arrangements;
- Issues concerning the possibility of inter-airline collusion (cartelization or price fixing), including through electronic tariff publishing and related channels;
- The treatment of predatory conduct (i.e. practices through which firms may seek to exclude potential rivals from markets) in the airline sector; and
- The contribution of competition advocacy – i.e. interventions by national competition authorities and other parties with related interests in national and international policymaking processes in the sector.

26 Abeyratne, R., ‘Competition and Liberalization in Air Transport’, *World Competition*, vol. 24 Issue 2, pp. 607-637, 2001.

27 Convention on International Civil Aviation, signed in Chicago on 7 December 1944, Chicago Convention. Available at www.icao.int/icao/en/dcs/7300.html

28 McDonald, J.B., ‘Competition in the Air’, Remarks to the IATA Legal Symposium 2007 on Competition, Compliance, Consequences: The New Regulatory Environment, Istanbul, 12 February 2007. Available at www.justice.gov/atr/public/speeches/222159.htm

Box 8: United States: lessons from airline deregulation – the viability and benefits of competition

Some lessons to emerge from analyses of the effects of deregulation in the United States of America:

- A key benefit of deregulation was to promote new entry into particular markets by existing and start-up carriers. From 1978-2003, 129 new carriers entered the industry.
- Enhanced freedom of entry and competition resulted in substantial improvements in performance, including an average 30%-33% reduction in fares for consumers in real (inflation-adjusted) terms
- Significant productivity gains were achieved, in part through new competitive strategies and operational adjustments made possible by the enhanced freedom of operations that deregulation provided.
- Although many individual large and small carriers have come and gone, deregulation has not led to significant reductions in service for small towns and rural communities. On the contrary, the number of scheduled departures available to such towns and communities has increased by 35%-40%.
- Deregulation has increased the need for the effective application of competition (antitrust) law in the airline sector, particularly with respect to mergers and strategic alliances. In a deregulated environment, mergers and alliances are a key means by which carriers can potentially preserve or enhance their market power. In cases where airline mergers were allowed to proceed, concentration in city-pair markets increased and consumer welfare was diminished.
- The mere elimination of regulatory barriers to entry has not generally proven sufficient to prevent higher than competitive pricing in the airline sector – actual competition in city-pair markets is required. This has called into question the so-called ‘contestability hypothesis’, which implies that the mere threat of entry is often sufficient.
- Contrary to fears expressed at the time, there is no evidence that deregulation has resulted in lower safety levels for consumers. Today, air travel is demonstrably safer than in the pre-deregulation period. While this may be due in part to extraneous developments such as improved technology, it clarifies that deregulation did not result in heightened risks for passengers. In making sense of this picture, it is important to note that deregulation in the United States did not involve any relaxation of legislated safety controls administered by the Department of Transportation and other authorities. Deregulation focused on the economic aspects of regulation – controls on entry, exit and pricing.

Source: ‘International Trade in Air Transport: Recent Developments and Policy Issues’, *World Trade Report 2005*, World Trade Organization, 2005 p. 225. Available at: www.wto.org/english/res_e/publications_e/wtr05_e.htm.

Box 9 provides an example of a recent price-fixing cartel in the air cargo sector operating within Europe, affecting airfreight prices on sales with third countries. This example shows the clear importance of competition law enforcement to ensure that the gains from market liberalization in service sectors are passed on to consumers, particularly business users.

ROAD TRANSPORT

Road transport services are equally important for developing business competitiveness. Road transport represents more than 70% of the land freight service at origin and destination points, connecting businesses to world markets.²⁹ For example, where trucking is a viable alternative to rail, water or air transport, a competitive road transport sector can lead to important welfare gains from inter-modal competition.

There is also a relationship of complementarity between road and other forms of transport. Road transport plays an important role in providing connections to and between transport hubs, such as ports and airports, potentially creating further intra-modal competition.

²⁹ Londoño-Kent, P., *Freight Transport for Development Toolkit: Road Freight*, International Bank for Reconstruction and Development, World Bank, 2009. Available at: siteresources.worldbank.org/INTTRANSPORT/Resources/336291-1239112757744/5997693-1266940498535/road.pdf

Box 9: Air cargo cartel fined by European Commission for price fixing

The facts

Airlines providing airfreight services primarily offer the transport of cargo to freight forwarders, which act on behalf of individual shippers. In November 2010, the European Commission fined 11 air cargo carriers approximately 800 million euros for operating a worldwide cartel, setting prices for surcharges for fuel and security.

The cartel members coordinated elements of air cargo prices for over six years, from December 1999 to 14 February 2006. The cartel established numerous bilateral and multilateral contacts between airlines, covering flights from, to and within the European Economic Area (EEA).

The cartel members first agreed on a flat rate fuel surcharge per kilo for all airfreight shipments and then extended their cooperation to a security surcharge. To ensure surcharge levels would be applied in full and without exception, they eliminated any possibility to grant discounts to customers by refusing to pay a commission on surcharges to their freight forwarders.

Impact on users

This cartel in an infrastructure sector of vital importance to many exporters of higher valued products directly raised their costs and/or prevented them from negotiating possibly significant discounts. Effective action by the European Commission was essential to protect user interests.

Source: 'Press Release No. IP/10/1487', European Commission, Brussels, 9 November 2010. Available at: europa.eu/rapid/pressReleasesAction.do?reference=IP/10/1487&format=HTML&aged=1&language=EN&guiLanguage=en.

Box 10: Examples of deregulation in freight transport

Mexico. Abolishing a government monopoly on freight allocation led to a 23% drop in prices within five years, and trucking services improved in frequency, access and speed of delivery.

Indonesia. Deregulating road transport prices led to a significant increase in the number of truck operators, creating a competitive market.

Czech Republic, Hungary and Poland. Market entry of new competitors led to competitive pricing and better quality services. In particular, larger, internationally connected trucking companies developed innovative logistics solutions conducive to faster delivery and better protection of cargo against breakage or spoilage.

Morocco: Abolishing a public monopoly in freight allocation and transport price de-regulation led to dramatically decreased transport prices. However, this led to under-investment in new technology and training for drivers.

Rwanda. Deregulating international transport by abolishing a parastatal monopoly led to a decline in prices of almost 75% in real terms when taking into account a continued increase in input prices. Furthermore, the Rwandan fleet grew quickly, recovering from a collapse at the height of the civil war in 1994.

Malawi. Trucking deregulation led to increased competition, lower prices and better services.

Source: Teravaninthorn, S. and G. Raballand, Transport Prices and Costs in Africa: A review of the main international corridors, Washington, D.C., World Bank, 2009.

While road infrastructure provided by the state is a basic requirement for well-functioning road transport systems, the private sector has an important role to play. Unlike rail transport, there are no generally recognized 'natural monopolies' in the trucking sector.

Box 11: Expected gains from the United States-Mexico bilateral trucking dispute

Under the North American Free Trade Agreement (NAFTA), the United States and Mexico had agreed to phase-out restrictions on cross-border passenger and cargo services. However, in 1995, the United States announced it would not lift restrictions on Mexican trucks, resulting in a ban on Mexican trucks in regard to most of its territory. In 2001, a NAFTA dispute settlement panel found the United States restrictions to be in breach of its NAFTA obligations and allowed Mexico to adopt retaliatory measures.

On 6 July 2011, the Governments of the United States and Mexico agreed to end the dispute. A formal agreement on a pilot cross-border trucking programme between Mexico and the United States was signed, based partly on findings of a study by the United States Department of Transport that found Mexican carriers had met all required safety mandates.

Efficiency gains resulting in lower prices for customers can be expected as a result. The previous requirements for cross-border transportation were costly and time consuming as goods had to be unloaded from Mexican trucks and reloaded onto United States trucks at the border. The crossing added an extra day to the journey, requiring three trucks and three drivers to transfer the cargo. According to estimates, this resulted in extra charges of US\$ 150 per passage for about 4.5 million annual truck crossings, creating an additional US\$ 675 million in annual fees to transport cargo across the United States-Mexico border.

Sources: United States Department of Commerce, International Trade Administration, Information on Foreign Retaliation. Available at: www.trade.gov/mas/ian/tradedisputes-enforcement/retaliations/tg_ian_002094.asp.

'US, Mexico Agree to Settle Truck Feud', *Wall Street Journal*, 4 March 2011. Available at: online.wsj.com/article/SB10001424052748703300904576178511087875924.html.

Centre for Strategic & International Studies, Washington, D.C., Simon Chair's Blog, 10 March 2011. Available at: csis.org/blog/united-states-Mexico-trucking-dispute.

Prices charged for transport services and the quality of service depend to a large extent on the regulatory regimes and competitiveness in the trucking industry.³⁰ At the same time, international experience shows that strong competition in this industry is beneficial. In that regard, there are indications that where competition in road transport is not kept artificially low due to restrictive regulations, a strong level of competition can be expected. As a result, many countries have reformed trucking markets by deregulating the industry and were successful in achieving significant reductions in transport prices³¹ (see box 10).

Most examples in this chapter have dealt with situations where developing and transition economy businesses can enhance marketing by proactive measures to restructure essential infrastructure sectors and by applying competition rules. However, it is important to note that sometimes the most effective tool to enhance competition – whether in infrastructure or other sectors – is trade liberalization. Trade liberalization entails removing legal or other barriers that prevent 'foreign firms' from participating in goods or services markets. A good example is the resolution of a United States-Mexico dispute regarding cross-border trucking services, which is expected to lead to competition and efficiency gains (see box 11).

As in all industries, in the road transportation sector cartels can erode potential gains from market liberalization. Box 12 provides an example of cartelization in road coach services from which lessons can be drawn for road transport services.

THE ENERGY SECTOR

Whether generated from traditional non-renewable sources like coal, petroleum, natural gas and uranium, or renewable sources like biomass, hydro, wind, solar and geothermal power, energy is essential to producing almost all goods and services. Energy is vital to the interest of the business community and the public. An efficient and effective electricity network provides energy for industrial purposes and improves living

³⁰ Teravaninthorn, S. and G. Raballand, *Transport Prices and Costs in Africa: A review of the main international corridors*, Washington, D.C., World Bank, 2009.

³¹ *Ibid.*

Box 12: Price fixing in bus services from Singapore to Malaysia and southern Thailand

The facts

Investigations of the Competition Commission of Singapore (CCS) revealed that between 2006 and 2008, 16 coach operators together with the Express Bus Agencies Association (EBAA) had fixed prices by imposing:

- A minimum selling price for one-way express coach tickets between Singapore and six destinations in Malaysia, which created a price floor on ticket prices; and
- A fuel and insurance charge levied on all tickets sold and used to mark up ticket prices.

The CCS imposed considerable financial penalties on the companies involved. Of the 16 coach operators and the EBAA that engaged in price fixing, six parties filed appeals. In its decisions of 24 March 2011, the Competition Appeal Board of Singapore (CAB) upheld CCS findings on liability on all counts. The total amount of financial penalties imposed on all 17 infringing parties is US\$ 1,135,170.

The law

Section 34 of the Competition Act of Singapore prohibits agreements between competing organizations, decisions of associations of organizations, and concerted practices, which have as their object or effect the appreciable prevention, restriction or distortion of competition within Singapore, unless they are excluded or exempted.

Analysis

Price fixing is considered as a serious violation of competition rules. It has a direct impact on the users of the service and related business activity. In this case, the cartel targeted international bus transport services. This cross-border case shows that to effectively address competition concerns, the international dimension must be taken into account.

Impact on local businesses and exporters

There are two ways in which local businesses could have been affected by the bus cartel. First, businesses may have used the bus transport services in their commercial activities and paid overly high prices. Second, the fact that the price fixing cartel remained stable over a long period of time could indicate that 'outsiders', potential competitors, were prevented from entering the market and gaining customers by offering lower prices.

Source: 'Press Release of 24 March 2011', Competition Commission of Singapore. Available at: app.casebank.ccs.gov.sg.

standards for the general public. For these reasons, energy is vital to development. Fast-industrializing developing countries must cope with extremely rapid growth in power demand, which can be twice as high as gross domestic product (GDP) growth.³²

Despite the need for efficient and competitively priced energy supply, in the past, public authorities have not focused on reforming the energy sector to maximize benefits from enhanced competition. At least until the early 1980s, most electricity industries were vertically integrated monopolies controlled by state-owned companies at the national or regional levels.³³

A large number of countries have initiated some reforms to restructure and privatize the electricity and energy sectors. However, these reform processes have not proven easy. As reliability and security of energy supply are crucial, mistakes can be costly and lessons need to be learned as quickly as possible. Especially over the past decade and as a result of first experiences with reform in different countries, views have changed considerably on how the electricity and energy sectors should be structured.³⁴

Developing countries face particularly difficult challenges. Building and operating national electricity networks requires upfront financing. Complex operating conditions and cost recovery situations may prove difficult for

³² *How to Utilize FDI to Improve Infrastructure – Electricity, Lessons from Chile and New Zealand*, Investment Advisory Series, Series B, No. 1, Best Practices in Investment for Development, 1995-6088, United Nations Conference on Trade and Development, 2009.

³³ Kessides, I., *Reforming Infrastructure; Privatization, Regulation, and Competition*, World Bank, Washington, D.C., 2004.

³⁴ *Ibid.*

many countries.³⁵ At the same time, rapidly growing demand is matched by an equally growing need for further investment in generating, transmitting and distributing power. New technologies with the potential to dramatically alter the cost structure of generating electricity are now available, but must be implemented for efficiency gains.

The traditional governance structure in the sector can be ill-suited to react flexibly to today's dynamic developments and fast-changing investment and other needs. The crucial question is how to best introduce competition into generation and supply markets. Past experience in various countries has shown that while no one model is a perfect solution, three ways of restructuring monolithic monopolies, reflecting varying competition and customer choices, have been identified:

- **Competition can be introduced at the generation level only.** A single privately or state-owned distribution enterprise buys electricity from different generators but maintains a monopoly over transmission and consumer supply. This is known as a 'single buyer' model.
- **Competition at the wholesale level can be introduced by spatially separating different services areas.** Different distribution enterprises purchase electricity from generators and use the transmission network on open access arrangements to transmit power to their services area where they maintain a monopoly on resale to the consumer. This is known as a 'wholesale competition' model.
- **Full competition can be achieved by introducing competition at the generation, wholesale and retail levels.** In this 'retail competition' model, the full transmission grid is subject to open access and consumers have a choice among different suppliers.

Box 13: Reform of the EU's electricity sector

The issue

Despite a longstanding reform process of the electricity market in the European Union, the European Commission's enquiries revealed that the EU's internal market in electricity was still deficient, due to inadequate framing of existing rules and measures. The Commission deemed it important to amend the current rules to ensure fair competition and supply electricity at the lowest possible price to complete the internal market in energy.

The reformed law

Directive 2009/72/EC of the European Parliament and the Council of 13 July 2009 was adopted. The Directive concerns common rules for the internal market in electricity and repealed Directive 2003/54/EC. The Directive introduces common rules for the generation, transmission, distribution and supply of electricity to develop a competitive, secure and environmentally sustainable market in electricity. The main benefits the Directive seeks to establish are:

- Ensuring that customers have the right to choose their electricity supplier and to change supplier easily;
- Ensuring that non-household customers may contract simultaneously with several suppliers;
- Ensuring that Member States implement an independent mechanism (energy ombudsman or consumer body) to manage complaints or disputes efficiently;
- Ensuring monitoring of security of supply by Member States;
- Unbundling transmission systems and transmission system operators (from March 2012) while ensuring stability and reliability of supply and services;
- Establishing a transparent system of third-party access to transmission and distribution systems; and
- Unbundling and transparency of accounts – electricity undertakings are required to keep separate accounts for their transmission and distribution activities, which can be accessed by the competent authorities.

Analysis

The variety of measures adopted shows that unbundling, regulatory activities, monitoring and strengthening of end-user rights are complementary measures to enhance competition. These measures must be adapted to specific situations and their effect must be monitored to achieve the desired results.

Source: Anderson, R. D., A. Heimler, 'What has Competition Done for Europe? An Inter-Disciplinary Answer', in *Aussenwirtschaft* (the Swiss Review of International Economic Relations), 62, Heft IV, pp. 419-454, Jahrgang, 2007.

³⁵ *How to Utilize FDI to Improve Infrastructure – Electricity*, Lessons from Chile and New Zealand, Investment Advisory Series, Series B, No. 1, Best Practices in Investment for Development, 1995-6088, United Nations Conference on Trade and Development, 2009.

Notwithstanding these options, there is wide agreement on the basic architecture for electricity restructuring. Generally, generation is separated from other operations and competition is introduced at the wholesale and/or retail levels.³⁶ The role of the regulator is to set tariffs and regulate access to the transmission and distribution networks.

Box 13 describes the latest reform efforts within the EU. This is an example of an ambitious attempt to maximize competition at all levels of the distribution chain.

The example of China, described in box 14, highlights the growing electricity demands of a fast-growing country as well as reform measures introduced to meet demand.

As in other sectors, structural reforms must be complemented by competition and anti-trust disciplines to provide checks and balances to possible abuses of remaining market power. Where some bottlenecks or monolithic/monopolistic structures are upheld, a sound legal framework is needed to regulate the behaviour of dominant players and allow competition in downstream markets. The Russian case in box 15 illustrates this point.

While liberalization of markets at the national level is a desirable first step, opening up supply to international competition can further reduce prices for businesses as consumers. The case of Pakistan in box 16 shows that competition authorities can play a vital role in ensuring that international competition is not stifled by cartelization in the energy sector.

Box 14: China: reform of the energy sector

The issue

China's rapidly growing economy puts pressure on its energy sector. To attract private investment and ensure the efficient use of investments, the Chinese Government has undertaken a fundamental restructuring of the electricity sector, including strategic measures such as separating the assets and operations of generation from those of transmission and distribution.

Impact on local businesses and exporters

Lack of competition can be expected to slow economic growth for private businesses that depend on energy to produce goods and deliver services. However, the same effect can occur if free market competition leads to price volatility and unstable supply. As a result, key factors of reform to introduce competition include price stability and steady supply.

Measures taken

The incumbent monopoly generator, transmitter and distributor of electricity, the State Power Corporation (SPC), was broken up in late 2002. SPC's generation assets were divided into five generation companies: Huaneng Group, Huadian Power, Guodian Power, Datang Power Group and China Power Investment Company. Each of the generation companies was to control no more than 20% of the national generation capacity. The transmission grid was separated from generation operations and then further separated into two power grid operators, the State Power Grid Company and the South China Power Grid Company. Transmission and distribution continue to be regulated monopolies, with power supplied from a competitive generation sector.

Source: Pittman, R. and V. Yanhua Zhang, 'Electricity Restructuring in China: The Elusive Quest for Competition', Economic Analysis Group 08-5 April 2008, 2008. Available at: www.justice.gov/atr/public/eag/232668.pdf

³⁶ Kessides, I., *Reforming Infrastructure; Privatization, Regulation, and Competition*, World Bank, Washington, D.C., 2004.

Box 15: Russian Federation: abuse of dominance in the power transmission market

The facts

In 2001, RAO UES Russia, a company with more than 65% market share in the electric power generation and high voltage transmission markets, refused to sign an electric power transmission service contract with Rosenergoatom, an electric power producer. The latter had concluded electric power delivery contracts with companies serving the Georgian and Ukrainian markets and depended on RAO UES Russia to fulfil the contracts. RAO UES Russia's refusal to provide the necessary power transmission services was based on the company's assumption that Rosenergoatom needed to seek prior approval of electric power export contracts with third parties by RAO UES Russia. Therefore, RAO UES Russia required Rosenergoatom to fully disclose their power export contracts with third parties.

The law

RAO UES Russia is a natural monopoly according to Article 4 of the Federal Law on Natural Monopolies and is inscribed in the Register of Natural Monopolies. Due to its monopoly position, signing contracts on electric power transmission with power providers is obligatory for RAO UES Russia according to Article 10 of the Civil Code and Article 5 of the Federal Law On Competition and Restriction of Monopolistic Activity at Commodity Markets (further, Competition Law) and Article 8 of the Federal Law On Natural Monopolies.

Analysis

Nuclear plants belonging to Rosenergoatom produce electric power to deliver it to the market. But a power line is necessary to deliver from producer to consumer. RAO UES Russia is a monopolist that owns these power lines. By refusing to provide power transmission services to competitors in the power production market, RAO UES Russia attempted to establish additional control over the power production market.

Impact on local businesses and exporters

Due to the fact that RAO UES Russia refused to render electric power transmission services to producers, in this particular case to Rosenergoatom, the generating company had no access to electric power export markets. The refusal to open the power transmission network to competitors resulted in the competitor's inability to fulfil such contracts, thus preventing them from successfully operating in the export market.

Source: OECD Global Forum on Competition, DAF/COMP/GF/WD(2005)20 of 14 January 2005, Abuse of Dominance in Regulated Sectors. Case submitted by the Russian Federation, Session III.

TELECOMMUNICATIONS

Information and communication technologies (ICTs) and services are vital to participation in the knowledge-based activities that are increasingly important in today's global economy.³⁷ ICTs and services are essential for development and for the competitiveness of developing economy businesses. Recent decades have seen an unprecedented growth in the availability of telecommunication services. This is directly linked to reforms introduced in the telecommunications sector. At the same time, technological changes, such as the expansion of mobile telecommunication services, have changed the landscape of telecommunications.

Both developments have competition at their heart. Beginning in developed countries, reforms to break up monopolistic structures in the telecommunications sector and create competition have now been introduced in many countries. Former state-owned companies have been privatized and made subject to competition from other private telecommunications providers. The significance of competition policy for this process is illustrated by a ground-breaking competition law case – the United States versus AT&T, which was resolved by a negotiated consent decree in 1982. This is an example of competitive restructuring that inspired related reforms around the world.³⁸

³⁷ Khalil, M., P. Dongier and C. Zhen-Wei Qiang, 'Chapter 1: Overview', in *Information and Communications for Development 2009: Extending Reach and Increasing Impact*, Washington, D.C., World Bank, 2009. Available at: siteresources.worldbank.org/EXTIC4D/Resources/5870635-1242066347456/IC4D_2009_Overview.pdf

³⁸ For a discussion of the long-run significance of the settlement see: Yoo, C. S., 'The Enduring Lessons of the Breakup of AT&T: A Twenty-Five Year Retrospective,' *Scholarship at Penn Law*, Paper 280, 2008. Available at: Isr.nellco.org/upenn_wps/280

Box 16: Pakistan: cartelization in liquefied petroleum gas market

The facts

National producers of liquefied petroleum gas (LPG) formed a cartel to keep producer prices for LPG low and prevent foreign importers from entering the market. Instead of charging a higher producer price when selling LPG on to marketing companies, they used their control over marketing companies to extract commission payments and other premiums.

This resulted in a high consumer price. Nevertheless, the official price that importers were bound to apply (due to government regulations) was kept low, as authorities determined the official price in relation to the local producer prices. Because importers were not able to sell to consumers directly and benefit from the high consumer price, importing LPG became unprofitable for them despite high consumer demand for additional quantities.

The law

Section 4 of the Competition Act of Pakistan prohibits price fixing agreements as well as agreements fixing or setting the quantity of production, distribution or sale of goods.

Analysis

LPG producers, by engaging in anti-competitive practices, were able to prevent competition from LPG importers that would have resulted in a lower consumer price. By circumventing the official consumer price regulations and control over the marketing companies, local LPG producers reaped high benefit margins despite artificially low producer prices.

Impact on local businesses and importers

Importers were prevented from engaging in business and local end users of LPG suffered from the artificially high consumer price.

Source: Inquiry Report 'Suo Moto Inquiry against JJVL and LPGAP', Competition Commission of Pakistan, March 2009. Available at: www.cc.gov.pk.

Box 17: Forms of market entry – the United States Telecommunications Act of 1996

The Telecommunications Act envisions three forms of market entry by competitors: facilities-based entry, resale and unbundling.

Facilities-based entry

This form of entry occurs where network infrastructure is duplicated so that direct competition among independent network operators occurs. While potentially high entry costs and a loss of economies of scale benefits may deter market entry, this form of competition requires the least regulatory intervention and provides for secure access to networks. Interconnectivity among networks, number portability and similar issues still require some oversight to ensure maximum competition.

Resale entry

Resale entry occurs where competitors are given the right to buy access to the incumbent's telecommunications infrastructure at wholesale prices (that is, at a discount when compared to the retail price). Unnecessary duplication of networks can therefore be avoided and/or entrants can use resale on a temporary basis until the installation of new infrastructure is completed. A main challenge regarding resale is access pricing.

Unbundling

Unbundling means that different telecommunications-related market segments are separated and sold to competing telecommunication service providers, i.e. access to local loops, switching, databases and signalling systems. Again, pricing is an important issue. Furthermore, transaction and interface compatibility costs may rise due to disaggregation.

Source: Laffont, J. and J. Tirole, *Competition in Telecommunications*, Cambridge, Massachusetts; London, England; MIT Press, 2000.

Box 18: Peru: abuse and transfer of monopolistic power

The facts

When mobile telephony arrived, the Peruvian Government gave concessions, distinguishing between mobile telecommunications services in Lima and outside Lima. While Tele 2000 (A band) and CPT (B band) competed in Lima, only Entel (A band) obtained a concession for mobile telecommunications outside Lima. In 1993, Telefónica bought CPT and Entel, and in 1994 these two undertakings merged. In this scenario, Telefónica began to develop automatic national roaming services, allowing its customers to freely use their handsets both in and outside Lima.

To offer its clients the same service, Tele 2000 requested that Telefónica open the Entel network outside Lima for automatic roaming to Tele 2000 customers as well, but Telefonica refused.

The law

The Peruvian telecommunications law stipulated: 'Because of the neutrality principle the operator of a telecommunications service that is in support of others' telecommunications services, or who has a dominant position cannot use these situations to provide simultaneously other telecommunications services with major advantages and with detriment to his competitors, using practices restrictive of free and fair competition, such as limiting interconnection or damaging services' quality.'

Analysis

Telefónica used its dominant position in the market outside Lima to generate advantages in the Lima mobile telecommunications market. Therefore, Telefonica transferred market power. Tele 2000's clients were only provided access to manual roaming.

Impact on local businesses and exporters

Tele 2000 could not compete with Telefónica's Automatic National Roaming services, because Tele 2000 exerted monopoly power in the market outside Lima. This significant disadvantage provided obstacles for Tele 2000 to compete in Lima's mobile telecommunications market.

Source: OECD Global Forum on Competition, DAF/COMP/GF/WD(2005)16 of 14 January 2005, Abuse of Dominance in Regulated Sectors. Case submitted by Peru, Session III.

Another building block for reforms in this sector was establishing separate regulators for the telecom sector. Today, more than 80% of countries have taken this step.³⁹ Typically, one of these regulators' primary roles is to create conditions for competition by regulating access to telecommunications infrastructure and interconnectivity. Box 17 provides an overview of 'traditional' reform measures by summarizing the patterns of market entry in local telephony⁴⁰ services envisioned by the United States Telecommunications Act of 1996.

In addition to regulatory reform, technological changes have led to competition within and among different forms of telecommunication.⁴¹ A report to the United States Chamber of Commerce notes that mobile phone services were first considered as a 'natural monopoly' by regulators, but the mobile phone industry is well able to establish parallel network infrastructure in different countries. In addition, mobile telephony has become a competitive telecommunications market. At the same time, mobile telephone users continue to rapidly increase in developing countries, where fixed-line services may not be available, for example in rural areas. This indicates that mobile telephony services, to some extent, act as a substitute for fixed-line services and therefore create competition in the sector.

An increasing focus on broadband Internet services through Digital Subscriber Line (DSL), cable or other fixed line networks shows that access is not an issue of the past. Even where duplication or multiplication of

³⁹ *Trends in Telecommunications Reform 2010-11: Enabling Tomorrow's Digital World – Summary*, International Telecommunication Union, 2011. Available at: www.itu.int/pub/D-REG-TTR.12-2010

⁴⁰ In telecommunications, telephony encompasses the general use of equipment to provide voice communication over distances, specifically by connecting telephones to each other.

⁴¹ Hazlett, T.W., C. Bazelon, J. Rutledge and D.A. Hewitt, *A Report to the U.S. Chamber of Commerce – Sending the Right Signals: Promoting Competition through Telecommunications Reform*, 2004. Available at: www.rutledgecapital.com/pdf_files/20041006_telecom_dereg_complete_study.pdf

Box 19: Chinese Taipei: abuse and transfer of monopolistic power

The facts

Based on a 1996 Telecommunications Act, Chinese Taipei has gradually liberalized its telecommunications services sector in sequence: from paging, mobile phones, satellite phones and mobile data communications in 1997, to the fixed communications networks in 2001. In 1999, Chunghwa was still the only telecommunications company operating in the fixed line telecommunications market, but faced competition in the already liberalized mobile telecommunications sector. The prevailing rate for mobile phone users was at NT\$ 1.7 for five minutes for local calls to fixed lines and the rate of local calls to mobile phones was at NT\$ 6 per minute. Then, Chunghwa introduced the so-called '099' service at a uniform rate of NT\$ 3.6 per minute, by which calls to the 099 service could be transferred to mobile phones.

The law

The Telecommunications Act provided the Ministry of Transportation and Communications with the authority to prevent the setting of tariffs by facility-based carriers engaging in cross-subsidization, thereby preventing them from hindering fair competition.

Analysis

By using its market power due to its monopoly position in the fixed line telecommunications sector and the related infrastructure, Chunghwa cross-subsidized mobile phone communications by its users. At the same time, it controlled access by competitors to the fixed line infrastructure and could set prices in that regard.

Impact on local businesses and exporters

Because no competitor could benefit from a similar possibility to cross subsidize mobile phone communications due to a lack of access to an alternative fixed line infrastructure, they could not offer lower rates to their customers. Eventually, all competitors in the mobile telecommunications sector could have been driven out of business and the monopoly of Chunghwa would have been reinstated.

Source: OECD Global Forum on Competition, DAF/COMP/GF/WD(2005)19 of 14 January 2005, Abuse of Dominance in Regulated Sectors, Case submitted by Chinese Taipei, Session III.

networks occurs, for example through the parallel use of cable, DSL and other networks for similar services, interconnectivity must be ensured and some bottlenecks continue to exist, even though their location may change due to changes in technology.⁴²

Furthermore, reform processes may not automatically have resulted in market entry and the desired levels of competition. The examples from Peru, Chinese Taipei and Latvia show that even after taking steps to introduce competition, oversight from regulators and/or competition authorities is needed.

The Peruvian case provides an example of market concentration through a merger that resulted in anti-competitive behaviour. The cases of Latvia and Chinese Taipei illustrate how market power in one telecommunication sector can be transferred to another. It should be emphasized that only under particular market conditions can a firm with a monopoly in one market extend its monopoly in another market through cross-subsidization. Most competition policy experts would agree that cross-subsidization should not be presumed to be harmful to competition in all cases. Rather, harmful effects, if any, need to be investigated and established on a case-by-case or 'rule of reason' basis.

An important example of the links between competition policy, economic regulation and international trade liberalization is provided by the Reference Paper on regulatory principles. This Reference Paper forms part of the commitments made by most WTO Members in the context of the WTO Negotiations on Basic Telecommunications Services, conducted under the General Agreement on Trade in Services (GATS) that concluded in February 1997. The Reference Paper is intended to address, among other things, situations where the services provided by public telecommunications networks constitute essential facilities that are exclusively or predominantly provided by a single or limited number of suppliers and for which there are no feasible substitutes – a situation that potentially constitutes an impediment to both competition and market access for service suppliers.

⁴² Laffont, J. and J. Tirole, *Competition in Telecommunications*, Cambridge, Massachusetts; London, England; MIT Press, 2000.

Box 20: Latvia: abuse of dominance

The facts

In November 2002, Lattelekom, historically the monopolistic provider of fixed telecommunications in Latvia, started to provide a combined service, Komforta ISDN (K-ISDN), which was based on the lease of ISDN telephone lines and the rental of a digital bureau telephone exchange (BTC). A discount was applied to the subscription price for K-ISDN. The amount of this discount depended on the quantity of conversations over the public fixed-line telecommunications network. In the framework of the above-mentioned combined service, the lease payment for connection to an ISDN line was fixed at half the level of the lease payment for connection to a separate ISDN line, without any BTC rental.

The law

Article 13 of Latvian Competition Law prohibits the abuse of a dominant position.

Analysis

Until 1 January 2003, Lattelekom had legal monopoly rights to provide voice telephony services over the public fixed-line telecommunications network, lease of lines and taxophone services. During 2003, Lattelekom lost only approximately 3% of its market share in providing voice telephony services and preserved its monopoly position in the market of leased lines. Thus, Lattelekom had a dominant position in two regulated markets – in the market for voice telephony over the public fixed-line electronic communications network and the market for leased line service. By using its monopoly position in these two markets to provide discounted services in a third, separate market (BTC), it sought to extend its monopoly to that market.

Impact on local businesses and exporters

Other companies that wanted to enter the BTC rental services market, but that were neither providers of voice telephony services over public fixed-line telecommunications network nor providers of leased ISDN telephone lines, did not have the possibility to offer discounts to their clients and were unable to compete successfully with Lattelekom.

Thus, unequal competition conditions would have been created. By combining three services in one package, two of them provided by Lattelekom as the dominant undertaking, and by applying discounts that could not be offered by other market participants, Lattelekom practically closed the BTC rental services market, not allowing new market participants to enter.

Source: OECD Global Forum on Competition, DAF/COMP/GF/WD(2005)17 of 14 January 2005, Abuse of Dominance in Regulated Sectors. Case submitted by Latvia, Session III.

To address this concern, the Reference Paper sets out detailed rules relating to interconnection of downstream service providers with major suppliers on non-discriminatory terms, the prevention of anti-competitive acts, including anti-competitive cross-subsidization, and the making available of information needed for efficient interconnection. These rules draw on concepts of anti-trust and regulatory policy such as exclusionary practices and the essential facilities doctrine.⁴³

In regards to the relationship between domestic reform and the Reference Paper, a recent World Bank report states:

Incorporation of the Reference Paper as an additional commitment in the GATS Schedule of Specific Commitments is a good example of using multilateral obligations to support domestic reform.

The fact that the Reference Paper obligations are binding help propel the domestic reform agenda needed to fully implement the opening to competition.

The Reference Paper is a good example of how international commitments can be used to carry forward national priorities in regards to maintaining and reinforcing competition in appropriate settings.

Key elements of the Reference Paper and related provisions of Mexico's GATS commitments were considered in the 2007 WTO Panel Decision in the Mexico telecoms case. In this case, which was brought against Mexico by the United States, the panel found that several features of Mexico's framework for regulation of

⁴³ Anderson, R.D. and P. Holmes, 'Competition Policy And The Future Of The Multilateral Trading System'. *Journal of International Economic Law*, vol. 5, No. 2, pp. 531- 563, 2002.

Box 21: Mexico: competition-related elements of the WTO Panel Report

Complainant: United States

Respondent: Mexico

Establishment of Panel 17 April 2002; Adoption of Panel Report 1 June 2004

Background

For many years, Telmex was the dominant supplier of telecommunications services in Mexico. According to the WTO Panel Report, the applicable regulations in Mexico conferred on Telmex, as the long-distance service licensee having the greatest percentage of outgoing long-distance market share for the relevant country in the previous six months, the power to negotiate the rate to be paid by foreign carriers – including United States carriers such as AT&T and MCI – for the interconnection of calls terminating in Mexico. In addition, Mexican law required all other licensed Mexican concessionaires to charge no less than the fee negotiated by Telmex for similar services.

Summary of competition-related findings of the Panel

The Panel ruled that Mexico violated its commitments under the Reference Paper and the GATS.

- Mexico failed to ensure interconnection at cost-oriented rates for the cross-border supply of facilities-based basic telecom services, contrary to Article 2.2(b) of its Reference Paper.
- Mexico failed to maintain appropriate measures to prevent anti-competitive practices by firms that are major telecom suppliers, contrary to Article 1.1 of its Reference Paper.
- Mexico failed to ensure reasonable and non-discriminatory access to and use of telecommunications networks, contrary to Article 5(a) and (b) of the GATS Annex on Telecommunications.

Source: Ibid. and WTO Dispute Settlement: One-Page Case Summaries, World Trade Organization, Geneva, 2006. Available at www.wto.org/english/res_e/booksp_e/dispu_summary06_e.pdf.

international telecommunications services were in violation of Mexico's commitments under the Reference Paper. See box 21 for a summary of points relating to the competition dimension of this matter.⁴⁴ Rather than appealing the case to the WTO Appellate Body, Mexico chose to accept the panel's ruling. In the view of some observers, it did so precisely because this was in the best interest of Mexico's consumers and the long-term development of Mexico's telecommunications sector.⁴⁵

CONCLUSION

The restructuring of public infrastructure sectors such as transportation, telecommunications and energy, and the application of appropriate competition rules in these sectors, offers a significant tool to enhance competitiveness and commercial success of developing and transition economy businesses.

Such measures merit active consideration by all countries as a complement or counterpart to participating in trade liberalizing agreements and arrangements, to better ensure the success of such participation. Implementing these measures involves practical and conceptual challenges. Informed input by export-oriented businesses and their associations and other relevant bodies can facilitate wise choices in this area.

The competitive structure and behaviour of firms involved in the delivery of public and business infrastructure services are significant for developing economy businesses. There are several possible approaches to enhancing competition in providing public and business infrastructure services through appropriate restructuring, and the application of related rules.

Reforms are ongoing and competition law will continue to play a role before and after structural reforms. Developing country businesses, their associations, and public interest organizations should provide appropriate input to policy design and implementation to ensure that the measures taken reflect their long-run competitive interests.

⁴⁴ A more complete summary covering other aspects of the case is available at: www.wto.org/english/tratop_e/dispu_e/cases_e/ds204_e.htm

⁴⁵ Hufbauer, G. and S. Stephenson, 'Services Trade: Past Liberalization and Future Challenges,' *Journal of International Economic Law* 10(3), 605–630, doi:10.1093/jiel/jgm028, Advance Access publication, 10 August 2007. E. Fox, 'The WTO's First Antitrust Case – Mexican Telecom: A Sleeping Victory for Trade and Competition', *Journal of International Economic Law* 9(2), 271–292, doi:10.1093/jiel/jgl012, Advance Access Publication, 8 May 2006.

For the most part, the measures and initiatives in this chapter are not legally mandated by trade agreements. Without them, however, export competitiveness will be at risk. Failures of trade liberalization to generate sustained development and growth often can be traced to a failure to introduce complementary domestic policy reforms. Countries, and their businesses, will not be well-poised to take advantage of the benefits of trade liberalization unless steps are also taken to: reduce costs and enhance the efficiency of infrastructure sectors; promote flexibility by eliminating artificial restrictions on entry, exit and pricing in manufacturing and other industries; and establish and strengthen incentives for investment, innovation, the creation of efficient management structures and productivity improvement.

In this spirit, a number of insights emerge from the overview of issues concerning restructuring of public infrastructure sectors and application of related rules:

- **Competition measures strengthen reform.** First, at the broadest level, measures to strengthen competition are an important complement to other reforms, such as privatization, aimed at improving performance in providing public infrastructure services in the transportation, energy and telecommunications sectors. Successfully implemented, such measures offer substantial potential benefits to users, especially export-oriented businesses. The gains for export-oriented businesses are equally applicable to importing businesses.
- **Technology is an asset.** Second, technological change and improved understanding of issues concerning industrial structure have enabled enhanced competition in providing infrastructure services. This can be achieved through measures such as separation of potentially competitive segments of a particular sector (e.g. train operation or power generation) from other segments that constitute genuine ‘natural monopolies’ (e.g. railroad track facilities or power transmission lines), the introduction of competitive access regimes, and related measures.
- **Use competition laws.** Third, competition laws, typically through application of their provisions regarding abuses of a dominant position, can sometimes be used as a platform to impose necessary restructuring and establish competitive access regimes. In other cases, the remedies available by enforcing competition law may not be sufficient and other measures may be needed to effectively address monopoly issues in infrastructure industries. Other measures may include: (i) repeal or reform of statutes or regulations that unnecessarily limit entry to particular markets; and (ii) enactment of new legislation to restructure (i.e. break up) established monopoly enterprises and permit competition to take place, for example by establishing industry-specific competitive access regimes.

Continuing applicability of general competition laws is, in any case, important to deal with harmful practices in public infrastructure as in other sectors, such as: (i) cartels – price fixing or market sharing arrangements among firms that should be in competition with each other; (ii) mergers that are likely to lessen competition or create a situation of market dominance; and (iii) abuses of a dominant position.

- **Apply a case-by-case approach.** Fourth, a uniform approach to implementing competition-oriented structural reforms across all sectors and countries generally cannot be recommended. Experts tend to counsel a case-by-case approach involving careful weighing of potential benefits and costs of particular reforms and restructuring measures. In this context, user businesses and their associations, in addition to public interest and other advisory bodies, have an important role to play in providing input to policy formulation.

At least three types of input can usefully be provided by such organizations. First, on a broad level, they can play a crucial role in building political support for necessary restructuring initiatives and reforms. Second, they can provide essential input to the design of specific restructuring initiatives. Third, businesses and their associations can play a role in referring to the appropriate authorities, for example, national competition agencies, complaints regarding apparent competition law violations by infrastructure service providers and other input suppliers.

- **Connect competition to international agreements where appropriate.** Fifth, measures to inject competition into moribund infrastructure monopolies have most often been implemented at the national level. However, in many cases there is also an interface with international trade agreements and cooperation. In particular, and as has been discussed with reference to the WTO Reference Paper on regulatory principles in relation to basic telecommunications services and other instruments, international commitments can be used to carry forward national priorities in regards to maintaining and reinforcing competition in appropriate settings. More generally, in many cases, the most effective tool to enhance competition, whether in infrastructure or other sectors, can be trade liberalization, which entails removing legal or other barriers to participation in goods or services markets by foreign firms.



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CHAPTER 2

PROMOTE EXPORTS AND FOREIGN INVESTMENT

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PROMOTE EXPORTS AND FOREIGN INVESTMENT

INTRODUCTION

Much of the debate about export strategy is related to better trade policies and institutions, more efficient physical infrastructure and the availability of skilled manpower. However, the debate goes beyond domestic issues. The export sector is dependent on the performance of product and factor markets¹ both at home and abroad. The links between export and foreign investments are strong. Foreign investment has an important role to play in the development of a country's exports. This chapter explains linkages between foreign investment and exports and makes recommendations as to how countries can promote export growth by adopting the 'right' policies towards foreign investment.

There are five areas in which exports and foreign investments are related. The first four relate to inward foreign investment. The last one relates to outward foreign investment.

- Exports and access to efficient service providers;
- The role of foreign investors in the access of exporters to credit and other forms of financing;
- Access to global supply chains;
- Export competitiveness and access to technology and know-how;
- Exports and outward FDI as alternative sources of supply. This is related to the choice of firms to export or to supply foreign markets by their subsidiaries established in those markets.

To better understand the links between exports and foreign investment, the following questions are explored:

- What are the linkages between exports and foreign investment?
- What are the channels through which foreign investment can improve export performance?
- Are all contributions of foreign investment to exports positive or are there also risks associated with foreign investment flows?
- Do different kinds of foreign investment have different impacts on a host country?
- What policies are needed to encourage foreign investment?
- In situations in which foreign investment involves heavy costs for host countries, should governments in those countries adopt more defensive positions? If so, what are the options open to them?

Foreign investment has for the most part played a positive role in development, economic growth and exports. Critics of foreign investment have identified situations in which foreign investment had negative effects on host countries, which incurred social costs from the foreign investors' activities. Outflows of foreign investment have sometimes been seen as detrimental to home countries.

The majority of observers and policymakers now acknowledge that the benefits from foreign investment far exceed their costs, and that foreign investment plays a positive role in a country's economic and social development.

FDI AS A DRIVER OF THE GLOBAL ECONOMY

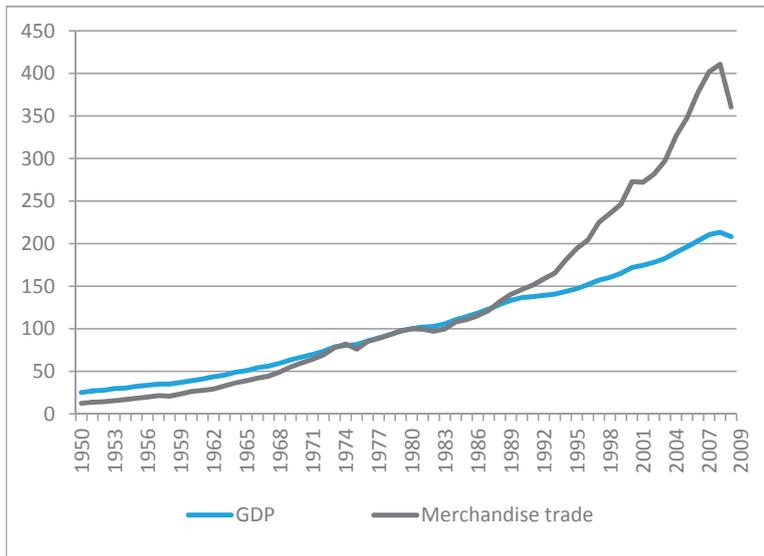
A positive correlation exists between exports and foreign investment – typically, export growth is accompanied by foreign investment growth in world markets.

Global merchandise trade grew faster than global output from 1950 to 2009, demonstrating that global trade in goods has become an important driver of global output growth (see figures 2 and 3).

¹ Product markets are markets for goods and services. Factor markets refer to markets for productive resources, such as land, labour and capital.

Figure 2 also shows that global trade in services has been growing on average even faster than merchandise exports. Moreover, due to serious methodological problems of data collection, the official statistics on trade in services are underestimated.² This suggests that globalization is no longer a matter of international trade in commodities and industrial goods, but reflects a deepening of global markets and a growing importance of trade in services, which also acts to facilitate greater goods trade.

Figure 2: Global GDP growth and merchandise trade volume, 1950-2009



Source: WTO Secretariat.

FDI IS GROWING FASTER THAN TRADE

The second important feature of global trends has been the rapid growth of global FDI.³ As global markets have deepened, there has been parallel growth in global FDI, particularly in recent years. As the data reveals in figure 3, between 1980 and 2008, the annual average percentage growth in the global stock of FDI exceeded the growth of global merchandise exports and services.

The impressive growth in global trade in goods and services can be largely explained by the heightened outsourcing and the emergence of supply chains as well as growth in trade in services. Research has commonly indicated that supply chain growth together with FDI growth into service sectors have led to rapid growth of global FDI. The list of service industries that are attracting foreign investors has dramatically increased over time.⁴

The growth of FDI in services can be partly explained by the fact that many services are at best – or can only be – transferred through FDI. (In World Trade Organization's (WTO) General Agreement on Trade in Services (GATS) terminology, that is Mode 3 – delivery of services through an established commercial presence abroad.) Globalization of production and enhanced technical know-how also has led to a considerable increase in intra-firm trade in services.

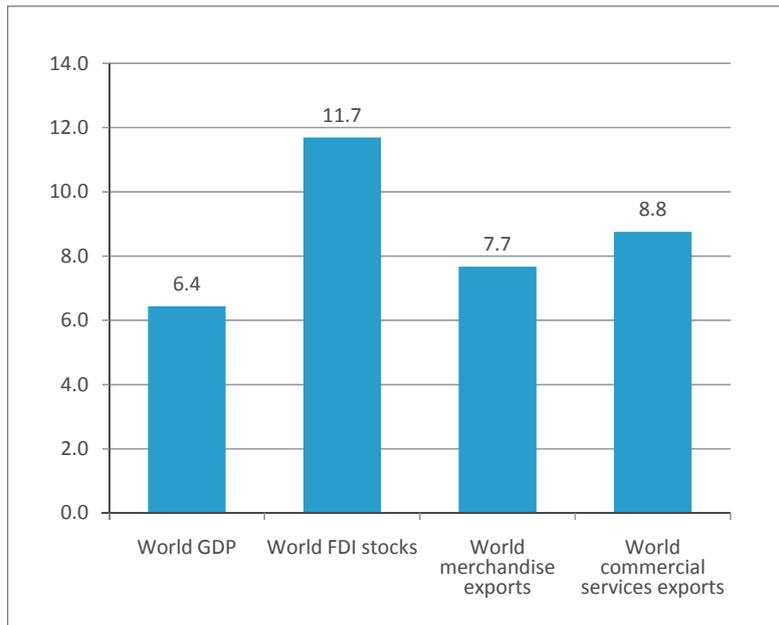
Growth in services entails significant flow-on effects: (i) services such as energy, communications and transport support exports of goods; (ii) the investment costs of service infrastructure projects are typically very high; as a result, FDI in those sectors is an attractive option for many developing countries with severe budgetary constraints; (iii) service sectors themselves have become dynamic exporters (as demonstrated in figure 3).

² Maurer, A. and P. Chauvet, 'The Magnitude of Flows of Global Trade in Services', in Hoekman, B., A. Mattoo, P. English, *Development, Trade and the WTO*, p. 243, Washington, D.C., World Bank, 2002.

³ For more discussion: Organisation for Economic Co-operation and Development (OECD), *International Investment Perspectives*, pp. 54-55, Paris, OECD, 2005.

⁴ For more discussion: *World Investment Report*, United Nations Conference on Trade and Development (UNCTAD), Geneva, 2004.

Figure 3: Growth of global output, FDI stocks, merchandise exports and services, 1980-2008



Sources: International Monetary Fund for GDP, United Nations Conference on Trade and Development for FDI, and WTO for merchandise and commercial services trade.

Note: Average annual percentage increase.

GLOBAL TRADE AND GLOBAL FDI ARE STRONGLY CORRELATED

The third global trend is the high correlation between the trade growth of trade in goods and services and FDI growth. Trade can be either a substitute for FDI or a complement to FDI, as noted above. Multinational enterprises (MNEs) may decide to service a foreign market either through exports or through a subsidiary by establishing a foreign presence. While establishing a subsidiary would lead to a substitution of exports by FDI, subsidiaries of MNEs often create new trade flows with their parent companies or foreign suppliers, and they can also export to third countries or back to the home country.

Trade can also complement FDI. Establishing foreign affiliates leads to new trade from the parent company to its subsidiary, or from other home or third country suppliers to the subsidiary. Under both situations – substitute and complementary trade to FDI – greater trade correlates with greater investment flows.⁵

WHY MULTINATIONALS INVEST ABROAD

In addition to factors such as the overall policy framework and business facilitation environment, the three main motivating economic reasons for firms to invest in foreign markets are to seek markets, seek resources and seek efficiency.

Market-seeking FDI

FDI that is carried out to augment sales in the existing market or to seek out opportunities for new markets is called 'market-seeking FDI'. Investing locally can be motivated by favourable regulations or to save on operational costs such as transportation. For example, General Motors's investment in China may best be seen as market seeking because the cars assembled in China are sold in China.

A market-seeking MNE invests to serve the host country's demand for goods, resulting in horizontal FDI. This occurs when a multinational company carries out a similar business operation in different countries; that

⁵ OECD, *op.cit.*, Figure 2.1, p. 53.

is, when the same production activities are replicated in several locations to satisfy local market demand. Inevitably, the market demand on FDI inflows is influenced by the market size or absolute value of gross domestic product (GDP), and market quality, or GDP per capita.

Resource-seeking FDI

Resource-seeking FDI is investment undertaken to gain access to natural resources, such as minerals, oil, natural gas and agricultural products, in particular countries. This type of investment seeks to acquire factors of production that are more obtainable in the host country. The investment seeks access to existing resources, such as Exxon Mobil investing in oil production in the North Sea.

Efficiency-seeking FDI

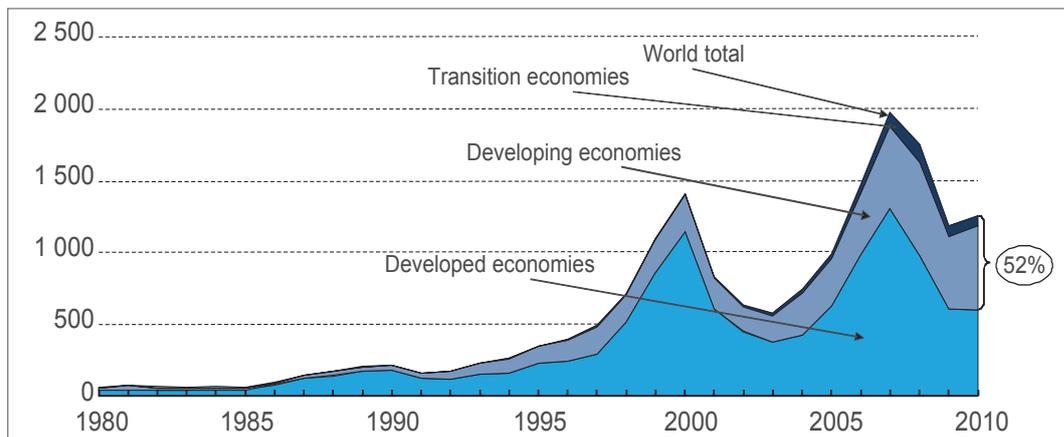
FDI activities may also be undertaken to guarantee optimization of accessible opportunities and economies of scale. Typically, firms partake in this type of investment in the hope that they will increase their efficiency by exploiting the benefits of economies of scale and scope. In addition, efficiency-seeking FDI typically involves investing in foreign markets to take advantage of a lower cost structure.

While market-seeking FDI results in horizontal investment, efficiency-seeking FDI implies vertical investment. The vertical investment strategy of MNEs connotes that it divides different stages of the production process among geographical locations to minimize production costs. For example, a production stage that is labour intensive is located where appropriately skilled labour is available at low cost. An example of efficiency-seeking FDI is that of a credit card company opening a call centre in India to serve United States customers.

FDI FLOWS

Most FDI originates in developed countries. Historically around two-thirds of this FDI has gone to developed countries, meaning FDI flows are heavily tilted towards developed country markets.⁶ For the first time developing countries levels surpassed the 50% mark of global FDI flows in 2010, as figure 4 indicates.

Figure 4: FDI inflows, global and by group of economies, 1980–2010 (billions of dollars)



Source: *World Investment Report 2011*, UNCTAD. Available at: www.unctad-docs.org/files/UNCTAD-WIR2011-Full-en.pdf

⁶ The actual numbers are even more dramatic. Industrial countries represented 90% of the origin of FDI outflows in 2000 and received almost 70% of all FDI inflows.

Maurer, A. and P. Chauvet, 'The Magnitude of Flows of Global Trade in Services', in Hoekman, B., A. Mattoo and P. English, *Development, Trade and the WTO*, p. 243, Washington, D.C., World Bank, p. 243, 2002.

According to the United Nations Conference on Trade and Development's (UNCTAD) *2010 World Investment Report*, the 10 leading developing countries for FDI inflows,⁷ account for approximately three-quarters of total developing country FDI inflows.⁸ However, the share of developing economy FDI has been tilted towards certain favoured investment destinations such as China, India, Mexico, Brazil and Turkey, rather than being more evenly spread across all countries.

Of further interest is the huge rise of FDI inflows in these and other most favoured economies. For example, China recorded FDI inflows of US\$ 578,818 million in 2010⁹ compared to US\$ 20,691 million in 1990; India recorded US\$ 197,939 million in 2010 compared with US\$ 1,657 million in 1990; Mexico recorded US\$ 327,249 million in 2010 compared with US\$ 22,424 million in 1990; Brazil recorded US\$ 472,579 in 2010 compared with US\$ 37,143 million in 1990; Turkey recorded US\$ 181,901 in 2010 compared with US\$ 11,150 million in 1990.¹⁰

Clearly, because of the link between FDI and increased exports, developing countries endeavouring to participate more in international trade must pay more attention to creating an enabling environment for investors. Developing countries must also learn from the experiences of those similarly placed countries that have undergone reform to attract investment.

LINKAGES BETWEEN FDI AND EXPORT GROWTH

The linkages between foreign investment and exports operate through different channels. There are basically four kinds of linkages between exports and foreign investment. All of these linkages relate to inward foreign investment. The fourth one also links to outward foreign investment.

- Access to efficient infrastructure services;
- Access to global supply chains;
- Access to technology and know-how;
- Exports or outward FDI by firms that seek to supply foreign markets by establishing foreign presence.

ACCESS TO EFFICIENT INFRASTRUCTURE SERVICES

Those countries that have successfully engaged in exporting provide a national environment in which access to services, particularly infrastructure services, are competitive. Moreover, ensuring competitive access in terms of increased efficiency, access and affordability of services can: contribute to a country's economic diversification, efficiency and export competitiveness; increase domestic supply capacity; contribute to development goals; and enhance a country's integration into the regional and global economy.

For example, landlocked countries are extremely dependent on efficient haulage companies, rail systems and/or road systems that effectively connect them with ports and foreign clients. Similarly, efficient sea transport has historically been the key to linking overseas markets across continents. Moreover, the competitiveness of firms depends critically on their access to services such as the provision of electricity, Internet, various business services and so on.

7 The countries are China, India, Brazil, Turkey, Chile, South Africa, Mexico, British Virgin Islands, Cayman Islands and Saudi Arabia. For further information on the FDI inflows and outflows see: *World Investment Report 2011: Non-Equity Modes of International Production and Development*, UNCTAD, pp. 191-193. Available at: www.unctad.org/Templates/webflyer.asp?docid=15189&intItemID=2068&lang=1&mode=toc

8 *Ibid.*

9 These figures are only for Mainland China, and do not include Hong Kong, which was re-united with China in 1997.

10 UNCTAD, *World Investment Report 2011: Non-Equity Modes of International Production and Development*.

SERVICES CAN BE A BOTTLENECK

Efficient service delivery does not come about cheaply in most cases. Service delivery depends in many instances on physical infrastructure, which often requires major policy reforms and institutional changes to increase the competitiveness of service providers. For example, many service providers operate in highly distorted markets as monopolies (for example electricity generation and transmission, rail transport or water companies), and could be more competitive if appropriate policy reforms were enacted.

While reforms are one part of the equation, it is also the case that there is a lack of public and private financial resources to improve upon the performance of services. In particular, infrastructural investment requirements are substantial and call for investments, often with long time periods. Power stations, road networks, undersea cables, rail rolling stock and aircraft are all examples of capital goods in service infrastructure that require massive investment that can typically only be amortized¹¹ over long periods. They are also subject to considerable risks.

Developing countries face a particularly serious problem in financing these infrastructural requirements. There are basically five different sources of financing investment in infrastructure. They include two public sources – government budgets and foreign donors. In addition, there are three private sources – loans from commercial banks, bond issues and equity investment. For a variety of reasons, which will be discussed in the following section, all these sources – with the exception of foreign equity investment – have major economic and financial disadvantages.

FDI – AN ATTRACTIVE SOLUTION

Foreign equity investment that is FDI-based financing of physical infrastructure has several advantages:

- Resources needed for financing infrastructural projects can be entirely mobilized by foreign investors;
- Government resources used to fund such projects can be made available for other useful projects, such as health and education;
- The risk of investment would fall on or be shared with foreign investors, depending on the structure of the actual deal;
- In countries with foreign currency shortages, foreign project financing can strengthen the home country's international reserves;
- Foreign-funded and owned projects typically involve the transfer of technology and know-how, which is of critical importance to most developing countries;
- There are also ways of ensuring that foreign investors use services or other inputs provided by local suppliers as much as possible, thereby creating backward linkages.

INVESTOR PARTNERSHIPS

There are three main channels for foreign investor participation in infrastructure: public-private partnerships, privatization and green field investment.

Private sector participation in the design, financing and execution of infrastructure projects reduces the large gap between infrastructure needs and the limited investment resources governments have at their disposal to meet them. Public-private partnerships (PPPs) bring the best features of the public and private sectors together. The private sector can leverage its advantages in creative financing, greater operational efficiency, lower costs of distribution, more complex delivery systems, faster decision-making, management flexibility and innovation. The public sector can provide strategic direction, including the choice, location and pricing of infrastructure; ensure value for money and transparency in procurement; and above all, through capital or user fee subsidies, or commitments to purchasing agreements, enable private firms to enter large markets with guaranteed consumers.

¹¹ In accounting the cost of a long-term asset is accounted for by deducting a portion of that cost against income in each period.

In relation to trade, infrastructure comprises not only roads, railways, ports, energy, water and telecommunications, but also laboratories for quality, sanitary and phytosanitary controls and verification of compliance standards with border posts and associated computer and customs software. The use of PPPs in infrastructure is often seen as a more economically efficient and sustainable option for governments, particularly those trying to address infrastructure shortages or improve the efficiency of their organizations. There are a number of different models, such as build, operate and transfer (BOT); build, own, operate and transfer (BOOT); or build, own and operate (BOO).

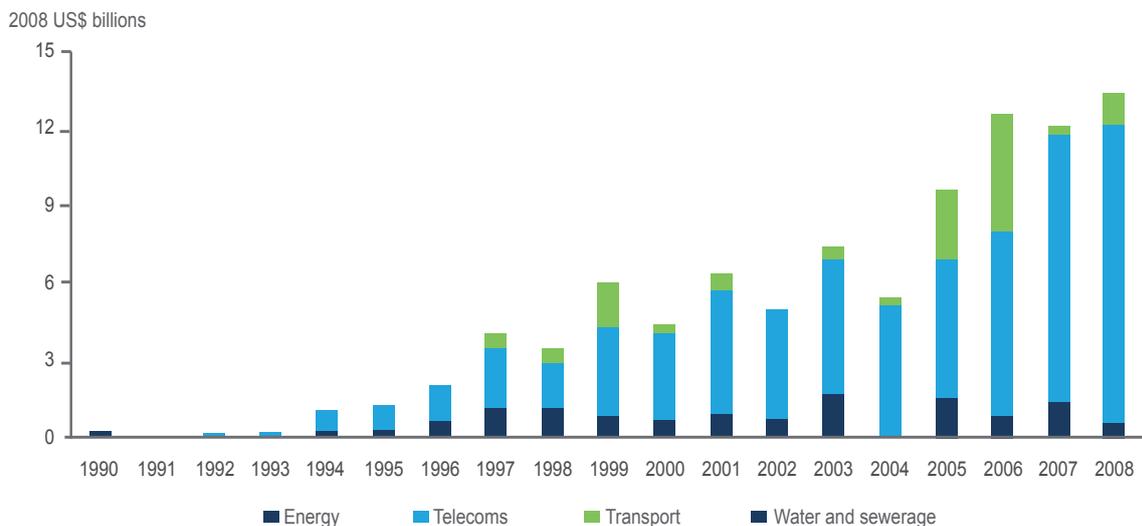
In recent decades there has been an upsurge in the use of PPPs. In sub-Saharan Africa, between 1990 and 2008 there was an immense rise in the investment commitments to infrastructure projects with private participation (see figure 5). In 2008, nearly US\$ 15 billion was invested, compared to minor investments recorded in 1990. For projects with high capital and maintenance costs, PPPs have proven to be particularly attractive for countries with tight fiscal constraints and the inability of public entities to finance projects. Benefits of PPPs include:

- Encouraging a strong customer service orientation;
- Enabling the public sector to focus on the outcome-based public value they are trying to create;
- Providing benefits by allocating the responsibilities to the party – either public or private – that is best positioned to control the activity that will produce the desired result;
- Expediting completion compared to conventional delivery methods;
- Improving quality and system performance from the use of innovative materials and management techniques;
- Substituting private resources and personnel for constrained public resources;
- Accessing new sources of private capital.

At the same time, implementing PPPs has been complicated in practice, often requiring additional government support. Therefore, it is important to ensure good practices for implementation.

The other two important channels for foreign investors to participate in costly infrastructure projects are privatization and greenfield investment. An example of a service sector in which greenfield investments have taken place is telecommunications. An example in which PPP and privatization channels have been used is the power sector, where the construction of power stations is particularly costly and the commercial risks are particularly high. The attractiveness of deals involving PPPs and privatization in project financing in developing countries can be also seen from the data on global PPP investment projects based from the World Bank. The data shows a considerable expansion of those projects around world over the last 25 years or so, with a particularly high share of those projects in the energy and water sectors.

Figure 5: Private investment in sub-Saharan infrastructure projects by sector, 1990-2008



Source: World Bank. Private Participation in Infrastructure Database. <http://ppi.worldbank.org/>.

Table 2 shows the sectoral and sub-sectoral breakdown of current PPP projects in the World Bank's Private Participation in Infrastructure Database (PPI database).¹² The energy sector comprises the bulk of PPP projects. Transport projects, mostly seaports, airports, highways and bridges, account for the second largest share, followed by telecommunications, then water and sewage. This sectoral breakdown reflects two key investment patterns in PPPs: sectors with cross-border applications and impact, such as energy and transport, attract the biggest investments, while sectors with more local applications, such as telecoms and water and sewage, see the least investment.

Table 2: Sectoral and sub-sectoral breakdown of PPP projects, as of 2009

Primary sector		Number of projects	Proportion of world total
Energy		1 524	38.32%
Telecom		818	20.57%
Transport		1 020	25.65%
Energy	Power generation	992	24.9%
	Power distribution	561	14.1%
Telecom	Fixed telecom	343	8.6%
	Mobile	542	13.6%
Transport	Airports	121	3.0%
	Seaports	303	7.6%
	Railroads	104	2.6%
	Roads	490	12.3%
Water	Water sewerage and treatment	305	7.7%
	Water utility	336	8.4%

Source: Resides, R. Global Determinants of Stress and Risk in Public-Private Partnerships (PPPs) in Infrastructure, ADB Institute Working Paper, No. 133, Asian Development Bank Institute, based on data from the World Bank PPI database. Totals of sub-sectors may not necessarily add up to sector totals because some projects may involve more than one sub-sector (e.g. in the energy sector, a project may involve both power generation and power distribution, so a single project can be classified under both sub-sectors).

WHY USE FOREIGN INVESTMENT FOR INFRASTRUCTURE?

The following section details why there is a need to use FDI in developing countries, often in favour of other possible alternatives.

- **Limited availability of domestic public funds.** Most developing countries struggle with government budgetary constraints in mobilizing sufficient resources. Governments in developing countries face powerful demands on their budgetary resources from social sectors, such as education and health. This creates serious dilemmas for policymakers endeavouring to support infrastructure projects. While valuable support has been provided by foreign public institutions, such as the World Bank and other regional banks, to carry out infrastructure projects, it is not nearly enough to satisfy demand.
- **Domestic private sources of funding are often inadequate.** While domestic private funding sources from the banking sector and capital markets could provide an alternative to the inadequacies of public support, they are also inhibited. For example, stock markets are one of the most vital areas of a developed country

¹² The Private Participation in Infrastructure (PPI) project database tracks infrastructure projects newly owned or managed by private companies that achieved financial closure in 1990-1999 in energy (electricity and natural gas transmission and distribution), telecommunications, transport and water.

because they provide companies with access to capital through individual investment. However, stock markets are at best in a nascent state in most developing countries, with very few actually having fully functional capital markets.¹³

Local domestic bank infrastructure financing is also limited. Access to credit is constrained by high interest rates, low creditworthiness of borrowers, and a highly limited ability of these banks to supply credit, typically with a short-end of credit maturities. While the reasons for high interest rates and for the bias towards short-term credit are complex, there is widespread agreement that low efficiency in the financial sector is one of the principal reasons.

- **Access to private foreign credit is poor and very risky.** Access to foreign borrowing is extremely limited for most developing countries due to the absence of well-functioning local capital markets, currency restrictions that limit access to loans in foreign currency in foreign credit markets, high levels of external debt, and an almost complete absence of companies able to provide adequate security to foreign lenders. Foreign borrowing by governments is limited to a few developing countries, which are primarily middle income. However, these governments typically must borrow at rates reflecting higher sovereign risks. Some local companies have the capacity to borrow abroad.

Some middle-income developing countries with fully liberalized foreign currency markets may be in the position to borrow abroad at interest rates lower than domestic rates and on-lend the funds at more attractive rates locally. This 'carry-trade' in recent years has spread through many markets due to the large differences in interest rates among countries, and in the pace of liberalization of capital accounts. Although an attractive option, especially for financial intermediaries, carry-trade is also very risky. Banks that borrow abroad contract their debt in foreign currency while the proceeds from their on-lending activities are usually in local currency. This currency mismatch has often resulted in serious problems. It has also led to local banks borrowing and lending the foreign currency, in which case the foreign currency risk is borne by the final borrowers. Either option entails significant risks to both borrowers and lenders.

- **Introducing new financing instruments is very complicated.** Bond financing, a type of long-term borrowing that government and public utilities use to raise money, primarily for infrastructure projects, has been proposed as the preferred option for developing countries.¹⁴ Finance is obtained by selling bonds to investors based upon the promise to repay this money, with interest, according to specified schedules. The interest government has to pay investors on the bonds is exempt from taxes, making it a more attractive proposition than it might otherwise be. Bond financing also has the advantage of being long term and at fixed interest rates – something that local banks in such countries are unlikely to be able to provide.

However, the problems of using bond financing on a large scale are immense. One major constraint is the poorly developed pension and insurance industries in most developing countries, which limits the range of long-term investors into bonds. Even in countries in which both industries are established, the liquidity of pension and insurance companies tends to be very limited.

The main advantage of FDI is its role in fully absorbing, or at least sharing, the commercial risk of the project, avoiding further increases in external debt, transferring technology and know-how, and providing external financing for the project. This also limits overcrowding and other adverse impacts on local credit markets. Furthermore, foreign investors normally have better access to credit markets than governments or private investors from developing countries and as a result are able to obtain better credit conditions.

ACCESSING GLOBAL SUPPLY CHAINS

One of the most remarkable changes in global trade has been the strong interdependence of trade and foreign investment. The growth of global trade in goods and services has been highly correlated with global FDI growth. Modern global trade trends reflect the importance of FDI as an important driver of trade. Moreover, increasing intra-firm trade, between developed and developing countries, highlights the trend towards more trade-intensive foreign investment.¹⁵

¹³ A capital market is a market for securities (debt or equity), where companies and governments can raise long-term funds (over a one-year period). The capital market includes the stock market (equity securities) and the bond market (debt).

¹⁴ *Making Finance Work for Uganda*, Washington, D.C., World Bank, December 2009.

¹⁵ OECD, *op.cit.*, p. 54.

A common scenario is when the developing country affiliate of a US multinational has been able to increase its exports to other affiliates rather than to the parent company. This is confirmed by empirical evidence showing that intra-firm exports as a percentage of total US MNE exports to both developed and developing countries have been growing. For example, from 1982 to 1994, the share of US parent companies that shipped to their foreign affiliates increased from 31% to 42%; the share of US parent company imports shipped from their foreign affiliates increased from 36% to 50%.¹⁶

These trends reflect the recent strategy of MNEs to engage in outsourcing and globalized production with a network of subsidiaries in various countries, thereby creating a global value chain. These trends also reflect a change in weight of importance given to the main determinants of FDI. Although market-seeking or resource-seeking investments still account for the majority of FDI between developed and developing countries, efficiency-seeking motives have increased over the past decade.

FRAGMENTED, GLOBALIZED PRODUCTION

As the world has become more globalized, it has become easier for production processes to be fragmented into separate stages. The simplest form is the subcontracting process, where the delivery of services or intermediate inputs is subcontracted to a service provider or a producer of inputs. In more complex supply chains, many stages of the production process may be located in different parts of the world and linked together by the final producer. The final producer typically uses modern management techniques, such as just-in-time deliveries and other methods of stock management, as well as highly advanced transport systems and communication technologies.

MNEs may use their subsidiaries for the delivery of important inputs, which leads to intra-firm trade. Alternatively, MNEs may contract other companies. Intra-firm trade is characterized by several important features:¹⁷

- Trade relates to goods and services that feed into many different stages in the production process;
- Because intra-firm trade involves different subsidiaries of MNEs, it also implies a strong link to foreign investment. This link comes from the fact that each subsidiary is created by foreign investment of the parent company. FDI is critical to the creation of the value chain;
- MNEs with intra-firm trade tend to be different from those with no intra-firm trade. They tend to be more dynamic technologically;
- Parents and subsidiaries of MNEs tend to be more deeply integrated and less sensitive to the economic environment, such as changes in tariffs and exchange rate movements;
- MNEs with intra-firm trade have more R&D operations.

Creating and maintaining supply chains is a complex process, and their origins may vary from case to case. Backward linkages to local firms represent a particularly tenuous relationship, involving the need for an MNE to carefully choose their suppliers from those local firms that meet stringent requirements set down by the MNE. Alternatively, the awarding of a contract or allowance for technical assistance by an MNE may be instrumental for local firms to become competitive suppliers. Local suppliers become competitive while doing business with MNEs due to more stringent requirements or technology transfer.

Multinationals choose their supply chain approach based on local conditions and favoured business approaches. Developing country governments are keen to design appropriate policies strengthening the linkages.

¹⁶ Zeile, W.J., 'US Intra-Firm Trade in Goods', Bureau of Economic Analysis, *Survey of Current Business*, Washington, D.C., July 1997. For more recent data see: Dunning, J., Lundan, S.N., *Multinational Enterprises and the Global Economy*, Second Edition, Cheltenham, Edward Elgar, 2008.

¹⁷ Feinberg, S.E. and M.P. Kean, 'Intra-Firm Trade of US Multinational Corporations: Findings and Implications for Models and Policies towards Trade and Investment', in Moran, T. H., E.M. Graham, M. Blomstrom, *Does Foreign Direct Investment Promote Development?* pp. 247-248, Washington, D.C., Peterson Institute for International Economics, May 2005.

Box 22: Global car production

In the United States, a manufactured car is a good example of production fragmentation in global trade where various value chains are created. United States car manufacturers have been adept at sourcing inputs and deliveries from various suppliers from all over the world, which has resulted in creating high value, particularly compared to other countries. A typical United States car built in the 1990s was created by suppliers from eight countries, including the Republic of Korea, Chinese Taipei and Singapore. Most of the value was created by foreign suppliers; the contribution of United States labour and capital and other inputs was only 37%.

Source: Grossman, G. and E. Rossi-Hansberg, *The Rise of Offshoring: It's Not Wine for Cloth Anymore*, Princeton University, 2006.

LINKING DOMESTIC FIRMS WITH GLOBAL SUPPLY CHAINS

Criteria for selection

A World Bank survey¹⁸ of activities of MNEs in the Czech Republic and Romania revealed that the decision of an MNE to choose one type of supplier over another is driven by several factors. The survey found that the top reasons reported for cooperating with Czech suppliers included: low prices (71%); geographic proximity (64%); savings in transport costs (56%); savings on import duties (44%).

Sourcing from foreign firms located in the Czech Republic was primarily driven by the fact that these firms were global suppliers of the MNE (45%) and offered more competitive prices (45%) and offered higher quality products (29%) not available from Czech firms; transport costs mattered (30%) as well, and benefits of proximity were also important.

Importing inputs from abroad was primarily driven by using a parent company's global suppliers (46%), implementing the decision of parent company (37%), unavailability of particular products from Czech firms (36%), or desire to purchase higher quality inputs (30%).

One of the benefits of participating in supplier firms is the potential for technology transfer by more advanced MNEs. While technology transfer is not the main reason for local firms to participate in supply chains, it can be an extremely important external benefit for them.

What do these trends and features of supply chains mean for developing countries?

First, the benefits of supply chains are not distributed equally around the world. Some countries participate in the process extensively, while other countries do so less or are left completely behind. Countries in South-East Asia and East Asia have been particularly active in various supply chains and strong involvement also takes place in Eastern Europe and parts of Latin America.

Second, an important message is that greater involvement of developing countries in supply chains is imperative if they want to benefit from the rapid growth of global markets. Developing countries will directly benefit from these global trends to the extent that MNEs locate their foreign activities in their markets. This also enables developing countries to diversify their economies away from primary commodities.

Developing countries benefit indirectly from the FDI activities of MNEs if their firms can be linked to their supply chains as direct or indirect suppliers in the manufacturing process of foreign affiliates of MNEs, or by providing services in the supply chain. It is clearly in the interest of developing countries to facilitate the development of backward linkages, creating new employment and income opportunities for local firms and workers. The value of backward linkages will be even greater if accompanied by transfers of technology and management skills. In some situations, this may call for direct interventions from governments to encourage backward linkages if they are impeded by market imperfections, as has been done in some countries. Governments also need to create a sound investment environment.

¹⁸ Javorcik, B.S. and M. Spatareanu., 'Disentangling FDI Effects: What do Firms Perceptions Tell us?' in Moran, T. H., E.M. Graham, M. Blomstrom, *Does Foreign Direct Investment Promote Development?* pp. 45-71, Washington, D.C., Peterson Institute for International Economics, May 2005.

Box 23: India: business service outsourcing creates value

India's US\$ 1.5 billion outsourcing business illustrates how foreign investment and trade have benefited the country. Together with information technology (IT) and software, business process outsourcing is perhaps the country's most open sector. In 2002, it attracted 15% of total FDI and accounted for 10% of all exports. By 2008, it was expected to attract one-third of all FDI and to generate US\$ 60 billion a year in exports, creating nearly 1 million new jobs in the process. Being a liberalized sector combined with some investments by a few key MNEs, the outsourcing industry took off. Pioneers such as British Airways, General Electric and Citigroup were among the first to move IT and other back office operations to India, entering in 1996, 1997 and 1998 respectively. The success of these companies demonstrated that the country was a credible outsourcing destination.

The MNEs trained thousands of local workers, many of whom transferred their skills to new Indian companies. For instance, India's Tata Consultancy Services recently went public valuing the company at US\$ 8.8 billion with US\$ 1.2 billion in total revenues, growing at 30% per year since 1997, and of which more than 90% is exports. The number of Tata's employees grows by 17% per year. Today, Indian outsourcing firms control over half of the intensely competitive global IT and back office outsourcing market. Many of the leading companies started as joint ventures or subsidiaries of MNEs, or were founded by managers who had worked for them. Liberalized sectors have grown faster and business process outsourcing has taken off.

Source: Organisation for Economic Co-operation and Development (OECD), *International Investment Perspectives*, pp. 69, Paris, OECD, 2005.

TRANSFERRING TECHNOLOGY AND KNOW-HOW

Export growth can be constrained by the use of old technology, a firms' poor knowledge of markets, poor management and weak marketing channels. These challenges can be overcome through increased FDI, which brings transfer of technology and know-how to local firms.

Foreign firms can bring the knowledge of markets, marketing channels and technological or managerial know-how. This transfer of technology and know-how can improve a local firm's profitability by stimulating productivity growth through modern technology or better management and/or reduction of unit costs due to economies of scale by expanding marketing channels and introducing new markets.

There are two main technology transfer channels that can assist local firms in linking up with foreign investors.

- **Horizontal technology transfer.** This occurs when MNEs enter the domestic market and provide technological support to local firms through the following:
 - Local firms can learn by doing from the MNE as they strive to meet the MNE's stringent quality standards;
 - Local firms can employ skilled labour from the MNE;
 - Local firms can benefit from the presence of various quality professional service providers that often accompany an MNE when it enters a country, including accountants, lawyers and brokers. Typically, these service providers can also be used by local firms, thus raising the competitiveness of many service providers. This expertise is also beneficial to local firms endeavouring to export.
- **Vertical technology transfer.** This can take the form of forward linkages from supplier to buyer and backward linkages from buyer to supplier. Vertical technology transfer can occur when foreign firms offer suggestions to improve technological processes after inspection of facilities, assistance in testing quality, leasing or lending machinery, training, supply of inputs, organization of production lines, maintenance of machinery and inventory management.

The examples above refer to technology transfer through supply chains. Another form of technology transfer can take place through direct linkages between an MNE (foreign investor) and a local firm. They can create joint ventures or local firms can offer their companies directly for sale. Alternatively, the links can be established through initial public offerings (IPOs), or mergers and acquisition (M&A) activities. Both IPOs and M&As would typically require deals to be consummated through well-functioning stock markets, a condition that is usually difficult to meet in most developing countries where stock markets are poorly capitalized and there is little liquidity. Until stock markets in developing countries are either developed or strengthened, local firms will need to seek direct links with foreign investors.

MULTINATIONAL FIRMS BOOST DOMESTIC COMPETITION

Both trade and investment influence domestic competition as imports compete with domestically produced commodities and foreign subsidiaries compete with local firms. The effects of both imports and foreign investment are similar. By increasing competition, imports and competition create pressure on local firms to reduce costs and to become more competitive. In many countries, government policies overly restrict foreign participation in the domestic market. This approach needs to be carefully considered as it may impede the potential export competitiveness of domestic firms.

However, it must be noted that the entry of MNEs may also hurt local firms. Multinationals have been known to hire talented staff away from local firms (brain drain). The entry of MNEs may also distort the local labour market by forcing local wages up to the point where local firms cease to be competitive.

EXPANDING DOMESTIC PRODUCTION CAPACITIES

FDI can contribute to expanding the production capacities of the local export sector. FDI can also encourage local firms to introduce new products and services. In all parts of the world, FDI projects have led to relocating manufacturing capacities from developed countries to transition and developing countries. Some of the many examples include the expansion by United States car manufacturers into Mexico, foreign investments by Intel in Costa Rica, Dell and other United States investors in Ireland, Volkswagen in the Czech Republic and the emergence of China as the major supplier of manufactured goods.

There is an abundance of research that positively links FDI's contribution to the competitiveness of local firms in developing countries. For example, researchers have identified and reviewed various FDI success stories ranging across different industries and countries and analyzed the contribution of foreign investment to the size of plants and their efficiency, productivity, technology transfer and other factors of successful performance.¹⁹ Overall, the research suggests an overwhelming link to FDI and its contribution to economic growth and to economic development in general. Other evidence comes from studies of the Spanish economy, which show not only that exports and FDI inflows were complementary, but also that the flow of causality was from FDI to exports.²⁰

A powerful example of a success story is the acquisition of the Skoda Car Manufacturing Company by Volkswagen in 1991. The success can be assessed in terms of output and profitability as shown in figures 6 and 7, as well as in terms of backward linkages that have created enormous job opportunities and led to a dramatic increase in productivity.

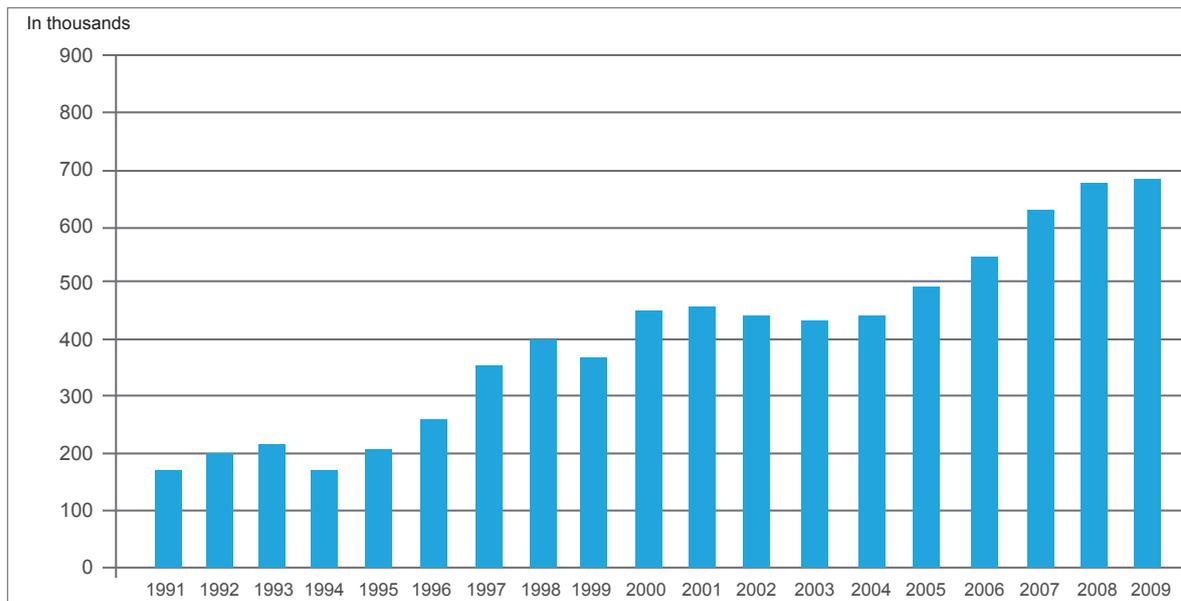
China represents an interesting case because of the important role of FDI in domestic resource mobilization and exports, as well as the country's strong competitiveness in world markets. For example, a study reveals that technological innovation and FDI have had positive effects on the export competitiveness of China's manufacturing industry. In addition, changes in the export competitiveness of China's manufacturing industry over time have been related to the path of FDI inflows.²¹ A great deal of empirical evidence is provided in numerous sectoral studies and studies considering the contribution of technology transfer to economic growth.

19 Blalock, G. and P.J. Gertler, 'Foreign Direct Investment and Externalities: The Case for Public Intervention', in Moran, T. H., E.M. Graham and M. Blomstrom, *Does Foreign Direct Investment Promote Development?* pp. 73-106, Washington, D.C., Peterson Institute for International Economics, May 2005.

20 Alguacil, M.T. and V. Orts, 'A multivariate co-integrated model testing for temporal causality between exports and outward FDI: The Spanish case', *Studies on the Spanish Economy*, FEDEA, 1999. Available at: www.fedea.es/pub/eee/1999/eee50.pdf

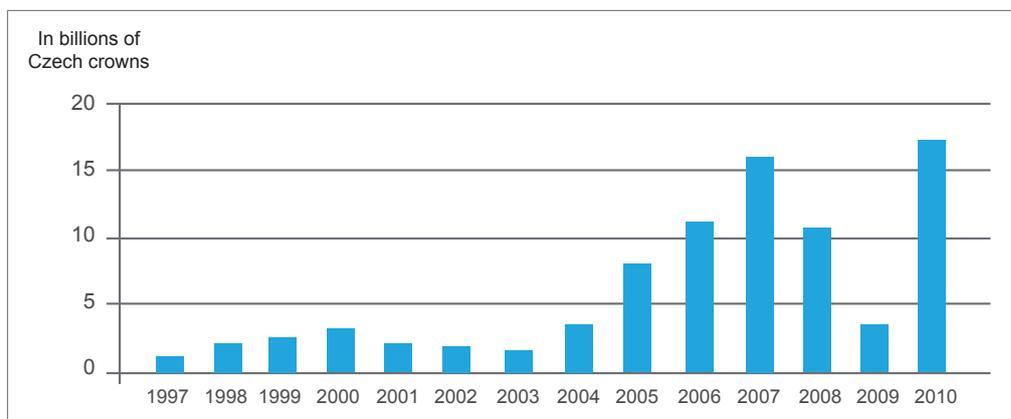
21 Yang Yonghua, 'Technological Innovation, FDI and China's Manufacturing Export Competitiveness: An Empirical Analysis based on China's 26 Industries Panel Data', International Conference on Information Management, Innovation Management and Industrial Engineering, vol. 4, pp. 579-582, 3rd International Conference on Information Management, Innovation Management and Industrial Engineering, 2010.

Figure 6: Skoda/Volkswagen car sales 1991-2010



Source: Compiled by ITC based upon the yearly reported figures of the Czech Car Association.

Figure 7: Skoda/Volkswagen after-tax profits 1997-2010



Source: Compiled by ITC based upon the yearly reported figures of the Czech Car Association.

EXPORTS AND OUTWARD FDI

Multinational firms have two options in servicing foreign markets. They can either export directly to foreign markets or they can supply foreign markets using their own subsidiaries established in those markets. Establishing subsidiaries requires outward FDI.

Why would exporters face the dilemma of exporting or investing abroad? There are several answers to this question. One answer is the costs of transport, insurance, energy and the complex logistics of organizing delivery across borders, all of which may create strong disincentives to export to foreign markets. As the costs of exporting and other logistical arrangements increase, the total costs of exports relative to the alternative – the costs of establishing a foreign presence and servicing foreign markets by the company's own subsidiary

Box 24: GATS – The relationship between trade and investment

The General Agreement on Trade in Services (GATS) is the WTO Agreement that defines the relationship between investment and trade in services using four modes through which services can be traded.

Mode 1 – Cross-border supply: the supply of a service ‘from the territory of one member into the territory of any other member’. The service crosses the border, but both the provider and the consumer stay home.

Mode 2 – Consumption abroad: the supply of a service, ‘in the territory of one member to the service consumer of any other member’. The consumer physically travels to another country to obtain the service.

Mode 3 – Commercial presence: the supply of a service ‘by a service supplier of one member, through commercial presence in the territory of any other member’, i.e. investment through the establishment of a branch, agency or wholly owned subsidiary.

Mode 4 – Presence of natural persons: the supply of a service ‘by a service supplier of one member, through presence of natural persons of a member in the territory of any other member’. Private persons temporarily enter another country to provide services.

Mode 3 encompasses FDI as a mode of supplying services. Although Mode 3 does not necessarily imply the presence of foreigners working in affiliated companies, Mode 4 often accompanies Mode 3 as the foreign firm may need to employ non-nationals in the host country, for example, persons from the parent company entering as ‘intra-corporate transferees’.

Modes 1 and 2 can also be complementary to Mode 3 when subsidiaries of foreign companies in developing countries are exporters of services to the parent company. An example is business process outsourcing, whereby a firm creates a subsidiary in a developing country to undertake database services and outsources the management of its databases to the affiliate, an illustration of developed country Mode 3 exports leading to developing country exports under Modes 1 and 2. Any effort to liberalize foreign investment in services (Mode 3) may need to consider barriers to trade in services through Modes 1, 2 and 4.

Source: ‘A Policy Framework for Investment: Trade Policy’, a paper prepared for an OECD conference on Investment for Development: Making it Happen, Rio de Janeiro, Brazil, 25-27 October 2005.

– also increase. It may be more profitable for firms to set up their affiliates abroad to service their markets. Services can be delivered in different forms, or ‘modes of delivery’ as defined by the WTO in the GATS. These modes are described in box 24.

However, some firms have no other option to access foreign markets except by establishing a foreign presence. Examples include hotel and restaurant services that require a foreign presence to satisfy foreign demand in foreign markets.

Another reason for firms to choose a foreign commercial presence as the form of service delivery may be market protection by foreign countries against imports of goods or services. Tariffs as an instrument of protection in the host countries against merchandise imports may induce foreign firms to abandon attempts to enter the foreign market via exports and supply that market using their affiliates. This practice of firms bypassing tariff protection is known as ‘tariff jumping’. Foreign governments may introduce or deliberately maintain protective measures to encourage foreign investors to set up businesses in their market to stimulate employment, incomes and tax revenues.

POLICY IMPLICATIONS

Foreign investment help developing countries gain access to more competitive infrastructure services, as well ensuring greater participation in global supply chains. Governments should pursue strategies that attract foreign capital and are conducive to conducting business.

STRATEGIES TO ATTRACT FOREIGN CAPITAL

Foreign investors are attracted to investing abroad by three main factors:

- Opportunities for profits;
- Macroeconomic stability determined by a mix of monetary, fiscal and exchange rate policies;
- A business-friendly environment, including protection of investors, attractive tax rates, ease of trading across borders, contract enforcement, rule of law, etc.

While profitability is clearly the necessary condition to invest, both macroeconomic stability and a business-friendly environment play important roles in investors' decisions to the extent that they affect the costs of investing and the need for insurance coverage.

TARGETING FOREIGN INVESTMENT

This is arguably the most controversial area of policymaking with regards to foreign investment. Given that FDI contributes to a country's competitiveness, it may be tempting for governments to pursue policies targeting FDI for specific local industries. However, the experience of countries has been quite negative except in very special circumstances. The conditions for the success of these policies are so stringent and country specific that it would be extremely risky and expensive to imitate them elsewhere. There are many examples of countries that have succeeded in attracting FDI without special foreign incentives or other 'targeting' policies.

Financial incentives should not discriminate against domestic investors. The discrimination would encourage domestic consumption rather than savings and possibly encourage capital flight, none of which is in the interest of developing countries. Moreover, government investment policies should not be seen as 'picking winners' by making investment decisions on the basis of the government's judgement of the relative profitability of individual projects. These judgements are best made by private investors who have the experience and skills in the given areas and risk their money and businesses to succeed.

There are few areas in which developing countries can consider government interventions. Where there are serious market failures or distortions, it is unadvisable to target foreign investment. At the same time, trade and investment barriers in developing countries are relatively high. Targeted incentives might be used temporarily to overcome anti-export bias in such circumstances (see chapter 5).

Developing countries are often unable to attract foreign investment due to shortages of technical or other labour skills, for example, in the financial services sector. Governments should consider more proactive support to develop these skills under labour policies.

In many countries, setting up foreign businesses can be excessively costly due to a range of issues, including complying with business start-up procedures and regulations, minimum capital requirements, labour shortages and other factors. Under such circumstances, governments are justified in providing financial support as an incentive to foreign investors to compensate for such costs.

GOOD GOVERNANCE, KEY TO INVESTMENT PROMOTION

Transparency results in improvements in overall governance standards. For simplicity, good governance for investment promotion can be reduced to four main principles: predictability, accountability, transparency and participation. Table 3 outlines these principles together with examples of how to improve governance and the necessary mechanisms to achieve good governance.

Table 3: Good governance in investment promotion

Requisites for good governance	Examples of how to improve governance	Mechanisms/instruments/practices
Predictability	Clear policies and a legal framework for investment Streamlined and simple rules and regulations governing investments Effective investment facilitation services	Strong advocacy role of investment promotion agencies (IPAs) Online road maps for investors IPA investment implementation support services
Accountability	Introduction of ethical standards for civil servants Anti-corruption instruments and measures Dispute resolution mechanisms for investors	Code of conduct Client charters Anti-corruption legislation and enforcement (anti-corruption board) Investment ombudsman
Transparency	Easy availability of information for investors Timely disclosure of information on changes in the investment regime Information collection and sharing of national data on FDI and impact of international investment on the economy	Investment regime data on website Investment guides Online application and tracking system for permits and licences Client charters Analysis of FDI data by IPA and frequent publication of FDI trends and impact
Participation	Regular public-private sector dialogue on efforts to improve the investment environment Consultations with civil society on legislative and regulatory changes that will influence businesses	National business council and local chamber of commerce and industry Involvement of NGOs and labour organizations in consultations on policy decisions

Source: Notes on Good governance in Investment Promotion, Strengthening the Investment climate: a blue book on best practices, UNCTAD, 2004. Available at: http://www.unescap.org/tid/publication/indpub2402_chap5.pdf

Transparency is key

Transparency is key to overcoming foreigners' disadvantages when investing in a host country. Transparent information on how governments implement and change rules and regulations concerning investment is a decisive factor in the investment decision.²² Transparent policy environments compensate for what foreign investors may consider as disadvantages when investing in a host country with very different regulatory systems, cultures and administrative frameworks. Policies implemented in a transparent manner help to avoid hidden costs that may increase the perception of risk by foreign investors.

A transparent and predictable policy and regulatory framework assists businesses in the evaluation of potential investment opportunities on a more informed and timely basis, reducing the period before the investment becomes productive. Transparency conditions have also been endorsed in almost all recent international investment agreements, including regional agreements and most bilateral investment treaties and various WTO agreements. Countries can provide a clear indication of their commitment to transparency by signing international, regional and bilateral agreements.

Transparency is also related to higher flows and quality of investment. A 2007 OECD study shows that there is a strong relationship between international investment flows and the quality of governance against FDI inflows.²³

²² 'Investment policy', in *The Policy Framework for Investment: A Review of Good Practices*, OECD, 2007.

²³ *Ibid.*

Barriers to transparency reform

A fundamental challenge in seeking to improve transparency is similar in all countries; it is the desire to protect 'concentrated benefits at the expense of broader wellbeing'.²⁴ A lack of transparency also protects government officials from accountability. The OECD describes some obstacles to reform:

Many actors – both inside and outside the public sector – can have a stake in non-transparent practices. It is for this reason that, despite the broad apparent agreement in principle about their benefits, actual implementation of transparency-enhancing reforms is likely to involve painful shifts in the way policies are made and implemented, especially in countries with highly opaque policy environments. The difficulty will be to develop the political momentum for pro-transparency reform and to prevent backsliding.

A further obstacle to reform is that it entails technological, financial and human resources and requires administrative costs. The main transparency actions entail the creation of registers, websites, the development of 'plain language texts', and other mechanisms for making legal and regulatory codes, and any changes or new regulations being made accessible to interested parties.²⁵

Implementing such measures can be particularly burdensome, particularly for developing countries often lacking financial and technical resources. Even when legislation has been introduced to reform the investment climate, implementation difficulties often remain, commonly due to resource constraints. In other examples, corruption has impacted adversely on the rule of law and integrity of the host country.²⁶

OPEN TRADE POLICIES

What trade policy would be conducive to FDI inflows? The answer can be split into two parts. The first part relates to trade policy as an instrument of incentives to attract FDI – the 'pre-establishment stage'. The second part refers to trade policy after the establishment by foreign investors in the host country – the 'post-establishment' stage.

In the **pre-establishment stage**, governments have two options with regards to trade policy as an instrument of attracting FDI:

- Lower trade barriers as an incentive to efficiency seeking foreign investors;
- Maintain a relatively high level of border protection of commodity and services markets with the hope of replacing imports by foreign producers establishing their presence in the host country.

Which of these two strategies should be pursued? The latter strategy, based on a high level of protection, presupposes a large domestic market in the host country that would make a foreign presence attractive. Small markets hardly create conditions for efficient plant size to make local production efficient and competitive. Yet even in large markets, the preferred option is a relatively open trade regime that creates better conditions for production efficiency in the post-establishment phase. As noted earlier in this chapter, those countries with more open trade regimes, typically developed countries, record higher levels of FDI.

In the **post-establishment stage** an open trade regime – with low tariffs, no quotas and no non-tariff barriers (NTBs) to trade – is also the preferred option as part of the strategy to enhance a firms' export competitiveness for several reasons. Tariffs and NTBs on imports constitute a tax on inputs used in producing exports and goods and services for the domestic market. They create an anti-export bias. Barriers to imports of capital and intermediate goods will be particularly costly.

Trade policy is not considered to be the best policy option to address government economic priorities. Other instruments should be used. A high level of harmonization of rules such as sanitary and phytosanitary standards (SPS) and technical norms with those agreed under the existing SPS and technical barriers to

²⁴ Nixon, R., 'Transparency Obligations in International Investment', 2004. Available at www.treasury.gov.au/documents/876/PDF/International_investment_agreements.pdf

²⁵ 'Investment policy', in *The Policy Framework for Investment: A Review of Good Practices*, OECD, 2007.

²⁶ 'Investment policy', in *The Policy Framework for Investment: A Review of Good Practices*, OECD, 2007.

trade (TBT) agreements in the WTO are also very important. Export controls and restrictions are also not recommended because they impede access to external markets, which would violate one of the foreign investors' main objectives in developing countries (for further analysis see chapters 4 and 5).

IMPLEMENTING TRADE POLICY EFFECTIVELY

Well-designed trade policies are critical, but just as essential is the need for effective implementation. Also critical are a well-functioning legal system supporting property rights and contract enforcement, well-functioning government legislative departments; efficient customs and tax administration, modern trade infrastructure, such as metrological systems, testing centres, information gathering and dissemination systems; and the absence of informal export and import barriers.

The non-discrimination obligation

Non-discrimination in the form of 'national treatment' obliges a government to treat enterprises controlled by the nationals or residents of another country no less favourably than domestic enterprises in like situations. It also holds that an investor or investment from one country be treated by the host country no less favourably than an investor or investment from any third country, referred to as most favoured nation (MFN) in international agreements. Reciprocally, non-discriminatory treatment does not grant advantages to foreign investors.

The practical use of these principles towards investment differs greatly across countries, because a state's right to regulate frequently entails discriminating against foreign investors. Subject to specific commitments agreed to in international agreements, governments determine which industries will, or will not, be subject to national treatment. This decision is motivated by concern about factors including development and equity, and national interest, such as security. Exceptions to national treatment include more onerous licensing requirements for foreign investors than for domestic investors, special screening procedures for FDI entry of foreign firms, and limits on foreign equity ownership ceilings. Exceptions to national treatment are most typical for the financial services, land and international transport sectors.

Although valid in many instances, government policies that detract from national treatment or MFN frequently involve costs that must be carefully balanced in relation to anticipated benefits. For example, they may cause less competition, distort resource allocation, hinder linkages between MNEs and local suppliers, and slow the diffusion of technological innovations. Such consequences may put off investors and give a negative perception concerning a country's openness towards investment. Consequently, exceptions to non-discrimination ought to be periodically re-evaluated to decide whether the original conditions that warranted such practices still exist.

Protect property and contractual rights

The protection of investment, including physical and intellectual property rights, is widely accepted as an essential component in creating the conditions for a strong investment environment and economic growth. Effective government policies play an important role in ensuring both the promotion and protection of property rights and contract enforcement measures are in place.

Secure, transferable rights to land are a vital precondition for creating a strong investment environment and an important inducement for investors and entrepreneurs to shift into the formal economy. Owing to these rights, the investor is able to participate in the eventual profits that are derived from an investment and diminish the risk of fraud in transactions. These rights provide an economic value and investors must be assured that their claim to these rights is properly established and protected.²⁷ Insecurity of property rights may arise due mainly to inappropriate or unclear legislation, non-existent or ambiguous land records and the inability to enforce existing land rights.²⁸

Contract enforcement is critical. The value of property is only realized when it is involved in a transaction. This transaction could involve using the property as collateral to obtain a loan or it could involve the sale of the property. It is ultimately the possibility of using an asset in a given market transaction that gives the asset its

²⁷ 'Investment policy', in *The Policy Framework for Investment: A Review of Good Practices*, OECD, 2007.

²⁸ *Blue Books on Best Practice in Investment Promotion and Facilitation*, UNCTAD. Available at: www.unctad.org/TEMPLATES/Page.asp?intItemID=4158&lang=1

value. Therefore, investors must have trust in the channels through which transactions involving these assets take place. Bureaucratic and cumbersome procedures for dealing with commercial transactions undermine the benefits to the investment environment of any established property rights.

Intellectual property rights as investment assets

A World Intellectual Property Organization report²⁹ notes that ‘property rights enable the exercise of ownership over the intellectual output of R&D activities. This is done by creating, using, and leveraging IP (intellectual property) rights that enable the owner of IP rights to enter into negotiations with others in order to take a new product to market through various kinds of partnerships.’ Frequently, these partnerships are based on special contractual arrangements known as licensing contracts that permit third party use of one or more types of IP rights in exchange for a valid consideration in cash or kind. In addition, a secure access to IP rights, through ownership or licensing of IP rights, can be essential to acquiring funds from financial institutions and investors.

A growing number of developing countries are seeking to attract FDI, including industries where proprietary technologies are important. But foreign firms are reluctant to transfer their most advanced technology or to invest in production facilities until they are confident their rights will be protected. Strengthening IP rights can be an effective incentive for inward FDI; however, it is only a component of a broader set of factors. For example, China had no IP rights protection before 1985, but has subsequently undergone a gradual reform of its patent system and introduced protection measures. Recent research suggests that the strengthening of IP rights protection in China has a positive and significant effect on attracting FDI.³⁰

Small- and medium-sized enterprises (SMEs) are often constrained in more ways than larger enterprises in making an effective and efficient use of the IP rights system. This means that their potential to invest in innovation activities is not always used. SMEs may profit from various features of the IP system depending on their individual needs and technological capacity. In today’s knowledge-based economy, it is their skill in using the IP system successfully that will chiefly influence their ability to make the most of their innovative capacity and regain their investments in innovation. For governments, it is important to ascertain the extent to which SMEs are currently aware of, have access to, and are making effective use of, the IP system and to determine the barriers that are preventing them from doing so.

An attractive taxation system

A host country’s tax policies can stimulate or discourage FDI inflows and affect foreign investment decisions. A high tax burden relative to benefits from the stream of income from the project and relative to tax burdens levied in other competing locations is likely to discourage foreign investment. Location-specific projects and hence profit opportunities may offer tax authorities somewhat greater room for manoeuvre, but the number of such projects is limited. In addition, it is well known that the host country tax burden is a function of statutory tax provisions and compliance costs. Compliance costs can become prohibitive. A poorly designed tax system and ineffective tax administration may discourage capital investment if the tax laws and regulations are not transparent, if they are too complex and if they are unpredictable. Under these circumstances, project costs would increase, and so would the uncertainty over net profitability of the project.

Countries with a low tax burden will attract more foreign investors than those with a high tax burden. Similarly, transparent tax regimes based on relatively simple tax rules and effective tax enforcement mechanisms will be highly desirable. Together with tax treaties signed with major partner countries, this will create a highly effective way of ensuring the predictability of tax burdens, both current and in the future.

Tax systems should be neutral with respect to location, size of firms, origin of ownership and sectors to avoid discriminating against the most efficient suppliers. However, exceptions to this rule could be envisaged and are even condoned under WTO rules. For example, lower tax burdens are often offered to investors, both foreign and domestic, for investments in poorly developed regions. Similarly, lower taxation privileges have

29 *Intellectual Property Rights and Innovation in Small and Medium Enterprises*, World Intellectual Property Organization (WIPO). Available at: www.wipo.int/export/sites/www/sme/en/documents/pdf/iprs_innovation.pdf

30 Using data for 38 diverse countries from 1992-2005, the empirical evidence suggests that the strengthening of intellectual property rights protection in China has had a positive and significant effect on attracting FDI. For further information see, Awokuse, T., ‘Intellectual property rights protection and the surge in FDI in China’, *Journal of Comparative Economics*, vol. 38, Issue 2, June 2010.

been offered to firms in favoured sectors to boost labour skills or help develop the small enterprise sector. The use of tax incentives always raises the question of their effectiveness, which is why it is prudent to carry out a cost-benefit analysis before they are introduced.

Subsidies usually do not affect project fundamentals, but investors happily receive them as an added bonus. Subsidies also tend to shorten the investment horizon and may make foreign investment decisions highly speculative. Much of what applies to tax policies also holds true for the use of subsidies by governments.

STRONGER REGIONAL COOPERATION

Stronger regional cooperation increases the attractiveness of domestic markets. At the same time, the markets in many developing countries are too small to make the case to foreign investors for economically and financially viable projects. Under these circumstances, there are two main solutions:

- Enable foreign investors to seek external markets outside the domestic markets of the host countries. Foreign investors would invest abroad with the view of using the host country as the production hub for exports to other countries and markets. In many parts of the world, this is becoming an increasingly realistic option, facilitated by regional integration and the accompanying lowering of trade barriers, which makes intra-regional trade a more viable option than in the past.
- Governments can greatly contribute to developing supply chains by expanding and integrating their external markets through, for example, regional trade agreements and deeper regional integration.

ENHANCING DOMESTIC COMPETITION

Contestable markets and domestic competition

For a contestable market to exist there must be low barriers to entry and exit so that there is always the potential for new suppliers to provide fresh competition to existing suppliers. For a perfectly contestable market, entry into and exit out of the market must be costless. However, contestability of markets and the benefits of FDI to the economy in general and to export sectors in particular can be adversely affected by high costs of imperfect competition. Competition in product and services markets can be impeded by the following barriers:

- Competition may be impeded by specific economic conditions that often originate in the small size of markets or in the nature of technology, typically leading to natural monopolies;
- Competition can be adversely affected by anti-competitive practices of firms, such as predatory pricing, price discrimination, price fixing, exclusive purchase agreements, or other measures preventing contestability of markets and collusion.

The desirable level of competition will differ in each of these cases. The anti-competitive practices of firms are in most cases considered to be detrimental to a country's competitiveness and social welfare. The origin usually lies in the market power of firms, which then becomes the target of efforts to enhance competition. This is of particular relevance to efforts to make the linkages between exports and foreign investment as effective as possible by generating additional efficiencies and reducing conflicts. There are two main policy instruments to be used by governments to enhance domestic competition – trade and investment policies and competition policies.

Open trade and investment regimes enhance domestic competition

Import penetration is a powerful channel to increase domestic competition. Therefore, trade liberalization leading to lower import restrictions can be used to that effect. But governments must also consider the other roles of trade policy. One role is the impact of trade policy on fiscal revenues by the collection of customs duties and other trade taxes, which constitute a large share of government revenues in many developing countries. The other important role is to protect domestic firms. The pro-competitive effect of trade policies may directly contradict the other two roles, and is usually taken into account in reaching the final decision. The general rule is for governments to meet their objectives with 'first-best policies' rather than relying on trade policy, which is often not even the second-best choice.

Open investment policies can have the same effect because they can lead to increased domestic competition as foreign MNEs establish their presence in the host country. However, when foreign firms establish themselves in the host countries, it could lead to maintaining the status quo or an even lower degree of competition as foreign firms acquire domestic firms to eliminate competition. Under these circumstances, an open investment regime should be accompanied by appropriate competition policy tools to achieve the objective.

Competition policies to target anti-competitive behaviour

Open trade and investment regimes are powerful instruments of competition policies, but they may not be sufficiently effective in reducing anti-competitive practices and production inefficiencies. Other tools of competition policy should be used to ensure that foreign investment leads to efficiency gains and increased competitiveness.

Competition policies should target the anti-competitive behaviour of firms, including MNEs, because in the long run they negatively affect the trade performance and competitiveness of firms in developing countries. For example, some foreign investment projects have included exclusivity clauses and non-competition provisions. While such provisions could be beneficial in the short term, they should be eliminated over time to ensure the competitiveness of incumbents.

Table 4: Policy matrix for the promotion of foreign investment in infrastructure and efficiency-seeking manufacturing and services

Policy conditions	Infrastructure	Efficiency-seeking manufacturing and services
Non-discrimination of foreign investors vis-à-vis domestic investors and among foreign investors	Membership in the WTO, which ensures conformity to the principles of national and most favoured nation treatment in domestic economic policies Bilateral and regional investment treaties	
Predictability, transparency and enforcement of domestic policies	Multilateral and bilateral investment agreements	
Globally competitive policy conditions for entry of foreign investors	Provisions for a satisfactory sharing of risks in public-private partnership (PPP) deals	Effective trade facilitation Open trade policies Elimination of foreign currency restrictions – a liberal currency regime Attractive tax policies Macroeconomic stability Attractive and predictable business environment – ‘friendly’ bureaucracy, rule of law, etc.
Market access for foreign investors	Wide range of commitments on Mode 3 [commercial presence abroad] in the WTO General Agreement on Trade in Services Privatization of state-owned utilities Framework for PPPs	Wide range of commitments on Mode 3 (commercial presence abroad) in the WTO General Agreement on Trade in Services Wide range of commitments in bilateral investment treaties Competition policies
Size of the market	Regional agreements to enlarge the size of the domestic market	Regional agreements to enlarge the size of the domestic market
Resource endowments	Availability of natural resources (e.g. coal, water)	Availability of skilled labour Availability of natural resources
Sectoral policies/conditions	Pro-competitive regulations Policies to encourage technology transfer	Government promotion of backward and forward linkages Policies to encourage technology transfer Neutral financial incentives to avoid the potential for bias and non-market orientated ‘picking of winners’ approach

Source: ITC.

The existence of dominant positions of foreign firms should also be closely monitored and, if necessary, addressed. The list of known examples of anti-competitive behaviour is long and the types of non-competitive behaviour of firms may vary from case to case. Not all of these practices need to be remedied by government intervention, but they should all be a matter of concern when designing export strategies.³¹

At the same time, foreign companies and MNEs should not be excluded from competition policies. Those companies are prone to seeking dominant and highly concentrated positions in the market. The need for competition policies becomes even more important in the aftermath of major privatization deals and deregulation. (For further analysis on competition policy, see chapter 1.)

Linkages with the domestic economy

The term 'business linkages' refers to any upstream or downstream, formal or informal relationship that takes place between MNEs and their local business partners in a country where the MNE does business. Such linkages fall into two categories: backward linkages with suppliers where MNEs source parts, components, indirect materials and services from local SMEs; and forward linkages developed between MNEs and their customers.³² The ability of foreign affiliates' linkages to contribute to domestic supplier development depends primarily on the domestic markets and local firm capabilities.

An effective business linkages programme is one of the fastest and most effective ways of upgrading domestic enterprises; facilitating the transfer of technology, knowledge and skills; improving business and management practices; and facilitating access to finance and markets.

Box 25: United Republic of Tanzania: private sector linkage programme

The Private Sector Initiative Tanzania (PSI Tanzania) began when BP Tanzania approached SBP, a research and private-sector development organization based in South Africa, to help create an enterprise development programme. PSI Tanzania was formally launched in April 2002 with eight corporate members, and has grown the number of private sector participants to 17.

The business linkages programme brings together major corporations – including Kahama Mining Corporation, Kilombero Sugar Company, National Microfinance Bank and Tanzania Breweries – in the United Republic of Tanzania in a forum where they share experiences of working with SMEs and actively seek out ways to better integrate local SMEs into their supply chains.

The project is an example of how overlapping interests of large corporations and host countries can be managed to achieve development goals. The successful implementation of a corporate social responsibility initiative has led to enhanced incomes and employment arising from the inclusion of local SMEs into the supply chains of BP and other major corporations operating in the United Republic of Tanzania.

The first stage of the programme focused on a supply chain diagnostic within each corporate partner, followed by sharing experiences and creating supplier development strategies. The corporations identified opportunities for local SME outsourcing and ways of working more closely with suppliers to develop their capacity. An SME database of 506 Tanzanian suppliers was designed by SBP and shared among PSI corporate partners. These suppliers are now shared between the procurement departments of the corporations, resulting in an expanded market and increased opportunities for the SMEs.

During 2005, each PSI member company agreed to select three of their SME suppliers for special attention, increasing support and mentorship. For example, BP Tanzania selected three SME suppliers, involved in printing, catering and plastic packaging, that are new to their vendor list. An initiative is underway to develop a proposal to private sector donors to fund SME supplier training and capacity building.

Source: Adapted from the United Kingdom Department of International Development's (DFID) review of the project: PSI, United Republic of Tanzania, 2006.

31 For more information about these practices and the need for government intervention, see: Graham, E.M. and J.D. Richardson, *Competition Policies for the Global Economy*, Institute for International Economics, Washington, D.C., vol. 51, p. 41, 1997.

32 'TNC-SME linkages for development: issues – experiences – best practices', *Proceedings of the Special Round Table on TNCs, SMEs and Development*, the Special Round Table on TNCs, SMEs and Development, UNCTAD, Bangkok, 15 February 2000.

A more active participation of developing countries in global supply chains dominated by MNEs will depend on the supply and demand conditions in supply chains. The condition for an effective participation of firms from developing countries is to have a product or a service to offer to firms. Nevertheless, the state of readiness to participate in supply chains can vary from firm to firm and from country to country. Some firms may be competitive and fully ready, others may need to strengthen some aspects of their business performance, such as management, quality control, technology and labour skills. In addition, firms can be prevented from becoming parts of multinational supply chains by infrastructure impediments well beyond their control, such as an unstable power supply, poor communications and poor road infrastructure. As detailed in box 25, governments can facilitate the process of greater involvement in global supply chains by putting in place favourable policies to encourage FDI.

MNEs typically seek ways to reduce costs across their supply chains. As a result, MNEs have incentives to cooperate – and transfer technology – with suitable suppliers in developing countries if more advanced technology will lead to lower prices, better quality of products or services and higher profits. Many developing countries need to take proactive steps to make their firms more attractive to MNEs.

Governments in countries with poor infrastructure services should ensure that local firms have access to competitively priced and reliable enabling infrastructure services, all of which are critical to the operation of supply chains. Financial policies should support an effective delivery of financial services to ensure greater access to credit for firms, and to effective international payment transaction systems.

The technological gap of firms in emerging markets may not necessarily be the fundamental constraint to their participation in supply chains. Various studies have shown that MNEs are often keen to assist local firms to ensure that they have the required know-how, technology and finance to deliver top quality products and services – provided that those products and services are price competitive.³³

A study by the World Bank³⁴ provides interesting findings from a wide range of case studies gathered to understand what large companies are doing to tackle constraints they face in doing business, as well as assisting their participation in global supply chain. The study's key findings are:

- Foreign companies investing in developing countries frequently confront situations where the conditions of existing infrastructure, technology and the general business environment significantly raise operating costs. A number of the case studies discuss transfers of technology, know-how and knowledge, and efforts to improve the business environment. Examples include the development of hard infrastructure such as facilities (Alstom, Barrick and Nespresso), the dissemination of technologies (Qualcom) and knowledge (Dow and the Karachi Chamber of Commerce), and providing access to finance for suppliers (Nespresso).
- Companies are also supporting participation links to supply chains, ranging from design to production, assembly, packaging, marketing, distribution and consumption, as well as participation in the agribusiness industry (Walmart, Transfarm Africa, Coca-Cola, Kraft, Cargill). Examples also include assistance in meeting quality and safety standards, which are important when helping to incorporate local producers into global value chains (Consumer Goods Forum and Danone).

No technology transfer will take place or be effective if it cannot be assimilated by the labour force in developing countries. Investment in human capital through education and skills upgrade training should be a government priority. All countries that have benefitted from technology transfer have simultaneously invested in education, particularly higher learning and targeted technical skills training.³⁵

33 For more discussion see: Smarzynska, J. and M. Spatareanu, *op. cit.*, pp. 62-69.

34 *The Role of International Business in Aid for Trade*, World Bank, July 2011.

35 For a brief review of the literature on technology transfer, see: Saggi, K., 'International Technology Transfer and Economic Development', in Hoekman *et al.*, *op.cit.*, pp. 351-358.

Box 26: Ireland: national linkage programmes

Since the mid 1980s, Enterprise Ireland (EI) has been operating various linkage programmes to integrate foreign enterprises into the Irish economy. It pursues two objectives: (i) to support Irish enterprises in building capacity, innovating and creating new partnerships; and (ii) to assist international investors in sourcing key suppliers in Ireland. EI collaborates closely with foreign affiliates, their parent MNEs, and the various government agencies involved with local suppliers.

Between 1985 and 1987, an estimated 250 foreign affiliates were actively involved in the linkage programme. During that period, affiliates operating in Ireland increased their local purchases of raw materials fourfold, from Irish £ 438 million to Irish £ 1,831 million, and more than doubled their purchases of services from Irish £ 980 million to over Irish £ 2 billion. In the electronics industry alone, the value of inputs sourced locally rose from 12% to 20%. On average, suppliers saw their sales increase by 83%, productivity by 36% and employment by 33%.

EI worked closely with foreign affiliates to ensure suppliers were capable of meeting the demand and quality requirements. One of EI's key criteria for selecting local suppliers was their management team's attitude and potential to grow. Also noteworthy is that EI's matchmaking is no longer seen as so critical. The need diminished over time as the composition of affiliates, their motivations for locating in Ireland, and their local knowledge changed. Ireland's competitive advantages in the global value chain are generally recognized.

Source: World Investment Report 2001 – Promoting Linkages, UNCTAD, 2001.

POLICIES TO ATTRACT TECHNOLOGY TRANSFER THROUGH FDI

Most countries prefer to access foreign technology through licensing agreements or joint ventures. However, in practice the most frequently used channel of technology transfer has been FDI.³⁶ At the same time, MNEs rely heavily on research and development expenditures to maintain their global competitive advantages. Policies should focus on attracting FDI as a channel of technology transfer. Policies to enhance technology transfer from MNEs in developed countries to developing countries rest on three pillars:

- Participation of exporters in supply chains;
- Strict and effective enforcement of intellectual property rights;
- Education and training for labour skills.

Open trade policies are a prerequisite for attracting FDI and seeking access to foreign technology and know-how. The experience of developing countries with technology transfer pursuing import substitution strategies has not been positive. The experience of the formerly centrally planned economies has been a failure. However, technology transfer has been relatively successful in countries with open trade regimes or, at least, with emphasis on growth of exports, for example in the Republic of Korea, Japan and China. All these countries have demonstrated considerable skill in acquiring and absorbing foreign technology and, over time, generating their own.³⁷

ATTRACTING FDI: PUBLIC-PRIVATE PARTNERSHIPS

Securing sustainable partnerships requires sophisticated skills to assess competing interests and negotiate pragmatic agreements. Despite the benefits, many countries remain unconvinced and cautious about implementing PPPs for a number of reasons. Private investors – both domestic and foreign – typically operate within a time horizon that could make pure economic pricing for final services or output difficult to implement. The private sector may also be fearful of what it perceives to be the risk associated with ever-changing government regulation. At the same time, both sides are often sceptical about the intentions of the other. For example, in a typical build-operate-transfer (BOT) project, the most common risks can be summarized as follows:

³⁶ *Ibid.*, p. 358.

³⁷ *Ibid.*, pp. 357-358.

- Risks in BOT projects
 - Completion risk that the project may not be completed on time at the required price
 - Performance and operating risk due to technical failures, interruptions, poor management and labour performance
 - Cash flow risks
 - Inflation and foreign exchange risks
 - Insurable risks
 - Political risks
 - Regulatory risks

Under these circumstances, additional government support is needed. In brief, various risk-mitigating instruments have been used to aid the implementation of BOT deals, including the following:

- Mitigating risks in BOT projects
 - Political and bureaucratic support
 - Assured supplies
 - Assured revenues
 - Loans and equity contributions
 - Earning assets – permission to use public assets to cover capital costs, debt service and operating expense
 - Regulatory, fiscal and other budget support
 - Project risk support
 - Inflation and foreign exchange cover
 - Sovereign guarantees
 - Temporary protection against competition³⁸

Overall, the challenge for PPP projects lies in creating awareness about their benefits, gaining the confidence of all stakeholders including civil society, building an appropriate regulatory framework and establishing a bankable business model. Prior in-depth dialogue that goes beyond the purely legal aspects is needed between the government and private operators. The underlying economic, social and regulatory issues must be thoroughly discussed, particularly how such collaboration fits into overall national strategies for growth, infrastructure and poverty eradication.

For the private sector to stay engaged in a PPP initiative, it is essential that tangible results be delivered within a reasonable timeframe. Because the time horizons of the private sector are often short and the focus is more results-oriented, programmes and projects need to be designed and delivered in a business-friendly manner.

Additionally, long-term projects face particularly complex issues of commercial, regulatory and sovereign risk.³⁹ PPP projects need to be carefully planned and managed when operated, which requires government support.

The successful completion of a PPP requires the presence of a strong banking sector that can act as a financier of PPPs. The presence of a deeper financial sector covering equity markets and their supporting services can be conducive to PPP deals. As a result, PPPs are more likely to be implemented in countries with relatively stronger and deeper financial sectors. Governments in countries with relatively weak and shallow sectors should consider the appropriate financial sector reform.

³⁸ For more details, see: Llanto, G. M., *Build-Operate-Transfer for Infrastructural Development: Lessons from the Philippine Experience*, pp. 338 ff., 2008.

³⁹ *Ibid.*, pp. 336-338.

FDI REDUCES VULNERABILITY TO CAPITAL OUTFLOWS

Developing countries have been historically vulnerable to capital outflows in view of low levels of their international reserves. More recently, some developing countries have experienced a major twist in this pattern, and they have generated large current account surpluses, which in turn have been reinvested in developed country markets. These issues are particularly important in the current debates about the linkages between export competitiveness and foreign investment.

Capital flows are extremely mobile and have been historically linked to a series of financial crises. What is also a matter of broad agreement is that financial crises have been typically associated with movement of portfolio capital that is highly mobile and is often invested short term. However, there is less of an agreement about the origins of financial crises, which may vary from case to case. Any loss of confidence of investors in the assets held in their portfolio will result in an instantaneous sale and repatriation of the proceeds from sales of those assets.

These features are in direct contrast to FDI flows. By their nature, FDIs represent a mid- or long-term commitment to the project and the host country, and this makes FDI far more stable than portfolio investments.⁴⁰

Sequencing liberalization of capital accounts

The distinctly different features of portfolio and foreign direct investment suggest two different answers to these questions and two different sets of policies. Governments should be concerned about which segments of foreign currency transactions should be encouraged first and which may have to come later.

Given the more stable nature of FDI, governments need not be as preoccupied about macroeconomic risks of FDI movements as they have to be in the case of portfolio investment. In fact, FDI has been seen to act as 'insurance' against market imperfections that limit credit availability in a financial crisis.⁴¹

For portfolio investments, monetary authorities have to be concerned about the speed of portfolio capital movement, which can be much faster than the ability of governments to respond. They must also be concerned about the size of cross-border portfolio capital, which dwarfs the size of a country's international reserves and hence its ability to defend itself against speculative attacks on their currency.

In the past, some countries like Chile adopted a 'prudent' approach by restricting parts of short-term capital movements. The pressures from creditors, with the cautious support of the International Monetary Fund, have led to policy reforms towards a complete elimination of those restrictions; even Chile eventually had to remove them.

Nevertheless, there is a great deal of support among many leading academic experts for the view that the complete elimination of all restrictions on short-term capital movement should only be adopted after careful consideration of all fundamental conditions needed for such a step, such as having a reasonable level of international reserves, a strong banking sector, a reasonably deep financial sector and macroeconomic stability.⁴²

Regulations concerning foreign currency transactions involving FDI are a different matter. Given the importance of FDI for development and its more stable properties, there are no reasons for any foreign currency restrictions. To reduce the incentives for firms to relocate abroad governments should ensure that exporters' operations are not constrained by domestic barriers to export, such as high costs of transport, insurance, Internet or energy.

⁴⁰ Some economists have tried to argue that FDI can actually be as unstable as portfolio investment; however, this view represents a minority.

⁴¹ Blalock, G. and P.J. Gertler, 'Foreign Direct Investment and Externalities: The Case for Public Intervention', in Moran, T. H., E. M. Graham and M. Blomstrom, *Does Foreign Direct Investment Promote Development?* p. 73 and pp. 75-77, Washington, D.C., Peterson Institute for International Economics, May 2005.

⁴² Magud, N. and K.S. Rogoff, 'Capital Controls: Myth and Reality – A Portfolio Balance Approach', Boston, NBER Working Papers 16805, February 2011.

If domestic barriers exist, efforts should be made to lower them through competition policies, regulatory measures or a public investment programme, among other measures. Exporters constrained by high external tariffs or other external restrictions to market access should become a matter of priority for country trade negotiators.

PROMOTING INVESTMENT

There are many factors determining location choices for multinationals, which explain what compels foreign investors to choose a particular country. These location-specific determinants are mainly political and economic fundamentals, including market size, overall political and economic stability creating a prospective business environment, the level of labour skills, availability of infrastructure and investment incentives. Investment promotion and facilitation, while no substitute for the basics being in place, also forms one of the important pull factors. The following clarifies the factors that have an impact on investment promotion, and outlines the additional value investment promotion agencies (IPAs) can provide.

Investment promotion is likely to have the greatest impact in countries where other factors that attract FDI are most comparable. The characteristics that are able to attract FDI are often found in the developed industrial countries that dedicate great effort to getting their fundamentals right and then implement investment promotion initiatives, which belongs to the final stage attracting FDI. This has been confirmed by recent research, which shows that investment promotion makes more sense in countries that improved their fundamentals because even outstanding investment promotion cannot compensate for a pro-investment environment.⁴³

INVESTMENT PROMOTION AGENCIES

Some IPA functions have been more helpful than others, depending on the stage of development of the host country and the existing levels of FDI. There are no quick fix solutions for attracting FDI; however, investment promotion and facilitation measures can make a difference provided the above-mentioned factors are also prioritized. The following sections outline the functions and suggest best practices for IPAs.

A foremost way of organizing and implementing a government's strategic investment promotion policies has been to decentralize many of the functions of government relating to foreign investment promotion and facilitation to a single agency providing 'one-stop-shop' services. An IPA's investment promotion role typically encompasses four main types of activities: image building, investment generation, investment servicing and policy advocacy (see table 5 below.) The degree of importance that IPAs give to the various sorts of activities can differ significantly. Strong IPAs commonly possess the following characteristics:⁴⁴

- Well-developed facilitation and aftercare services identified and prioritized explicitly in their investment promotion strategy;
- A clear target of working for second-generation investment;
- Post-location problem-solving services for the investor clients; and
- Facilitation and aftercare services geared to 'anchoring' the investment to the location.

43 Morriset, J. and K. Andrews-Johnson, *The Effectiveness of Promotion Agencies at Attracting Investment*, Washington, D.C., World Bank, 2004.

Well, L. and A. Wint, *Marketing a Country: Promotion as a tool for Attracting Foreign Investment*, Revised Edition, Washington, D.C., International Finance Cooperation, 2000.

44 *Blue Book on Best Practice in Investment Promotion and Facilitation – Cambodia*, UNCTAD, 2004. Available at www.unctad.org/sections/dite_dir/docs/dite_pcbb_iprs0001_en.pdf

Table 5: Major functions of an investment promotion agency

Function	Objective	Activities
Image building	Create the perception of a country as an attractive site for international investment	Advertising PR events Mass media campaigns abroad Investor forums Maintaining relationships with journalists and business partners Developing the agency's website
Investment targeting/generation	Create investment leads that target investment into specific sectors, development areas, or companies	Identifying potential investors Matchmaking Direct mailings, telephone campaigns Seminars for targeted investors
Pre-investment services	Facilitate a foreign investor's entry into the economy and to assist in analysing investment decisions	Providing information Setting up a one-stop-shop registration/ approval service. Sectoral analyses Offering assistance in obtaining sites, suppliers, etc
Post-investment or aftercare services	Assist foreign investors in maintaining their businesses in good standing, facilitating reinvestment decisions in the future	Legal or other advisory support to ongoing foreign investment projects. Dealing with bureaucracy, etc.
Policy advocacy	Improve an investment climate by establishing an effective feedback between a foreign investor and government	Surveys of the private sector Participating in task forces Making policy and legal proposals to authorities Lobbying

Source: Well, L., A. Wint, *Marketing a Country: Promotion as a tool for Attracting Foreign Investment*, Revised Edition, Washington, D.C., International Finance Cooperation, 2000.

BUILDING NATIONAL AND REGIONAL IMAGE

One of the main tasks of an IPA is to generate a positive international image for a country or specific area within the investor community. Image building activities form an important part of agency operations, particularly in the early phases of investment promotion.⁴⁵ Its function is mainly that of 'focusing investor interest on the location and overcoming negative perceptions rather than directly persuading a multinational company to invest'.⁴⁶ The agency needs to generate an image of the host country from the standpoint of investors. This is of considerable importance for a country with a poor investment climate and low levels of FDI that wants to generate investment interest.

Regional promotion can give support to country-level promotion as many potential investors think in regional terms due to such factors as the potential offered by larger markets. Regional promotion can be difficult as neighbouring countries often see themselves as competitors for FDI. However, the flow-on effects are more likely to be experienced by all, particularly in those regions that are less well known by investors.

45 Piontkivska, I. and E. Segura, *Survey on International Foreign Investment Promotion Practices*, The Bleyzer Foundation, 2003. Available at www.sigmbleyzer.com/files/International_agencies_review_eng.pdf

46 Ogutcu, M., 'Investing in Turkey's future: Competing for, "seducing", "winning" and "enduring" the benefits of foreign direct investment', *Stredigma.com*, e-journal of strategy and analysis.

Box 27: Czech Republic: targeting the right technology investment

CzechInvest has opted for industry targeting that reflects the characteristics of the Czech Republic's economy. The logic behind this can be explained by IPAs efforts to deliver the maximum technology transfer to their home economies. It was assessed that the industrial capabilities of the country were not too underdeveloped. However, by promoting too great an influx of foreign technology, local firms would not be able to benefit as the 'knowledge gap' would be too great. Thus, CzechInvest targeted FDI from industries that embodied more technology than the domestic national average, but not so much more that domestic companies would have difficulty learning from them.

CzechInvest built on the presence of the country's existing industrial roots, trying to capitalize on its strengths, and thus send a message to investors about their potential.

Source: Trnik, M., *The Role of Investment Promotion Agencies at Attracting FDI and their Impact on Economic Development in Central Europe*, 2007.

Common image building activities include various kinds of advertising in financial and industry- or sector-specific international media, generation of favourable news stories about the progress in reforms and other positive changes occurring in the country. It also includes other public relations events, like participation in investment exhibitions and fairs, conferences and organization of investment opportunity seminars'.⁴⁷

Image building can also require tackling more basic quality of life issues, for instance the quality of services provided by immigration authorities and agencies in charge of granting visas.

INVESTOR TARGETING

Often governments are unable to serve everyone in the FDI markets because there are too many MNEs and they are diverse in their investing requirements. Effective IPAs seek out segments that they are better able to serve, reflecting the specific locational advantages, and matching the requirements of foreign investors with their countries' unique development objective. Investor targeting is a cost saving method used by IPAs to attract FDI by narrowing the range of their promotional efforts. Most commonly it occurs on multiple levels involving selection of countries, regions, sectors, industries or particular companies.

IPAs recognize investor targeting as a way to use often-scarce resources efficiently by focusing their promotional efforts on the most receptive sectors or on those that have been recognized as being potentially most valuable to the economy. Box 27 details the successful use of investment targeting of technology in the Czech Republic.

PROVIDING INVESTMENT SERVICES

The majority of IPAs place great importance on investment servicing and facilitation, which is an essential component of investment promotion. Investment servicing involves a broad range of services to help investors analyse investment decisions, found a business and keep it operating effectively and efficiently. Investors' services that IPAs typically offer can be divided into two groups: pre-investment and post-investment, or aftercare, services.

All IPAs provide services in the pre-investment decision-making stage. IPA services typically include 'giving interested investors information about the country, its macroeconomic situation, major industries, legislation and procedures required of investors, investment incentives, costs of doing business and other information that can facilitate an investor's decision to launch a business or set up a joint venture in the country'.⁴⁸ IPAs generally assist investors with the process of beginning their investment projects.

⁴⁷ Piontkivska, I. and E. Segura, *Survey on International Foreign Investment Promotion Practices*, The Bleyzer Foundation, 2003. Available at www.sigmbleyzer.com/files/International_agencies_review_eng.pdf

⁴⁸ *Ibid.*

IPAs can act as a one-stop-shop to accelerate the registration or approval process, attaining sites, utilities, identifying suppliers, etc. The speed of service matters. 'Long delays and costly procedures to establish a new business entity is one of the obstacles to new investment and entrepreneurial activity'.⁴⁹ One-stop-shops enable investors to access information on the required steps to set up or expand a business and provide services to accelerate the granting of needed permits and licenses. Box 28⁵⁰ outlines Botswana's experiences in enabling investors to secure clearances and approvals quickly.

Reinvestments by the foreign business community comprise a large part of FDI inflow into the country. Therefore, providing post-investment services is founded on the belief that content investors will eventually increase their business and assist in attracting other foreign investors to a country.⁵¹ This belief has been supported in an extensive survey of investment promotion in sub-Saharan Africa, where the United Nations Industrial Development Organization found that investors indicated they were far more likely to be attracted to a location based on the recommendation of an existing investor.⁵²

Post-investment services include 'assistance to foreign investors in overcome problems that occur while they are operating, such as advice and consultation in dealing with bureaucracy'. These types of services also help identify administrative and other barriers to foreign investments, and thus facilitate implementation of the other important function of an IPA – policy advocacy.⁵³

The important contribution that high-quality post-investment services can make is also shown by the experience of some European countries, especially Ireland and Scotland, where incremental investment by existing investors accounts for 60% of the annual flow of FDI. The Industrial Development Agency of Ireland has specific responsibilities both for securing new investment from foreign investors in manufacturing and international service sectors, and for supporting foreign enterprises already in Ireland to expand their business.

As a result of the day-to-day contacts with private sector representatives, an IPA could be considered a link between the private sector and the government. IPAs are typically engaged in a wide range of activities, from amendments to legislation to minor improvements in administrative procedures that can facilitate investor operation in the country. 'While being either part of the government or having close connections with high-level government officials, an IPA has the ability to advocate changes in investment policies, and to play a key role in the preparation of new investment legislation and regulations.'⁵⁴

Box 28: Botswana: enabling investors to secure clearances and approvals

The Botswana Export Development and Investment Authority (BEDIA), established in 1997, enables investors to secure clearances and approvals, including licenses, work and resident permits, visas and utility connections, as well as infrastructural facilities such as land and factory space. It does this through its One-Stop Service Centre, which operates with liaison officers from various government and parastatal institutions, whose roles and responsibilities are clearly defined through memoranda of understanding. Importantly, BEDIA has been given the right to approve applications for work and resident permits for the chief executive officers and six management positions without having to go through normal ministry channels.

Source: BEDIA.

49 OECD, 'Investment promotion and facilitation', *op.cit.*

50 *Blue Book on Best Practice in Investment Promotion and Facilitation – Nigeria*, UNCTAD, 2009.

51 Piontkivska, I. and E. Segura, *Survey on International Foreign Investment Promotion Practices*, The Bleyzer Foundation, 2003. Available at www.sigableyzer.com/files/International_agencies_review_eng.pdf

52 *Africa Foreign Investment Survey: Motivations, Operations, Perceptions and Future Plans – Implications for Investment Promotion*, United Nations Industrial Development Organization, 2003. Available at: www.unido.org/fileadmin/import/20146_survey_2003.pdf

53 Piontkivska, I. and E. Segura, *Survey on International Foreign Investment Promotion Practices*, The Bleyzer Foundation, 2003. Available at www.sigableyzer.com/files/International_agencies_review_eng.pdf

54 Piontkivska, I. and E. Segura, *Survey on International Foreign Investment Promotion Practices*, The Bleyzer Foundation, 2003. Available at www.sigableyzer.com/files/International_agencies_review_eng.pdf

CONCLUSION

FDI can have powerful export-development effects. It can create an improved domestic environment that will enable firms to better compete in global markets, including:

- **Access to efficient service providers.** Successful exporting countries provide a national environment in which access to services, particularly infrastructure services, is competitive. Owing to severe constraints in financing infrastructure in many of these countries, FDI can bridge this gap, and also provide benefits such as transfer of technology and know-how and risk-sharing through public-private partnership models.
- **Access to credit and other financing for local exporters.** Developing country firms face difficulties in attaining favourable access to finance. Thus, foreign investors, who are well-financed with better access to credit markets than governments or private investors from developing countries, fulfil this gap.
- **Access to global supply chains.** MNEs should engage in outsourcing and globalized production with a network of subsidiaries in various countries, thereby creating a global value chain. There has already been a significant rise in intra-firm trade between developed and developing countries. Governments can play an important role in assisting in the creation of these linkages – both backward and forwards.
- **Access to technology and know-how.** Outdated technology, poor knowledge of markets, poor management and weak marketing channels constrain export firms from developing countries. Local firms would thus benefit from the transfer of technology and know-how from foreign firms directly to them.
- **Outward FDI as alternative sources of supply.** Firms can choose to export or to supply foreign markets by their subsidiaries established in those markets.

Reforms that remove barriers to trade protect foreign investors, promote competition and attract FDI. There is a need for stable, predictable and reliable investment frameworks, efficient infrastructure and efforts to develop appropriate skills, and specific policy approaches and strategies to promote FDI in export conducive areas. An example is participating in global supply chains.

Many countries have not been successful in attracting significant FDI flows and have not reaped the potential benefits of exporting through such linkages. These countries remain inhibited by the combined effects of political and macroeconomic instability, weak infrastructure, poor governance, inhospitable regulatory environments, intensification of competition for FDI flows due to globalization, and poor promotion strategies in particular. This runs counter to the experience of those countries that have been most successful in leveraging FDI for export competitiveness, which shows that an appropriate policy and institutional setting is needed to complement market forces.

CHAPTER 3

MOVE GOODS ACROSS BORDERS EFFECTIVELY

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MOVE GOODS ACROSS BORDERS EFFECTIVELY

INTRODUCTION

Global trade has burgeoned in recent years largely because of the progressive reduction of tariffs and quotas from trade liberalization. More goods are crossing borders and must comply with customs procedures and other border administration measures. Customs and other border regulation policies, as well as procedures and practices for international trade, are created and generated by the need for governments to control and monitor the movement of goods, transfer of services and associated financial flows. This is done to conform to each country's particular requirements, to collect appropriate tariff and tax revenues, to prevent, detect and deter the cross-border movement of illegal drugs, arms, protected species, hazardous waste, and other controlled products, as well as to collect relevant information for operational and statistical purposes.

International trade has some direct costs:

- Compliance costs, such as processes, procedures and requirements of customs and other border control and clearance agencies;
- Costs of trade-related services, such as trade insurance, port services, cargo handling, local and international transportation, and cross-border banking services.

The processes involved with executing these direct cost-related activities are loaded with inefficiencies due to factors such as inefficient import and export procedures, other border management procedures, lack of competitive transport services and an unfriendly business environment. These inefficiencies then give rise to indirect costs, such as the increased cost of transportation, capital demurrage and port charges, loss of perishable goods, increased cost of holding inventories, and other costs associated with unpredictability created by these inefficiencies. Various trade facilitation measures can be deployed to effectively reduce the level of these direct and indirect trade transaction costs.

If trade policies, procedures and practices are cumbersome or applied inefficiently, they can create major barriers to the fluid movement of goods from export departure to import arrival. The primary aim of trade facilitation is to minimize the transaction costs and complexity of international trade for businesses, while maintaining efficient and effective levels of government control.¹ Businesses have increasingly expressed concern about overbearing or unnecessary trade transaction costs and have called for greater transparency, efficiency and procedural uniformity of cross-border transportation of goods.

Trade facilitation can have important implications for trouble-free exporting. Efficient customs clearance influences imports and exports. Competitive exporting requires efficient access to imported raw materials, intermediate goods and capital goods. For landlocked countries, the need for effective trade facilitation is even greater because inputs are dependent on the efficiency of the customs in neighbouring countries. Reduced trade costs and lead times make local firms more competitive in international markets, thereby increasing the likelihood that existing exporting firms will carry on and new firms will begin exporting.

There is a need to complement more traditional trade facilitation areas, such as border processing and clearance systems and procedures, with competitive trade logistics services. Many of these services are performed 'behind the border' as compared with 'at the border'. These services include domestic transport, warehousing, port services, information management and the ability to track and trace consignments.

¹ 'Trade Facilitation: An Introduction to the Basic Concepts and Benefits', ECE/TRADE/289, United Nations Economic Commission for Europe, 2002.

The benefits of trade logistics as a strategic source of competitive advantage are even more critical in today's environment of increased global production sharing, the shortening of product lifecycles and the intensification of global competition. Global production chains need a robust logistics sector to complement more traditional trade facilitation areas, such as border processing and clearance systems and procedures. Coordinating the various stages of product development, component production and final assembly is dependent upon the ability to move goods across borders rapidly, reliably and cost effectively.

Improvements in a country's ability to connect to the global logistics network can bring access to vast new markets for its businesses. This chapter assists readers in understanding and tackling trade facilitation and trade logistics issues. As a trade supply chain is only as strong as its weakest link, there is a need for countries to understand what those weak links are and devise appropriate policy responses.

WHY TRADE FACILITATION MATTERS FOR NATIONAL COMPETITIVENESS

INCREASING TRADE FLOWS

There is an abundance of research linking the benefits of trade facilitation to increased trade. The research often finds that even modest reductions in trade transaction costs significantly increase trade flows. Some of the main studies are described below.

- The World Bank's study, *Trading on Time*, explores the effects of additional transportation time using World Bank data on the number of days it takes to move standard cargo from the factory gate to the ship in 126 countries. The study finds: 'On average, each additional day that a product is delayed prior to being shipped reduces trade by at least 1%.' The report shows that delays have an even greater impact on exports of time-sensitive goods, such as perishable agricultural products: 'A day's delay reduces a country's relative exports of time-sensitive agricultural goods by 6% percent.'²
- The World Bank's 2008 studies by Bernard Hoekman and Alessandro Nicita conclude that increasing the Logistics Performance Index of low-income countries to the level of the average for middle-income countries would boost trade for these low-income countries by about 15%. Similarly, reducing low-income country trade costs, as measured by the Ease of Doing Business Index, to the average for middle-income countries would boost exports by about 7% for these low-income countries.³

ATTRACTING FOREIGN DIRECT INVESTMENT

Trade facilitation reforms also improve the flow of 'efficiency-seeking' foreign direct investment (FDI), commonly described as off-shoring or investing in foreign markets to take advantage of a lower cost structure. Lower trade costs and entry barriers attract foreign direct investors. These trade transaction costs are usually factored into the cost-benefit analysis of corporations as they evaluate alternative locations for foreign investment. The case study of Philips Electronics is a good illustration of efficiency-seeking FDI (see box 29).

Efficiency-seeking FDI is when investors set up production facilities where goods are mainly exported. Production fragmentation opens up new opportunities for export-led industrialization in developing countries. One of the most important export development strategies is to become a part of a global value chain. Globalization and international competition encourage international corporations to use a variety of locations for the manufacture and sourcing of components and final products. Increasingly, products are assembled in one country from components manufactured in several others.

² Djankov, S., C. Freund and C.S. Pham, 'Trading on Time', World Bank Policy Research Working Paper No. 3909, World Bank, 2006. Available at: www.doingbusiness.org/documents/trading_on_time_full_report.pdf

³ Hoekman, B. and A. Nicita, 'Trade Policy, Trade Costs, and Developing Country Trade', Policy Research Working Paper No. 4797, World Bank, 2008.

Box 29: Investment decision-making for Philips Electronics

Philips Electronics is Europe's largest electronics company. The company operates a fairly decentralized organization and is dependent on a large number of production units located around the world. These units are united in a complex global supply chain. Philips has established a specialized service unit of approximately 150 professionals whose purpose is to serve and assist the movement of goods across borders. For example, this unit handles issues related to border and customs procedures such as customs declarations and customs invoices. About 40 of the professionals in this unit work solely with the Chinese market, which represents about 25% of production and 20% of sales.

Customs issues are high on the agenda when production is outsourced, where short lead times are critical and documentation requirements complex. Customs procedures are normally taken into consideration at the end of the investment evaluation process. Potential locations are first identified using a broad set of criteria, and it is in the final stages of the evaluation process that the company investigates the efficiency of the customs procedures of candidate countries.

Customs procedures are less important to investment decisions in major markets. In China, Philips enjoys an early mover advantage where its dedicated service unit for border issues has long-established relations and agreements with local authorities concerning customs clearance. The company's relative market size and importance as a large foreign investor also play an important role in its ability to affect border barriers. For example, in the beginning of the 1990s, Philips invested in production facilities in Hungary. One of the company's preconditions was that the local authorities agree to cut clearance time – a major hurdle at the time. The company managed to negotiate a cut in customs clearance time from an average of 4-5 days to 1-2 days.

Source: 'The Economic Impact of Trade Facilitation', *Trade Policy Working Paper No. 21*, OECD, 2005.

Firms are outsourcing and offshoring to places where costs are lower, acquire higher quality inputs and improve their competitiveness. The simultaneous liberalization of investment and trade policies attracts international corporations, which set up manufacturing facilities in low-cost destinations. However, this has been highly dependent on good trade facilitation. As complexity in the supply chain increases, efficient speed and movement of goods and services becomes critical.

There is an abundance of research linking improvements in trade facilitation with increased FDI:

- Key factors in FDI flows include low direct and indirect trade transaction costs, including costs and risk associated with a country's border procedures.⁴
- If the number of days required to clear customs were halved in Ethiopia, average firm-level productivity would increase by 18%, thereby raising the likelihood of FDI.⁵
- Effective trade facilitation can attract FDI and better integrate countries into international production supply chains. For example, the manufacturing sector relies heavily on cheap, quick, transparent and predictable customs services. Countries could increase the flow of FDI by adopting modern and efficient border procedures.⁶

INCREASING GOVERNMENT REVENUES

Enhancing the efficiency of border procedures can substantially increase customs revenue. One International Monetary Fund study⁷ shows a very high reliance on trade taxes as a percentage of total tax revenues across

⁴ Radelet, S. and J.D. Sachs, *Shipping Costs, Manufactured Exports and Economic Growth*, Harvard International Institute for Development, Harvard University, Cambridge, Massachusetts, 1998.

⁵ Eiffert, B. and V. Ramachandran, 'Competitiveness and Private Sector Development in Africa: Cross Country Evidence from the World Bank's Investment Climate Data', Asia-Africa Trade and Investment Conference (AATIC), Tokyo, 1-2 November 2004.

⁶ 'The Economic Impact of Trade Facilitation', *Trade Policy Working Paper No. 21*, OECD, 2005.

⁷ *Changing Customs Challenges and Strategies for the Reform of Customs Administration*, International Monetary Fund, 2003.

all regions of the world, except for OECD countries. The study concludes: 'For many developing countries, and especially the poorest of them, tariff revenue will continue to be a core component of government finances for many years to come.' In Africa, more than one-third of total government revenue still comes from trade taxes, about one-fifth in Asia and the Pacific, and just over one-fourth in the Middle East. Ghana, as the case study in box 30 explains, is one of the leading examples of how government-led measures to modernize customs have reaped substantial trade and government revenue collection benefits.

Box 30: Ghana: customs reform and modernization

The Ghanaian Government decided to use a public-private partnership to modernize its customs operations. This meant the government did not have to solely support the project on its own, which included the total cost of US\$ 12 million for physical infrastructure work, establishing communication networks, upgrading customs facilities, and placing electric generators in remote border stations. The partnership is based on a private share of 65% (60% contributed by SGS, a Swiss inspection company, 5% by Ecobank Ghana and a public share of 35% (20% from Ghana Customs, 10% from Ghana Shippers' Council and 10% from Ghana Commercial Bank). The partnership relies on a custom's management software that has been successfully used in other countries, such as Singapore. Some of the main outcomes are:

- **Simplified customs procedures.** For example, clients shuttling from one agency to the other to procure certain permits, licences or exemptions required as part of the clearance process has been largely eliminated. The tedious process of getting cargo manifests to Ghana Customs and other relevant agencies was eliminated as cargo manifests are submitted electronically in advance.
- **Faster clearance times.** For example, previously at the main port of Tema, clearance times averaged 14 days, compared to 2-3 today. At airports, clearance time now averages 2-4 hours, compared to 2-3 days in the past.
- **Quicker exits of transit consignments.** Due to satellite tracking of goods, transit consignments are exiting the country quicker than when escorts were being used.
- **Increased revenue collection.** The annual average growth in revenue is 33% for the port of Tema and 32% for Koltoka Airport. The total revenue collected by Ghana Customs grew by nearly 170% between 2003 and 2008.

According to the World Bank's Trading Across Borders dataset of the Doing Business project, in 2005, Ghana ranked 108th, with an index of 6 against a regional index of 8.5. By 2007, Ghana's ranking had further improved to 61. The main reasons cited for this success include: new technology links with commercial banks so that customs officers can confirm the payment of duties without additional work; and changes in the operations sped up imports, while new civil procedural rules and mandatory arbitration and mediation reduced the time needed to enforce contracts.

Success factors

- Government support and belief in the project;
- Credible partners;
- Development of its own infrastructure to overcome core infrastructure issues;
- Phased project implementation that controlled costs and delivered consistently high-quality service;
- Tangible manifestation of the transformation and improvements of processes;
- Training, sensitization and extensive capacity building;
- Responsiveness to emerging trends and demands;
- A sustainable self-financing arrangement.

These results highlight the importance of private sector participation in creating an enabling business environment for economic growth. The strategic partnership of one multinational company was a major contributing factor to the project's success. As a result, the competitiveness of Ghana's exports was significantly improved, above all for small- and medium-sized enterprises.

Source: 'Public-Private Partnership on Integrated Customs Services in Ghana', paper prepared by ITC based on presentations made by Nortey Omaboe, Executive Chairman, GCNet, Ghana, at an ITC seminar, and the case study prepared by Emmanuel Darko, Deputy General Manager, GCNet, Ghana, 2009.

IMPROVING PRODUCT AND MARKET DIVERSIFICATION

'A 10% improvement in trade facilitation – as measured by the [World Bank's] Doing Business dataset's cost of exporting – is associated with product diversity gains of the order of 3%-4%.⁸ Furthermore: 'There is evidence that differentiated goods (such as manufactures) have stronger diversification responses to trade facilitation than do homogeneous goods (such as agricultural products). Successful export promotion programmes have been found to increase trade flows largely through the product diversification channel.'⁹

The findings were similar for the geographical dimension of diversification: 'A 10% improvement in trade facilitation is associated with a 5%-6% increase in the number of foreign markets served. In other words, geographical export diversification appears to respond considerably more strongly to trade facilitation than does product diversification.'¹⁰

WHY TRADE FACILITATION MATTERS FOR BUSINESS

In 2010 the Economic Commission for Africa reported:

- Increased competition and the changing business environment require efficient trade facilitation techniques because products need to be delivered quickly. In the current business environment, a manufacturer expects uninterrupted delivery and cannot afford to have goods tied up at the border because of unnecessary or over-complicated customs procedures.
- Businesses located in countries with poor trade facilitation especially are seriously inhibited from attaining such opportunities in the era of heightened globalization and intensification of trade.¹¹

Trade facilitation is critically important to SMEs, which have lower turnovers than large multinational firms, and thus a lower capacity to absorb trade transaction costs. Moreover, SMEs frequently have less financial means to deal with administrative burdens, which often means they forego opportunities to enter new markets or raise trade volumes in existing markets.

HIGH TRANSACTION COSTS DAMAGE COMPETITIVENESS

Often businesses need to bear not only the direct costs associated with moving goods, such as freight costs, port and handling charges, procedural fees (such as bonds), agent fees, and side payments, but also the indirect costs caused by 'procedural delays, lost business opportunities and lack of predictability and reliability in the supply chain'.¹²

Box 31: Delays damage companies' competitiveness

Bedi Limited, a garment producer in Nakuru, Kenya, spent 18 months pursuing a trial order for school items from Tesco, one of the United Kingdom's largest retail chains. Bedi landed the order and the delivery date was set for early July 2009, in time for the August back-to-school promotions. Bedi's goods arrived in Kenya's port city of Mombasa at the end of June, ready for shipment. But they were delayed at the port due to congestion and did not arrive in the United Kingdom until August. Bedi missed Tesco's school promotions – and lost out on the chance to become part of its global supply chain.

Source: Doing Business 2011: Making a Difference for Entrepreneurs, World Bank, 2011. Available at: www.doingbusiness.org/~media/FDPKM/Doing%20Business/Documents/Annual-Reports/English/DB11-FullReport.pdf

8 Shepherd, B., 'Enhancing Export Diversification through Trade Facilitation', *ARTNet Policy Brief*, Brief No. 19, May 2009.

9 *Ibid.*

10 *Ibid.*

11 'Trade Facilitation and Intra-African Trade', *Assessing Regional Integration in Africa IV: Enhancing Intra-African Trade*, Economic Commission for Africa, 2010.

12 Arvis, J., M. Mustra, J. Panzer, L. Ojala and T. Naula, *Connecting to Compete: Trade Logistics in the Global Economy*, World Bank, 2007. Available at: siteresources.worldbank.org/INTTLF/Resources/lpireport.pdf

International trade involves unavoidable transaction costs as goods cross borders, which cannot be completely eliminated. However, businesses often incur additional avoidable costs, which raise the cost of goods and services to end users and consumers. These unavoidable and avoidable costs constitute what is generally referred to as trade transaction costs (TTCs). In terms of trade facilitation, TTCs are particularly hard felt in the following areas:

- **Border crossing time.** Inefficient border crossings procedures impose several costs to the trader: (i) delays at the border are costly in terms of immobilized equipment and staff, (ii) compliance costs that come in addition to the taxes and fees levied, and (iii) costs that result from uncertainties, such as variance in time to cross the border. The government also loses out by poorly functioning border-crossing services because of inefficiencies in use of staff time and lost revenue. Spending excessive time at the border represents one major complaint by traders, as it requires the immobilization of trucks and staff and results in higher levels of inventory and associated financial costs. With fixed costs and driver salaries costing about US\$ 140 daily, traders highly appreciated reform that created a one-stop-border post and sped up border crossings at Chirundu, the border between Zambia and Zimbabwe.¹³
- **Trader compliance costs.** Limited research has been done on trader compliance costs, but it is increasingly recognized that they are significant and often excessive due to the complexity, unpredictability and inefficiency of the customs procedures. The World Bank's *Doing Business 2011: Making a Difference for Entrepreneurs* report quotes a Turkish trader who said that customs reform in his country reduced his compliance cost by about 10%-15%.¹⁴ A 2003 Organisation for Economic Co-operation and Development (OECD) study confirms these observations based on survey data from the EU and Japan, suggesting that compliance costs could range from 3.5%-5% of the value of import cargo. These costs also include bribes paid to speed up customs clearance.¹⁵ Freight forwarders note that the introduction of the Single Window in Singapore reduced compliance costs by 20%-35%.
- The unpredictability of the logistics chain. Traders are required to hold on to larger inventories and incur the associated financing charges.¹⁶

Box 32: Indonesia: pineapple producer faces inhibiting trade facilitation costs

Bambang, a local Indonesian pineapple producer, would like to can pineapples in Lampung, Sumatra, and export them to Europe. Sumatra Island is competitive in pineapples because of its environment, but port and logistics bottlenecks within Indonesia raise transport costs for Bambang and other pineapple producers. Transport costs are substantially above those of Thailand – the principal exporter of canned pineapples in the world – and shipping charges out of Lampung are about 4% higher per carton. Higher costs are partly due to back hauling of empty containers and the need to tranship imported tin for cans through Jakarta rather than directly to Sumatra. Lowering transport costs and improving logistics infrastructure and services would not only allow producers like Bambang to sell more, but also boost other key exports from Indonesia.

Source: *Connecting to Compete in Indonesia*, World Bank, 2010. Available at: siteresources.worldbank.org/INTINDONESIA/Resources/Publication/2800161264668827141/LPI.indo.en.pdf

13 *Doing Business 2011: Making a Difference for Entrepreneurs*, World Bank, 2011. Available at: www.doingbusiness.org/~media/FPDKM/Doing%20Business/Documents/Annual-Reports/English/DB11-FullReport.pdf

14 *Ibid.*

15 Bribes are also used to lower assessed duties and taxes. More transparent and efficient customs procedures have been shown to reduce the amount of bribes solicited as well as the incidence of this practice.

16 Arvis, J., G. Raballand and J. Marteau, 'The Cost of Being Landlocked: Logistics Costs and Supply Chain Reliability', Policy Research Working Paper No. 4258, World Bank, June 2007. Available at: ssrn.com/abstract=995079

Box 33: Yemen: poor trade facilitation hurts tuna exporters

A case study from Yemen documents that fresh tuna to Germany fetched a price of US\$ 4 per kilo, while frozen tuna exported to Asia fetched a price of US\$ 1 per kilo. About one-fifth of total exports was frozen and sold in the Asian market, although it could have been exported to Germany for four times the price were it not for delays caused by a combination of poor infrastructure and poor transport services. The foregone net income amounted to US\$ 480 per ton of exports compared to total sales revenue in Germany of US\$ 4,000 per ton. The total cost of logistics for this exporting firm was 55% of landed product price.

Source: Nordas H., E. Pinali, M. Geloso Grosso, 'Logistics and Time as a Trade Barrier', *Trade Policy Working Paper No. 35*, OECD, 2006.

REMOVING OBSTACLES TO JUST-IN-TIME DELIVERY

In many countries, time for administrative procedures related to exports and imports prevents local manufacturers from exporting time-sensitive products. 'In an environment of "just-in-time" production, where car manufacturers, for example, rely on the uninterrupted reception of the necessary components, business cannot afford to have imported or exported goods tied up for long periods at the border because of unnecessary or over-complicated trade procedures and requirements.'¹⁷

In addition, businesses may also need to carry higher inventories of supplies or finished products, or change to more expensive means of transportation to be certain of meeting delivery schedules. Some recent studies find the following:

- Inventory holdings in manufacturing are two to five times higher in developing countries than in the United States. Halving inventories could reduce unit production costs by 20%.¹⁸
- Suppliers to the same automobile manufacturer will carry seven days of inventory in Italy, but 35 days in Morocco.
- On average, Bangladesh has to ship 10% of its garment production by air to be certain to meet the schedules of European buyers.¹⁹

BENCHMARKING TRADE FACILITATION

The periodic surveys in the World Bank's *Doing Business* and *Connecting to Compete: Trade Logistics in the Global Economy* reports detail where countries stand with regards to trade facilitation. Both reports show that trade facilitation indicators vary widely across countries. While the ranking is generally correlated with income levels, countries with similar income levels often fare quite differently in the measured indicators. This is good news as it suggests that with vision, political will and leadership countries can enhance national competitiveness.

KEY SUCCESS FACTORS

Countries that obtained successful results from trade facilitation typically follow a comprehensive approach to reforms covering all key logistics: trade-related infrastructure, quality and supply of logistics services, core customs modernization, border management integration, regional facilitation, and transit. Reform in these key logistics is done in parallel. This type of an approach addresses 'at the border' and 'behind the border' constraints. Typically, the benefits of progress in one area may not be realized until impediments to trade in other areas are also removed.

¹⁷ 'The Costs and Benefits of Trade Facilitation', *Policy Brief*, OECD, October 2005. www.oecd.org/dataoecd/58/25/35459690.pdf

¹⁸ Guasch, J.L. and J. Kogan, 'Inventories in Developing Countries: Levels and Determinants – A Red Flag for Competitiveness and Growth', Policy Research Working Paper No. 2552, World Bank, 2001.

¹⁹ *Connecting to Compete 2011: Trade Logistics in the Global Economy*, World Bank, 2011.

Table 6: Measuring national logistics performance

Logistics performance factors	Logistics-unfriendly	Partial performers	Consistent performers	Logistics-friendly
Trade-related infrastructure	Serious constraint	Major constraint	Capacity bottlenecks to support trade expansion	Few bottlenecks, except rail
Quality and supply of logistics services	Low development	Weak market	Emergence of a diversified supply of logistics services	Industry leaders
Core customs modernization	Often still a major constraint	Potentially a major constraint	No longer a constraint	Best practice
Integration of border management	Comparatively a lesser problem	Major constraint	Typically the final binding constraint	Lesser problem
Regional facilitation and transit	Main issue for landlocked least developed countries	Problematic	Depends on the region	Streamlined
Definition of terms				
1. Logistics unfriendly (bottom quintile) – severely logistically constrained (LDCs)				
2. Partial performers (third and fourth quintile) – typically low- or middle-income countries that have not yet consistently addressed all the factors of non performance				
3. Consistent performers (second quintile) – typically emerging economies with a strong logistics constituency				
4. Logistics friendly (top quintile) – high performers, for the most part high-income countries				

Source: Logistics performance survey data, *Connecting to Compete*, World Bank, 2010.

Trade facilitation measures can be undertaken along two dimensions: (i) a 'hard' dimension related to tangible infrastructure such as roads, ports, highways and telecommunications; (ii) a 'soft' dimension related to transparency, customs management, the business environment, contestability of services markets, and other institutional aspects that are intangible.²⁰

In practice, this might mean that large investments in hard infrastructure projects to improve infrastructure quality alone do not necessarily lead to lower transport prices, unless complementary steps in soft regulatory reform are also undertaken. ITC's 2010 survey²¹ of companies and business associations in Uganda revealed that while the largest share of aid for trade disbursements in 2008 (38%) was absorbed by transport and storage, less than 50% of business associations and companies' perceived improvement in these services. The lack of competition along different segments in the trade logistics chain, for example, can result in high mark-ups favouring cartels among logistic service firms.

In addition, interest group lobbying and corruption can make regulations work as barriers. Inappropriate regulation in transport services can protect inefficient logistics operators and discourage the entry of more efficient logistics operators with lower operational costs. Complementary reform to dismantle cartels and enhance competition along different segments of the logistics chain is crucial to lowering trade costs. In a more competitive environment, measures to improve physical infrastructure are likely to yield more significant results.

²⁰ Portugal-Perez, A. and J. Wilson, 'Export Performance and Trade Facilitation Reform: Hard and Soft Infrastructure', Policy Research Working Paper No. 5261, World Bank 2010.

²¹ 'Aid for Trade and Export Performance: A business perspective from Uganda', Working Paper, ITC, 2010.

Box 34: Infrastructure for trade facilitation

Hard infrastructure

- **Physical infrastructure** measures the level of development and quality of ports, airports, roads and rail infrastructure.
- **Information and communications technology (ICT)** is interpreted as the extent to which an economy uses ICT to improve efficiency and productivity as well as to reduce transaction costs. It is built on indicators of the availability, use, absorption and government prioritization of ICT.

Soft infrastructure

- **Border and transport efficiency** aims at quantifying the level of efficiency of customs and domestic transport reflected in the time, cost and number of documents necessary for export and import procedures.
- **Business and regulatory environment** measures the level of development of regulations and transparency. It is built on indicators of contestability of service markets and government transparency.

Source: Portugal-Perez, A., J. Wilson, 'Export Performance and Trade Facilitation Reform: Hard and Soft Infrastructure', *Policy Research Working Paper No. 5261*, World Bank 2010.

Improvements to the trading environment are critical. This includes the full range of transaction costs affecting trade. As made clear by John Wilson and others, trade facilitation, 'can be seen as the set of policy instruments aimed at improving a country's trading environment by reducing unnecessarily high transaction costs across all of these hard and soft infrastructure fronts'.²²

A FOCUS OF WTO NEGOTIATIONS

Traditionally, trade facilitation measures have focused primarily on simplifying and rationalizing customs procedures and eliminating red tape to move goods across borders. The current Doha Round of negotiations on trade facilitation has focused on getting these core customs procedures right. Negotiations have focused on clarifying and improving rules pertaining to: (i) the transit of goods, (ii) the fees involved in importing and exporting, (iii) the publication and administration of trade regulations, and (iv) promoting effective communication and cooperation between customs authorities.

Often the trade facilitation agenda has limited itself to discussion of what processes and procedures a trader needs to comply with to import or export. The Doha Round of trade negotiations, initiated in 2001, added trade facilitation in mid-2004 to the issues that had dominated the agenda, including tariffs for agricultural and non-agricultural imports, non-tariff barriers, services and conflict resolution. This decision was the result of the recognition that traders face many obstacles that inhibit the smooth transfer of goods from production sites to external markets.

The WTO chose not to tackle the whole trade logistics chain, but focused on the actions that governments take to control and administer the way in which goods move across their national borders, through the various documentary and physical inspection stages to clearing customs and receiving approval from border agencies, such as health and safety or revenue authorities. The objectives of the trade facilitation negotiations are straightforward:²³

- **Clarify and improve General Agreement on Tariffs and Trade (GATT) rules on the movement, release and clearance of goods**, including goods in transit, with the aim of reducing the transaction costs of

²² Wilson, J. *et al.*, 2005, 'Assessing the Benefits of Trade Facilitation: A Global Perspective', *The World Economy*, 28(6), pp. 841-871, 2005.

²³ Elgin R., 'The Doha Round Negotiations on Trade Facilitation', *The Global Enabling Trade Report*, 2008. Available at https://members.weforum.org/pdf/GETR08/Chap%201.2_The%20Doha%20Round%20Negotiations%20on%20Trade%20Facilitation.pdf

trade. Three GATT Articles are at the centre of the trade facilitation negotiations: Article V on facilitating transit trade, Article VIII on limiting border fees and formalities, and Article X on making trade regulations transparent so that foreign traders can understand them and work with them more easily.

- **Develop special provisions for developing countries and least developed countries (LDCs)** and provide them with technical assistance and capacity building support to help them to implement better trade facilitation policies and practices.
- **Improve communication and cooperation between the customs authorities** of WTO member countries, which have proposed a set of resolutions to articulate these commitments. As of the writing of this chapter, much progress has been achieved and a consensus has emerged as to which proposals could be retained. However, finalization of the trade facilitation discussions is being delayed by lack of progress on the highly controversial issue of agricultural tariffs.

The GATT Articles to be clarified during the Doha Round of trade negotiations pertain to all border control agencies. To the extent that they pertain to customs clearance, they are largely a subset of the Articles spelled out in detail by the World Customs Organization (WCO) and agreed to by most countries in the 1974 Kyoto Convention. This Convention has been updated and the Revised Kyoto Convention came into force in 2006. The WCO has no enforcement mechanism to ensure that members adhere to their commitments. However, WTO trade facilitation is intended to be legally binding and enforceable and provides technical support to members that request it to implement their commitments. The WTO grants 'special and differential treatment' for developing countries and LDCs that need time to fully implement the agreed upon measures.

A 2006 review of trade facilitation measures included in the proposals submitted by WTO members found that customs organizations, which still had to tackle a serious reform agenda, had made substantially more progress to ease border crossings. In addition, customs organizations were better aware of the challenges ahead and more prepared to tackle them than other border agencies. Overall, trade facilitation would greatly benefit if the agencies responsible for the inspection of industrial standards, security, and phytosanitary and animal health standards would similarly improve their performance. Delegating some of their functions to customs, cooperating in establishing a risk-based inspection programme and undertaking joint inspections would mark progress.

THE PIVOTAL ROLE OF CUSTOMS

The role of customs is to control the movement of goods and thus secure the state's interests and protect revenue collection. For traders, delays in customs clearance raise trade costs. This involves opportunity costs for firms that are slower to market and may lose contracts with importers, as well as higher storage fees at the port of entry. It is critical to keep procedures as simple and transparent as possible to reduce the time needed to clear customs.

Customs operations consist of a complex set of interlocking processes. At each stage, complications and inefficiencies can and often do emerge. Customs processes fall under four categories, each with sub-procedures:

- Taking control over the goods that cross the border;
- Processing of customs declaration to establish the dutiable value;
- Collecting the duties assessed;
- Undertaking the post-release control and audit.

Trade facilitation is mainly concerned with the first two categories. Customs authorities are typically faced with many challenges as they struggle to meet the diverse demands of government, business and society. These challenges are typically exacerbated in developing countries:²⁴

- Complex trade regimes include multiple rules of origin, difficult to implement tariff regimes and ambiguous customs valuation rules.

²⁴ De Wulf, L. and J. Sokol, editors, *Customs Modernization Handbook*, World Bank, 2005. Available at: siteresources.worldbank.org/EXT/EXPCOMNET/Resources/2463593-1213985777369/01_The_Customs_Modernization_Handbook.pdf

- Government-wide personnel policies often make it difficult to attract, retain and motivate staff with the skill mix required by increasingly complex trade transactions.
- Complexity of rules and procedures coupled with lack of transparency create a fertile ground for corruption.
- International trade techniques are increasingly complex and rely on ICT support. Customs need up-to-date ICT capability.
- Clearance times are often very long, imposing substantial costs on the trader in terms of ‘facilitation money’, higher inventory levels and financing costs.

CHALLENGES FOR CUSTOMS AUTHORITIES

The following section details some of the main challenges for customs. An extensive discussion of the various customs modernization issues can be found in the World Bank’s *Customs Modernization Handbook*.²⁵

Are customs laws and regulations transparent, standardized and harmonized?

Customs plays a very important part in trade operations and revenue collection. Customs is also expected to play an active role in protecting society and reinforcing national security by preventing cross-border movements of prohibited or restricted goods, such as counterfeit goods, illicit drugs, endangered species, human trafficking and illegal arms.

Customs operations need a solid legal framework within which responsibilities can be performed. Without an effective legal framework that assures transparent, predictable and rapid customs clearance, the private sector finds it very difficult to conduct business with or to invest in a country. This is particularly critical in today’s competitive international business environment.

In reaction to immense increases in trade volume and heightened requirements for security, particularly post 9/11, many customs administrations are evaluating their operations from the perspective of international standards and best practices to assess the need to introduce legal reforms. For many countries the Customs Code needs to be modernized, particularly to eliminate non-essential customs aspects and comply with international commitments.

Because traders are often not informed and are thus unprepared for newly introduced regulations, it is important to guarantee transparency and predictability by providing basic information on issues such as customs laws, certification requirements, decisions, consultation mechanisms, and appeals processes. Improvements in transparency and predictability are valued by the private sector as one of the most important gains from trade facilitation.

To do so, authorities can refer to the WCO’s Revised Kyoto Convention, which aims to simplify and harmonize existing international customs procedures around the world. The Convention provides a legal framework and a range of agreed upon standards to improve customs operations. The Convention is commonly recognized as the international standard and is used as a benchmark for the global customs community. The Convention’s provisions can be adopted in a flexible manner in the customs legislation of many countries.

Is there sufficient human resource capability to carry out all of the increasingly complex customs responsibilities?

Because of the ongoing demands of customs modernization, capable human resources are needed to cope with the full range of operations. Customs administrations need to constantly stay abreast of developments in international trade – particularly in the areas of ICT, legal provisions and economic conditions. Customs services should endeavour to develop a competent and efficient administration, determine the optimum management of staff and available technical resources, and create a culture of good governance and integrity.

Managing risk

There is a trade-off between control and trade facilitation – too much of one makes it difficult to achieve the other. Risk management seeks to strike an appropriate balance between trade facilitation and control. It aims

²⁵ *Ibid.*

Box 35: Dealing with corruption

Customs is susceptible to corruption. Officials are vested with considerable authority and responsibility to make decisions that influence the duty and tax liability of traders and the admissibility of goods. Complex regulations and high tariffs increase incentives and opportunities for corruption. The use of procedures that offer little discretion to customs staff and that have built-in accountability methods limits the incentive for corruption.

Reform efforts should include automating clearance systems, which limits opportunities for customs officials and traders to meet. Automation, coupled with measures such as providing sufficient staff compensation and increasing the risk of detection, helps stem corruption. The WCO's Revised Arusha Declaration, which is a central global effort to increase the level of integrity in customs, provides a series of self-assessment, action planning, implementation and evaluation processes using WCO 'integrity tools'.

For more information:

www.wcoomd.org/home_cboverviewboxes_valearningoncustomsvaluation_cbintegritytooloverview.htm

to adjust operational practices to minimize the number of transactions that require detailed inspection. This is achieved by applying a set of management procedures that include identifying, analysing, evaluating and mitigating the risks that might have an impact on achieving regulatory and revenue goals.

Customs also needs to keep pace with today's constantly changing international environment, driven by huge increases in international trade, transnational organized crime, and terrorism. Customs administrations are increasingly aware that national and international cooperation is vital, which requires increased information sharing among customs services. The value of sharing information with other law enforcement agencies and the business sector has also been recognized as vital. All of this information forms the basis for risk management.

SECURITY OF TRADE SUPPLY CHAINS

Increasing international concern about the security of trade supply chains has increased the need to secure the movement of goods and protect means of transport. This concern for security needs to be balanced with the recognition that legitimate cargo should continue to receive the full benefits of trade facilitation. To this end, the WCO Framework of Standards to Secure and Facilitate Global Trade has been developed and endorsed by WCO members to address this issue in a balanced manner. A core element of the Framework is the initiative to use a consistent risk management approach to tackle threats to the trade supply chain.

The SAFE Framework of Standards – the Two Pillars

As detailed by WCO: 'At the June 2005 annual Council Sessions in Brussels, Directors General of Customs representing the Members of the WCO adopted the SAFE Framework of Standards by unanimous acclamation. Not only did the adoption of this unique international instrument usher in a safer world trade regime, it also heralded the beginning of a new approach to working methods and partnership for both Customs and business.'²⁶

Importantly, the framework is to act as a deterrent to international terrorism, secure revenue collections and promote trade facilitation worldwide. The majority of the WCO's 171 members have signed a letter of intent to implement the SAFE Framework. However, progress has been slow. Inhibiting factors include the level of awareness and preparedness, which is very uneven from one country to another.

Private sector representatives have strongly advocated for such an approach, but many have been frustrated by the lack of progress. The WCO's Columbus Programme is building capacity through training and technical assistance for implementation in developing countries. The SAFE Framework is based on two pillars: customs-to-business partnerships and customs-to-customs cooperation:

²⁶ WCO Framework of Standards to Secure and Facilitate Global Trade. Available at: www.wcoomd.org/files/1.%20Public%20files/PDFandDocuments/Procedures%20and%20Facilitation/safe_package/safe_package_1.pdf. 2007

- **Customs-to-business partnerships.** Customs should enter into strategic pacts with trusted economic operators. Customs needs to understand the concerns of business and business needs to know the requirements of customs. Most importantly, this relationship must become a partnership that results in mutually beneficial outcomes.

This goal is promoted through the concept of the authorized economic operator (AEO), which allows for imported shipments from trusted operators to be rapidly moved from the controlled area of customs ports to the public area. The objective is for scarce customs resources to be focused on monitoring risky transactions. Low-risk AEO transactions should be subjected to simplified customs clearance procedures with the least interference to supply chains. The AEO system requires that the customs authority be confident in its procedures and that the use of simplified customs clearance procedures be coordinated by an agreement between the customs authority and the AEO.

- **Customs-to-customs cooperation.** The new challenges of the 21st century demand a new concept of customs-to-customs cooperation. Closer real-time collaboration is needed among customs administrations and between customs and business in facilitating legitimate trade and undertaking customs controls. The objective is to create a global customs network to support the international trading system, in partnership with the various public and private sector stakeholders. To establish this network, an international 'e-Customs' network to ensure seamless, real-time and paperless flows of information and connectivity is needed.

Guided by the principles of cooperation, the Framework strengthens the links between customs administrations and their business stakeholders (customs-to-business partnerships) as well as cooperation among customs (customs-to-customs cooperation).

CUSTOMS VALUATION – A DIFFICULT TASK

Because of the asymmetry of information, valuation is one of the most difficult tasks for customs officials. Traders have a deep and intricate knowledge of the value of the inspected cargo and all of the factors that impact on that value. Customs officials must deal with many commodities and do not have the same expertise. Where traders take advantage of this asymmetry of information, they can declare a price that is lower than the true value. If this goes undetected, the trader benefits from lower duties. It is up to customs officials to acquire the expertise to counter this tendency.

In 1994, WTO members adopted the Agreement on Customs Valuation (ACV), which established that customs value should to the greatest extent possible be based on the transaction value – the price actually paid or payable for the goods, subject to certain adjustments.²⁷ Where the transaction value cannot be used because there is no transaction value or the price has been influenced by certain conditions or restrictions, the ACV provides five alternative methods to be applied in a prescribed order.²⁸

Applying the ACV has presented serious problems for many customs administrations, particularly in developing countries. Efforts are ongoing in many administrations to enhance trader compliance and train staff to apply the ACV. Two approaches to assist customs officials to correctly implement the ACV are:

- **Price lists.** When customs officials can consult up-to-date price lists of the most frequently imported goods, they are in a better position to claim 'reasonable doubt' and request further documentation from the trader as to the prices actually paid or to resort to the alternative valuation methods specified in the ACV. Examples are the price lists maintained for the valuation of second-hand cars, an imported item that is often grossly undervalued and for which reliable invoices do not exist. These lists consist of the prices of the new car according to model and year of construction plus a set rate of depreciation.
- **Pre-shipment inspection (PSI) and destination inspection (DI).** Under a PSI programme, a country's Ministry of Finance or Customs Department contracts with a private firm to inspect cargo destined for its country at the point of export. A DI contract specifies that the contractor inspects the cargo at the point of import, and relies on its corporate expertise and contacts abroad to undertake this task. PSI and DI contracts detail the specific data that need to be covered in the inspection reports as well as the service

²⁷ For a full treatment of this subject see: Goorman, A. and L. De Wulf, 'Customs Valuation in Developing Countries and the World Trade Organization Valuation Rules', *Customs Modernization Handbook*, World Bank, 2005.

²⁸ Details can be found at: www.wto.org/english/docs_e/legal_e/20-val.pdf

fee to be paid. The inspection report is provided to the importer and to the contracting authorities and can be used as additional information to assess the acceptability of the declared value for the purpose of calculating the duties and taxes due.

As of June 2010 12 countries have a PSI contract in place and 16 countries have a selective PSI contract or a DI contract in place.²⁹ The practice of customs authorities to contract PSI/DI services has frequently been criticized, including by the WCO and the WTO. However, having recourse to these services was authorized in the WTO Uruguay Round of trade negotiations. Some proposals submitted by WTO members in the ongoing Doha trade negotiations would prohibit the use of PSI/DI.³⁰ The matter is discussed in detail in the World

Box 36: Guidelines – pre-shipment inspections and destination inspections

- Contract only PSI/DI companies that have a good reputation and operate under the Code of Conduct of the International Federation of Inspection Agencies.
- Select PSI/DI service providers and renew their contracts through transparent and competitive bidding procedures.
- Contract a single PSI/DI company for a period of a few years and renew the contract under competitive conditions.
- Avoid split contracts. Companies are more complex to supervise, contracting costs tend to be more expensive, and individual companies are less carefully supervised by their respective headquarters for which they represent lesser profit opportunities. Also, split contracts may lead importers to adjust their import patterns so as to benefit from the most helpful inspection service providers.
- Have PSI/DI contracts fully endorsed by customs, not imposed on customs by the Ministry of Finance or the Central Bank.
- Link the PSI/DI contracts with a customs modernization project that clearly delineates the respective responsibilities of customs and the PSI/DI company.
- Make the PSI/DI contract explicit:
 - Determine services to be rendered (price, classification, duties paid, special import regimes);
 - Establish time limits without automatic extensions;
 - Create a list of goods to be inspected with exceptions detailed;
 - Customs should be assisted in setting up databases;
 - Establish clear performance criteria that will allow the government to verify performance, with penalties for failing to adhere to the criteria retained;
 - Secure commitments to train customs staff and to transfer technology;
 - Specify reporting requirements, including the number of inspections, irregularities addressed, adjustments to value made and resulting additional assessments;
 - Implement a process to handle complaints.
- Record the PSI/DI inspection reports in the customs declaration and in the automated customs management system. Reconcile the findings of PSI/DI inspection reports with customs declarations and values retained for the calculation of duties and taxes; explain the reasons for deviations detected.
- To enhance importers' compliance, apply the legal penalties for offenses of undervaluation.
- Specify an arbitration or appeals procedure to provide importers with an avenue to contest PSI/DI assessments.
- Create a steering committee (located outside customs, but with the participation of customs) to oversee PSI/DI activities and report periodically to the private sector.
- Articulate an exit strategy to ensure a smooth transition of the functions that were performed by the PSI/DI service to customs. PSI/DI companies could be retained to assist in dealing with fraud-sensitive goods, or other cases where valuation poses particular problems.
- Introduce a publicity campaign to inform traders and the public about PSI/DI systems.

Source: De Wulf, L., Sokol, J., editors, Customs Modernization Handbook, World Bank, 2005. Available at: siteresources.worldbank.org/EXT/EXPCOMNET/Resources/2463593-1213985777369/01_The_Customs_Modernization_Handbook.pdf.

²⁹ Countries that report PSI or DI contracts that are subject to the WTO Agreement on PSI. See: www.ifia-federation.org/content/wp-content/uploads/2010/04/IFIA_PSI_list_06_10.pdf

³⁰ Agreement on Pre-shipment Inspection, WTO. Available at: www.wto.org/english/docs_e/legal_e/21-psi.pdf

Bank's Customs Modernization Handbook.³¹ Many customs authorities believe that having recourse to PSI and DI services has enabled them to collect more revenue. This is despite the fact that many of them have inadequately supervised the performance of the companies rendering these services and/or failed to make full use of the information provided.

Countries that have opted to use these services could do so as a temporary solution, while strengthening their in-house customs valuation capacities by carefully using the inspection data provided and setting up a mechanism to supervise the quality of the services rendered. Countries should also follow the guidelines listed in box 36 to ensure that PSI/DI services interfere as little as possible with legitimate trade.

RULES OF ORIGIN

Customs officers need to ascertain the origin of goods in order to apply basic trade policy measures such as quantitative restrictions, anti-dumping and countervailing duties, safeguard measures, origin marking, and public procurement, and for statistical purposes. These rules of origin (ROOs) are non-preferential in that they are intended to apply to all goods. However, preferential tariffs often apply as a result of preferential trade agreements between the importing country and the country of origin. These ROOs are often strict for the following reasons:

- They avoid trade deflection, which results from claims that a good comes from a particular country that benefits from preferential tariffs, whereas that may not be the case; or
- The good may not comply with the specifications spelled out in the trade agreement.

The proliferation of trade agreements, each with their specific regulations, has caused problems for customs administrations and traders. Compliance with ROOs is often costly to the trader and verification by customs officials is complex. Traders that are the most adept at complying with product-specific ROOs, and/or adjusting their product strategies to meet the ROOs, are most able to counter negative effects that arise.

ROOs have a legitimate purpose in preventing trade deflection. However, critics point to an over abundance of ROOs and lack of harmonization between different national and regional rules. They also point to concerns that ROOs are used in a protectionist manner. For example, research carried out in 2007,³² showed the system of trade preferences granted by developed countries to African countries is often undermined by restrictive ROO measures. The research showed that protectionist interest groups act to restrict the integration of preference-receiving developing countries into the global economy. For more information on ROOs and their application in the global trading system, see chapter 4.

IMPROVING COORDINATION AMONG BORDER AGENCIES AND SERVICE PROVIDERS

Improving coordination among border agencies and service providers is essential, particularly for developing countries and LDCs. Trade depends on a large number of agencies and service providers, all of which participate in the trade logistics chain at the border. Goods are finally cleared by customs, but only after clearances from other border agencies have been obtained. Agencies responsible for quality standards make separate inspections and may take samples to ensure imports conform to local quality standards. This process often delays release and can add considerable costs to imports due to delays, de-stuffing fees and demurrage, among other issues.

The final clearance of goods is determined by the least efficient border control agency. As a result, reforms limited solely to customs will be substantially less effective if other agencies and service providers are unable to enhance their performance.

There should be no duplication of effort among border agencies. For example, it makes little sense for customs to have a modernized risk management system if it is compromised by another government department's mandatory reporting or examination approach. Better integrated border management requires coordination among border control agencies, including standards, sanitary, phytosanitary and veterinary

31 For a full treatment of this subject see: Goorman, A. and L. De Wulf, 'Customs Valuation in Developing Countries and the World Trade Organization Valuation Rules', *Customs Modernization Handbook*, World Bank, 2005.

32 Cadot, O., J. De Melo and A. Portugal-Perez, 'Rules of Origin for Preferential Trading Arrangements: Implications for the ASEAN Free Trade Area of EU and US Experience', *Journal of Economic Integration* 22(2), pp. 288-319, 2007.

agencies. In most instances, it is recommended that customs, as the dominant agency, take the lead in coordinating various smaller agencies so as to ensure smoother functioning among the agencies. The WCO is currently considering the addition of a third pillar to its Safe Framework of Standards relating to cooperation between customs and other government border agencies – the customs-to-government pillar – in recognition of the importance and need for inter-agency collaboration to encourage better, more secure and efficiently coordinated border management.

REFORMING ELECTRONIC CUSTOMS MANAGEMENT SYSTEMS

In recent years, customs clearance has greatly benefited from an electronic customs management system (ECMS). Applying an ECMS is the single most important reform measure of the last few decades and has greatly benefited trade facilitation. This trend is well documented in the World Bank's Doing Business 2010 project. When correctly introduced, it leads to the replacement of old-fashioned and redundant customs procedures by modern and efficient processes that provide transparency and speed. However, introducing an ECMS must be complemented by other modernization processes, policies and personnel management, including adequate compensation, training and career planning.³³ In addition to a number of administrative customs processes, an ECMS promotes trade facilitation by:

- Permitting traders to deposit their declarations electronically from their offices ahead of the arrival of the cargo at the border using electronic data interchange;
- Assisting customs in establishing whether these declarations are filled in correctly and notifying the traders if they are unacceptable;
- Applying a risk module to select those goods that will be subject to either document or physical inspection;
- Selecting customs staff to handle declarations;
- Registering the findings of the inspections;
- Assisting customs staff to establish the acceptability of declared values;
- Calculating the duties and taxes due;
- Issuing customs invoices;
- Providing a payment platform;
- Issuing the release documents.

Traders can follow the entire process electronically and prepare themselves and their transport to take the goods across the border as soon as the release documents are transferred electronically.

Single Window – using ICT to facilitate trade

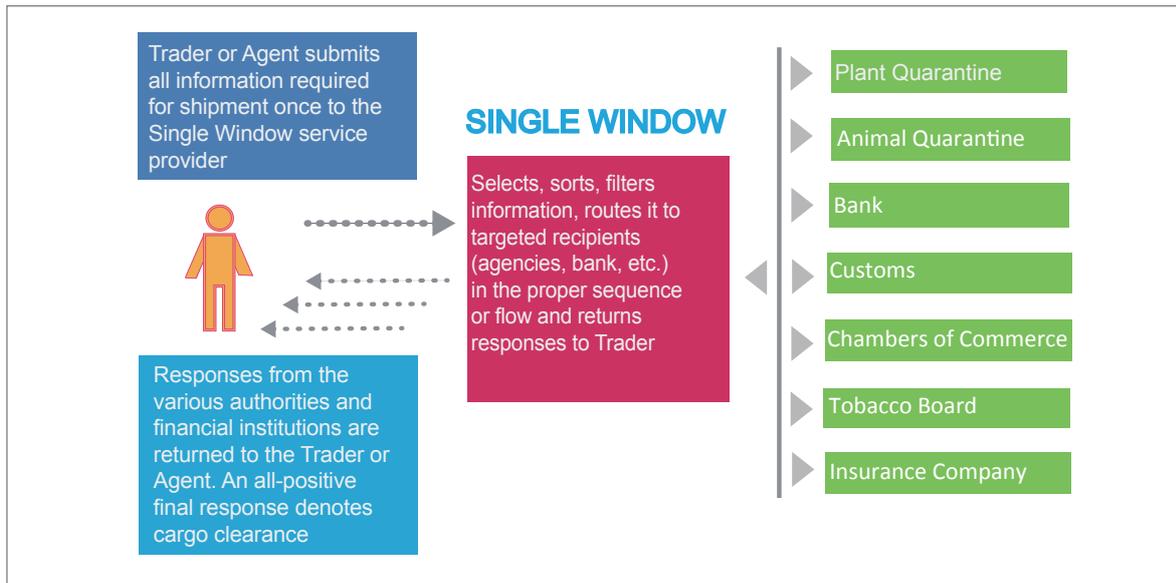
The Single Window (SW) demonstrates how advanced ICT can facilitate trade. First introduced as Tradenet in Singapore in 1989, it has attracted significant interest by the trading community worldwide and has been implemented in several countries. Early adopters include Mauritius, Ghana, Senegal and Tunisia.

As shown in figure 8, the SW enables traders to submit regulatory documents at a single location and/or single entity, thereby avoiding duplication and increasing efficiency through time and cost savings for traders. For example, in Pakistan one electronic declaration has replaced 26 clearance steps, 34 signatures and 62 verifications. As a result, more than 70% of consignments are cleared within one hour and the overall average clearance time has come down from several days to less than eight hours. Only 4% of import and 2% of export consignments are now examined, down from 100% previously. Rebate payments are made automatically without having to file a claim. Refunds take less than 48 hours, compared to 90 days. Because there is no contact between the taxpayer and the tax collector, chances of malpractice or corruption are very remote.³⁴

³³ Doyle, T., 'Information and communications technology and modern border management', in Mclinden, G. *et al.*, editors, *Border Management Modernization*, pp. 37-38, World Bank, 2011.

³⁴ For more information: www.utradepoint.com/eMagazine/04-2010/inner-pages/Reforming-Trade-Facilitation-The-Experience-of-Pakistan.aspx

Figure 8: The Single Window

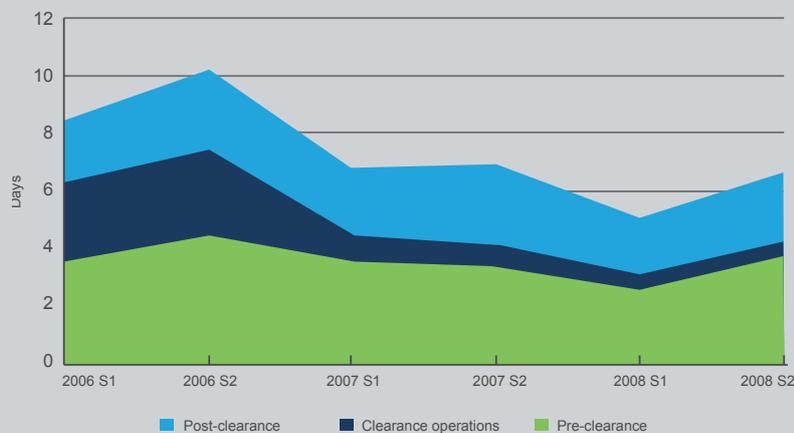


Source: ITC.

Box 37: Tunisia: improved clearance time at the port of Radès

The border management project at the port of Radès, Tunisia, demonstrates the gains in clearance times that have been achieved. The project focused on integrating the clearance procedures of different agencies. Clearance operations (the middle band in the figure) accounted for one-third of the dwell time, which is the amount of time a ton of cargo remains in the port. Lengthy dwell time is typically an indication of an inefficient port operation. Further gains are expected to come upstream (the bottom band) from automated transmission of the manifest by the port operators and investment in handling to customs. Further gains are also expected downstream (the top band) by making e-payment possible and by reforming the port rate structure to ensure rates are predictable.

Structure of clearance time for containers at the port of Radès, 2006-2008



Source: World Economic Forum, *Global Enabling Trade Report*, 2009.

Several key factors contribute to the successful launch of a SW:

- There must be a commitment from the highest level of government to stimulate the various national institutions that deal with trade to adhere to SW procedures. Governments must be willing to drastically simplify operating procedures that are engrained in the habits of operators and bureaucrats, many of whom may resist change.
- All trade procedures must be catalogued and streamlined to permit the single file submission to the SW. This is an arduous and time-consuming task that often encounters resistance.
- An agency must be identified and vested with the power to implement decisions. This could be customs, but other agencies could also undertake this task.
- The SW operations can be undertaken by a government agency or subcontracted to a corporation operating under a public-private partnership, as is the case in Singapore and Ghana.
- The SW must have sufficient financial resources to operate efficiently. Financing can be obtained either by budget transfers or from the revenues of transaction fees.
- The various border agencies involved must improve their clearing performance as the release of the import or export cargo will depend on the worst performer in the logistics chain.

TOWARDS FLUID TRANSIT PROCEDURES

Transit procedures permit the movement of goods through countries from one customs office to the other without paying import duties, domestic consumption taxes or any other charges normally due on imports. These procedures are intended to protect the revenue of the transit country – for example to prevent goods intended for transit to be ‘leaked’ to the domestic market. A poor transit system is a major obstacle to trade. Only in exceptional cases should goods be subject to other import regulations applicable in the transit country, such as health and safety requirements. These procedures cannot nullify the costs related to distance, but should aim at introducing efficient border-related procedures.

Border-crossing procedures can be complex when the transit country wants assurances that the transit goods that have entered its territory without paying duties leave the country. In the process, some transit countries introduce strict controls that slow down the transit trade. Smugglers have been known to exploit the weaknesses of transit procedures to discharge some of their ‘transit’ cargo domestically, thus avoiding paying the import taxes and fees. Dysfunctional transit procedures are a major issue for landlocked countries and hamper economic development (see box 38).

Box 38: Economic development in landlocked countries – ‘very, very tough’

In a speech at the International Development Research Centre in Ottawa, Ontario, Canada, world-renowned economist Jeffrey Sachs described the special challenges faced by landlocked countries:

‘It’s a very peculiar thing. If you look at the landlocked countries in the world, like Bolivia (Plurinational State of), you will find no success stories, except if you happen to be landlocked surrounded by rich countries. So there are a couple of rich landlocked countries, Switzerland and Luxembourg. And then there is a world of poor landlocked countries: in South America, Bolivia (Plurinational State of) and Paraguay; 14 utterly impoverished landlocked countries in tropical sub-Saharan Africa – Chad, Mali, Niger, Central African Republic, Rwanda, Burundi, Zambia, Malawi, and so forth – not big success stories economically; the landlocked countries in Central Asia – the ‘stans’ (Turkmenistan, Kazakhstan, Uzbekistan, Kyrgyzstan, Tajikistan) where there’s nothing going on economically except pumping oil, because that’s the one commodity that you can fruitfully transport over 1,000 miles across borders. And you have to pity Uzbekistan in this regard: it’s the world’s only double landlocked country, meaning it’s the only country all of whose neighbours are landlocked, so you have to cross two international borders to get to a coast. It’s the only place like that in the world. And Lao People’s Democratic Republic and other landlocked countries – there’s not a success story among them in the world.

It’s tough being landlocked: overland transport costs are extraordinarily high still. You don’t ship most goods by air, except at a very late stage of economic development. And if you want to get started in economic development, if you don’t have access to a seaport, it’s very, very tough.’

Source: New Approaches to International Donor Assistance’, speech by Jeffrey Sachs, International Development Research Centre, Ottawa, Ontario, Canada, 19 June 2001. Available at: www.idrc.ca/en/ev-25642-201-1-DO_TOPIC.html

THE CASE OF LANDLOCKED COUNTRIES

Exporters in landlocked developing and developed countries operate under great constraints. Table 7, based on findings from the World Bank's 2009 Logistics Performance Survey, clearly shows that costs in both Africa and Europe are much higher for landlocked countries than for their coastal counterparts.³⁵ Not only are the distances to the export market larger than for countries that share a border with these markets, but they must also deal with the procedures related to crossing one or even two additional borders to acquire imported inputs and to get their final products to market.

Table 7: Export distance, cost and time in landlocked countries³⁶

		Africa		Europe	
		Coastal countries	Landlocked countries	Coastal countries	Landlocked countries
	Logistics performance index	2.46	2.39	3.68	3.58
Port or airport	Export time (days)	4.82	18.10	2.3	2.4
	Import time (days)	7.21	6.99	2.2	3.6
	Export cost (US\$)	1 810.00	2 867.00	696.00	1 227.00
	Import cost (US\$)	2 701.00	3 059.00	823.00	1 496.00
Land	Export time (days)	4.13	4.67	2.3	6.0
	Import time (days)	6.93	8.41	2.9	2.9
	Export cost (US\$)	2 125.00	4 000.00	593.00	1 704.00
	Import cost (US\$)	2 581.00	3 221.00	670.00	1 489.00

Source: Logistics Performance Survey data, 2009.

KEY ELEMENTS OF A TRANSIT OPERATION

Seals. There should be a physically secure mechanism to ensure that goods present at the start of the transit operation leave the transit country in the same quantity, form and status. The simplest way to guarantee this is for customs to seal the truck³⁷ to ensure that goods cannot be removed from or added to the loading space of the truck without breaking this seal or leaving visible marks on the loading space of the truck. Trucks and seals approved for use in the transit operation must conform to well-specified criteria that guarantee their effective operation and security. New transport seals are under study and prototypes are already in use. These seals include a microchip that, when broken, transmits a signal, picked up via a satellite network that sends information to the organization or principal of the sealed container, including information on its location. Although the prices of such automated seals are relatively high, the cost will likely decrease in the coming years.

Sealing containers is relatively easy. However, sealing non-containerized conveyances presents some problems because the trucks often are not of as high quality as those that carry containers, and often participate in informal trade. Various sealing procedures have been proposed and are in operation. Good sealing systems conform to the WCO Kyoto Convention. They should be (i) strong and durable; (ii) capable of being affixed easily and quickly; (iii) capable of being readily checked and identified; (iv) cannot be broken, tampered with or removed without leaving traces; (v) cannot be used more than once, except for those seals intended for multiple use (e.g. electronic seals); and (vi) be made as difficult as possible to copy or counterfeit.

Guarantees. Customs must be given a guarantee to cover the payments of import duties, taxes and other charges due on importation in the transit country in case goods do not leave the country via the transit procedure. Guarantees should correspond to the duties and taxes 'at risk', but are sometimes calculated

³⁵ *Connecting to Compete: Trade Logistics in the Global Economy*, p. 20, World Bank, 2010.

³⁶ Note: African coastal countries: Benin, Cameroon, Côte d'Ivoire, Ghana, Kenya, Mozambique, Namibia, Nigeria, Senegal, South Africa, Togo and United Republic of Tanzania. African landlocked countries: Burkina Faso, Central African Republic, Chad, Ethiopia, Malawi, Mali, Rwanda, Uganda, and Zambia. European coastal countries: Belgium, Croatia, Germany, Italy, Netherlands, and Poland. European landlocked countries: Austria, Czech Republic, Hungary, Luxembourg and Slovakia.

³⁷ Trucks are used as an example. However, seals could be used for other modes of transport, such as wagons, barges, trains, etc.

in terms of the value of the cargo, which is easier to establish than the 'at risk' duties. Banks and insurance companies can issue guarantees and in some instances obtain reinsurance from international insurance companies.

Non-guarantee forms of security such as deposits or the value of the trucks exist in some transit countries. These guarantees tend to be more expensive and difficult to mobilize and are not recommended. Guarantees can cover a single transit operation affected by the principal concerned or several transit operations up to given limits and specifications. Customs procedures specify the modalities of recovering the guarantee.

Authorized operators. Operators providing guarantees that they will abide by the transit rules and operating with acceptable vehicles are permitted to engage in the transit trade. National transit organizations are largely responsible for identifying authorized transit operators.

Documentation flow. To control the beginning and completion of a transit procedure, customs should have a reliable monitoring system. This system could be based on paper documentation issued by the customs post that controls the origin of the transit shipment and the documentation issued or verified by the customs post at the exit of the country.

Increasingly, documents are transmitted electronically, relying on the transit module of the customs management system. This system permits the timely lifting of the bond upon the completion of the transit transaction. When the copies of the documents – or the electronically generated data match – have been returned to the point of origin of the transit and matched with the documents issued at the start of the journey, the transit operation is considered completed and the guarantee released. When they do not match, payment of the import duties, taxes and other charges – including a fine – are due. These charges are covered by a guarantee.

Human error and lax recording of the exit formalities can lead to redundant claims on the transit guarantee. These claims are costly and lengthy to settle and undermine the trade facilitation aspects of the overall transit procedures.

NET BENEFITS OUTWEIGH COSTS

Many bilateral, international and regional transit agreements are in place. The WCO and the WTO have agreements among their members. Yet, many of these agreements and treaties exist only on paper or are in a prolonged state of ineffective preparation or implementation. Inadequacy of or lack of legal instruments and frameworks are not the problems. Implementation is hampered by a perceived lack of capacity, scepticism that transit procedures can be implemented to adequately protect fiscal revenue, or from the lack of political will to overcome vested interests that benefit from poorly operating transit mechanisms. In addition, the erroneous perception that fluid transit procedures largely benefit landlocked countries has undermined progress.

The World Bank estimates indicate that the benefits from transit can be significant. For Kazakhstan they were estimated at 0.5%-0.6% of GDP; about two-thirds accrued to the railway sector and one-third to road transport. In the case of the United Republic of Tanzania vis-à-vis Rwanda, Burundi and Uganda, the main benefit is the additional traffic handled profitably by the transit country's ports and trucking firms, the volume of transit traffic being large relative to domestic traffic. The same type of benefit accrues to Thailand from transit traffic with Lao People's Democratic Republic, though in this case the volume is small. In the case of Chile vis-à-vis Bolivia (Plurinational State of), the largest benefit arises from a free trade zone from where imported vehicles and consumer goods are sold on to inland countries.

The general perception is that the net benefits accruing to transit countries substantially outweigh the costs.

EFFICIENT TRANSIT PROCEDURES AND PRACTICES

Efficient transit operations involve customs as well as transport operators, and require transport procedures that allow trucks and drivers to cross borders without transshipment of the cargo or switching of drivers. Mutual recognition of truck certification insurance and driving licenses, as well as traffic rights in the transit country for national trucks, are issues that need to be considered.

Transport regulations that specify which trucks are allowed to transport the transit goods also undermine competitiveness. For example, 'tour de role' rules imposed by transporters associations allocate transportation services. Table 8 provides an overview of how various trade and transport procedures and practices hamper transit trade and undermine competitiveness.

Table 8: Trade and transit procedures and practices

Procedure/practice	Documentation	Charges, cost	Comment
Unloading in port	Bill of lading	Port charges	The efficiency of port operations is not always up to standard
Inspection and clearance by customs	Invoice to determine value, classification and weight that permit the calculation of the duties to be guaranteed Transit declaration	Guarantee (deposit)	Often transit shipments are subjected to the same time-consuming procedure applied to imports for home consumption. Transit guarantee is purchased. Often the guarantees are calculated not on the 'revenues at risk' but on the value of the transit cargo, which may overstate the 'duties at risk'.
Loading of vehicle			Seals of containers and other conveyances. Poor sealing practices leads customs to operate convoys.
Formation of a convoy		Convoy charges	Convoys depart only when all trucks are present, cause delays en route (mechanical problems with older vehicles), and can pass border control only when all trucks have reassembled at the border. Corruption issues.
Road transport in the transit country		Road transport charges Fixed transit routes	These charges are often contrary to GATT Agreements. Fixed routes are not always those trucks would chose. This limits the freedom of transporter.
Controls en route			Transit and other transport are often impeded by numerous road checks by police and customs and involve payments of gratuities.
Customs inspection upon exit from first country	Copy of transit document In the absence of an ICT system, this presents problems		Seals are checked. Transit document checked and slowly remitted to issuing office to discharge the guarantee.
Border inspections (vehicle)		New insurance charges	Driving license and insurance of vehicle check. If invalid, change of operator is needed. Possible axle load control, with axle loads that differ across countries.
Transfer to other truck		Transfer charges	When trucks cannot operate on the other side of the border, cargo can be damaged, lost or stolen.
Customs inspection entry in the destination country	Transit declaration – beginning of a national transit link	New guarantee must be purchased	Delays when customs do not recognize/accept/doubt the transit seals/documents and insist on inspections.
Other inspections upon entry of second country	All documents		Security, health checks; could lead seals to be broken.
Arrival at destination	All documents	Costs of damage, loss	The seals are broken, duties paid and guarantee discharged.

Source: Arvis, J.F., Transit and the Special Case of Landlocked Countries, World Bank, 2005. Available at: www.gfptt.org/uploadedFiles/4afdccb3-f851-4641-a38b-98bd481f10c7.pdf

Box 39: A pragmatic solution – the West African Transit Agreement

Economic Community of West African States (ECOWAS) member countries signed off on a transit agreement in 1982 that clearly identifies the various elements that permit smooth transit among its 16 member countries. The agreement has been largely ignored and today most transit cargo is regulated by bilateral agreements. However, some progress is being made that could result in the final adoption of the Agreement.

Ghana's pragmatic solution for transit shipments to Burkina Faso, Niger and Mali is an example of best practice:

Guarantees. In 2006, ECOWAS countries adopted a proposal to create a chain of guarantors and agreed on a fee-sharing arrangement covering all transit through West Africa. In March 2009, an agreement was reached among Ghana, Burkina Faso and Mali to start a pilot and guarantors were identified to launch the programme.

Seals. Ghana initiated a sealing system for transit trucks in agreement with the transport associations of the destination countries – Niger, Burkina Faso and Mali. The system consists of a one-piece or approved multi-piece tarp that is secured on the truck using tight ropes that are affixed on hooks at the base of the truck platform cover. A sealed nylon tape is placed through the hooks, upon which a numbered seal is affixed. The number is noted on the transit documents.

Documentation flows. Ghana's exit border is equipped with the transit module of its customs management system, which registers the completion of the transit journey and transmits this information to headquarters in real time. This permits the prompt release of the transit bond. Burkina Faso and Mali are in the process of doing the same and are implementing a special module to permit the seamless transfer of the transit information across customs administrations. This procedure is required because the customs management systems in Niger, Burkina Faso and Mali differ from Ghana's system.

Transit truck tracking system. Ghana customs operates a tracking system that allows customs officials as well as owners to follow the trucks over its territory. Burkina Faso and Mali are studying the possibility of extending this system to their territories. However, there is little agreement among transit experts that the benefits to customs of using such a system warrant their cost.

Sources: De Wulf, L., 'Ghana Leads West Africa in Transit Reform', *Investment Climate in Practice*, Nr. 10, World Bank, 2010. Arvis, J. F., 'Transit Regimes', Mclinden, G., et al., editors, *Border Management Modernization*, World Bank, pp. 292-293, 2011.

TRADE LOGISTICS SERVICES AND COMPETITIVENESS

The ability of businesses to connect successfully to international markets relies on the performance of the entire supply chain. Six areas best capture the most important aspects of the current logistics environment:

- Efficiency of the customs clearance process;
- Quality of trade and transport-related infrastructure;
- Ease of arranging competitively priced shipments;
- Competence and quality of logistics services;
- Ability to track and trace consignments;
- Frequency with which shipments reach the consignee within the scheduled or expected time.³⁸

The broadened approach to trade facilitation ranges from traditional issues, such as customs procedures and infrastructure quality, to new concerns, such as tracking and tracing shipments, timeliness in reaching a destination and the competence of the domestic logistics industry. Weaknesses in any one of these areas are critical to whether businesses can trade goods and services on time and at a competitive cost.

Trade logistics refers to the management of international flows of goods and related documentation and payments. Many of these services are performed 'behind the border' as compared with 'at the border'. These

³⁸ Arvis, J., M. Mustra, J. Panzer, L. Ojala and T. Naula, *Connecting to Compete 2008: Trade Logistics in the Global Economy*, World Bank. Available at: siteresources.worldbank.org/INTTLF/Resources/lpireport.pdf

services include domestic transport, warehousing, port services, information management, infrastructure that allows exporters to comply with standards imposed by the importing country, and capacity to track goods to comply with increasingly stringent security requirements. The availability of high-quality and price-competitive trade logistics services is strongly correlated with country competitiveness.

Companies must bear the direct costs associated with moving goods, including port and handling charges, freight costs, agent fees, procedural fees and side payments. Furthermore, they often must incur further costs associated with hedging for the lack of predictability and reliability of the supply chain.³⁹ Companies often need to carry higher inventories of supplies or finished products or change to more expensive forms of transportation to be certain to meet delivery schedules.⁴⁰ These costs are related to predictability and are inclined to climb sharply in relation to declining logistics performance.

Efficient logistics are one of the preconditions for developing countries to successfully conduct trade – both exports and imports – and to integrate more fully with world markets. The lack of an efficient logistics sector can discourage or needlessly tax export activity. The cost of logistics relative to export value is a major market access barrier for developing country exporters of goods. Relative to total export value, average logistics costs are estimated to account for 3% in developed countries and 8% in developing countries. Among developing countries, the share has been estimated at 15% in Africa and to almost 30% in landlocked developing countries.

Supply chain performance relies on the quality of services provided by the private sector: customs brokers, road transport operators, shipping agents and haulers. An efficient supply chain relies on the competence and diligence of public agencies that oversee border procedures. In many developing countries and LDCs, there is dissatisfaction with the quality of trade logistics services provided by both the private and public sectors. This is in stark contrast to developed countries, where there is more satisfaction with private providers than with public providers. The negative view of private providers in developing countries and LDCs can have significant consequences. Frequently in these countries, inadequate regulations and a lack of competition are the causes for dissatisfaction with private providers.

An example is the profession of customs brokers, which typically has a low barrier of entry without adequate regulations to ensure the quality of services. As a result, there is an over presence of 'suitcase' operators whose practices obstruct trade facilitation. Often these operators upset the clearance process and prevent the emergence of capable local logistics operators that are better able to work with international operators.

Another example provided by the World Bank shows that increased competition and successfully liberalizing trucking services is critical:

'Rent-seeking behaviour and governance of the trucking industry are at the core of the issues faced by many low-income African countries. Without increased competition and successfully liberalizing trucking services where regulation remains strong, transport prices will remain high, service quality will not improve and road users will not reap all the benefits of costly investments in infrastructure rehabilitation.'⁴¹

The World Bank's *Connecting to Compete: Trade Logistics in the Global Economy*⁴² report sheds some light on the impact that infrastructure and infrastructure services have on country rankings according to the Logistics Performance Index (LPI). When countries are ranked from high to low LPI, a positive relationship is apparent between this ranking and the satisfaction of operators with the infrastructure services. For instance, 33% of operators in countries that belong to the top quintile of the overall LPI ranking indicated that road infrastructure was of high or very high quality, compared to 4% of operators in the bottom quintile that were of this opinion. Improvements would assist the competitiveness of all operators, but much more so for operators in countries that belong to the lower quintiles. A similar relationship is found with respect to infrastructure services

39 Arvis, J., et al. *Connecting to Compete*, World Bank, 2008.

40 Guasch, J. and J. Kogan, 'Just in Case Inventories: A Cross Country Analysis', Policy Research Working Paper 3012, World Bank, 2003. Available at: www.wds.worldbank.org/external/default/WDSContentServer/IW3P/IB/2003/04/23/000094946_03040404262960/Rendered/PDF/multi0page.pdf

41 Freund, C. and N. Rocha, 'What Constrains Africa's Exports?', Policy Research Working Paper 5184, World Bank 2010. Available at: www.relooney.info/0_NS4053_347.pdf

42 Arvis, J.F. et al., *Connecting to Compete: Trade Logistics in the Global Economy*, World Bank, 2010. Available at: siteresources.worldbank.org/INTTLF/Resources/LPI2010_for_web.pdf

POLICY RESPONSES

In getting products to market more quickly, safely and cost-effectively, developing countries have the choice of relying on foreign logistics services suppliers or enhancing their own national supply capacity – or a combination of both. Developing countries can clearly derive benefits from engaging in trade and investment liberalization in logistics services. However, experience shows that certain preconditions must be met, including infrastructure and its quality, access to and efficient use of technology, providing security, and the availability of skilled human resources. An important precondition is proper pro-competitive regulation with the means to enforce domestic regulatory requirements while meeting international standards. A sound and balanced regulatory framework, buttressed by policies to ensure a competitive environment for the sector, is imperative. It is also fully consistent with the right to regulate that is enshrined in the WTO's General Agreement on Trade in Services (GATS) and in the growing number of preferential trade agreements (PTAs) covering trade in services.⁴³

A domestic trade and transport logistics audit

Policies to improve trade logistics and trade procedures should start with a domestic trade logistics audit that identifies the potential shortcomings that must be addressed in an action plan. The action plan should be prepared with the full participation and support of the various actors in the domestic logistics supply chain. This is further discussed in the 2010 World Bank study, *Transport Facilitation Assessment: A Practical Toolkit for Country Implementation*.⁴⁴

'The objective of [a] Trade and Transport Facilitation Audit (TTFA) is to establish a diagnostic, as comprehensive as possible, on the situation in a country in terms transport costs and efficiency related to external trade and international transportation services providing an integrated approach.

A logistics audit will invariably start with gathering quantitative and qualitative data from key stakeholders and with analysing and interpreting this information. The main departments collaborating in data collection and interviews will typically be Logistics and Transportation as well as Warehousing, Purchasing, Production, Trade Compliance, Customer service and IT departments.

All these departments are involved directly or indirectly in the supply chain and can provide a valuable insight into the situation as well as benefit from the outcomes of the audit.'

The information gathered and analysed will be transferred to an 'as-is' process, with documentary and physical flow maps to provide a clear understanding and help evaluate the entire process to identify any inefficiencies, bottlenecks and waste. The audit team then provides suggestions for improvements and modifications summarized on 'to-be' maps. The team also ensures the suggestions are adequately prioritized. Specific recommendations, action items and risk assessments are presented together with solutions to help with their implementation. The data gathered is used to back-up findings, quantify logistics costs and identify potential savings through data analysis and benchmarking.

The main purpose of a TTFA is to enable policymakers to understand how supply chains for international trade operate and identify opportunities to improve their performance. Governments play an essential role in improving trade and freight logistics. Governments are also responsible for creating a pro-competitive environment to enable trade and freight logistics providers to better operate. According to an UNCTAD report:

'Regulation of logistics services and trade procedures influences the performance of international supply chains, as does the quality and capacity of public infrastructure. Countries aspiring to progress trade logistics may need to reform and modernize border management institutions, change transport regulation policy, and, in some cases, invest significantly in trade-related infrastructure.'⁴⁵

43 *Trade and Development Aspects of Logistics Services*, UNCTAD, 2006. Available at: www.unctad.org/en/docs/c1ahm1d2_en.pdf

44 Readers are advised to refer to this study for an in-depth understanding of the issues. *Trade and Transport Facilitation Assessment: A Practical Toolkit for Country Implementation*, World Bank, 2010. Available at: siteresources.worldbank.org/EXTTLF/Resources/Trade&Transport_Facilitation_Assessment_Practical_Toolkit.pdf

45 *Trade and Development Aspects of Logistics Services*, UNCTAD, 2006. Available at: www.unctad.org/en/docs/c1ahm1d2_en.pdf

An audit can assist governments in gaining a comprehensive understanding of trade facilitation and logistics as well as supply chain constraints in a country irrespective of their cause. Some key areas include the following:

- Organization and quality of transport and logistics services as well as infrastructure offered to exporters and importers;
- Procedural and documentary requirements necessary to move goods through borders or in transit operations;
- Foreign trade patterns;

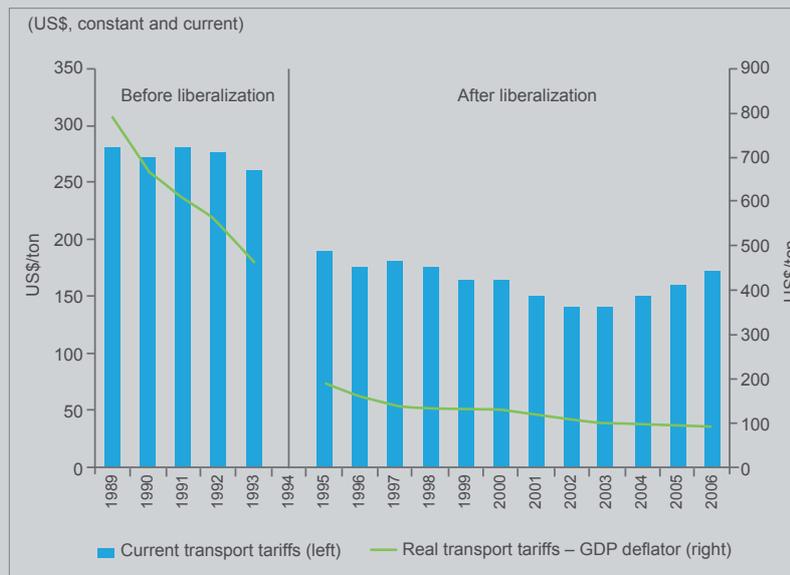
Box 40: Rwanda: deregulating international transport

In 1994, Rwanda's initiative to deregulate the international transport sector had a huge impact on transport prices. The dramatic decline in prices confirmed the effect that cartels had on the country. Prices declined by more than 30% in nominal terms and by almost 75% in real terms when taking into account the continued increase in input prices. The impact in Rwanda was probably stronger than in most other African countries because before deregulation a parastatal trucking company held a monopoly and was able to set high prices without any restraints. At the same time, 1994 was the most violent period of the Rwandan civil war, when a road freight fleet ceased to operate.

Deregulation resulted in lower prices and led to growth in the Rwandan fleet. This is in contrast to common fears that deregulation, which liberalizes market entry, helps to eradicate the fleet owned by truckers from landlocked countries. In the case of Rwanda, this fear was even stronger given the disappearance of its trucking fleet in 1994.

On the contrary, deregulation boosted the rapid recovery of the domestically owned fleet. A distinctive feature of Rwandan truckers' business strategy has been to specialize in specific goods – such as petroleum products – to capture niche and profitable markets. This largely explains why the current fleet is equal to the level prior to deregulation.

Average transport prices from Mombasa to Kigali (US\$, constant and current)



Source: Teravaninthorn, S. and G. Raballand, 'Transport Prices and Costs in Africa: A Review of the Main International Corridors', Africa Infrastructure Diagnostic, Working paper 14. Available at: infrastructureafrica.afdb.org/system/files/WP14_Transportprices.pdf

Box 41: Czech Republic, Hungary and Poland: privatization

Road freight transport was one of the first sectors to be privatized and liberalized in most Central and East European countries. Hungary, followed by Poland and then the Czech Republic, was the earliest to adopt pro-competition reforms. Hungary and Poland passed laws granting free entry to the trucking market in 1988, as did the Czech Republic after 1990. Market forces freely determine transport prices. The combination of privatization and liberalization, which included deregulation reforms, such as eliminating rate and route controls, led to the entry of many new trucking operators with competitive prices and better quality services.

A consequence of the new competitive environment includes several innovative logistics services initiated by the trucking companies. This has resulted in faster delivery times and less breakage or spoilage of cargo. In most cases, the more significant service innovations were initiated by the larger, internationally connected trucking companies.

Source: Source: Teravaninthorn, S. and G. Raballand, *Transport Prices and Costs in Africa: A review of the main international corridors*, Washington, D.C., World Bank, 2009.

- Constraints in regulatory, documentary and procedural requirements concerning international trade transactions and equivalent transport operations;
- Availability and the organization of transport services and obstacles to their modernization and development;
- Regulation, quality and reliability of transport and logistics services and business practices.

Using the Logistics Performance Index

Policies that have an impact on trade and logistics regulations and procedures should be developed based on an understanding of their impact on trade competitiveness. The World Bank's Logistics Performance Index (LPI)⁴⁶ is detailed in the *Connecting to Compete: Trade Logistics in the Global Economy* report as well as in numerous country specific studies. The LPI provides policymakers and private sector stakeholders with benchmarking data along the entire supply chain. This information, available since 2007, enables stakeholders to identify trade constraints, highlight poorly performing areas along the entire trade supply chain, and target areas for reform. The World Bank's *Trade and Transport Facilitation Assessment: A Practical Toolkit for Country Implementation* reports:

By providing comprehensive data on country performance and a broad indication of where problems are, the 2007 LPI helped raise awareness and intensified the dialogue between policymakers and the private sector in several countries about logistics bottlenecks and priorities for reform in facilitating international trade and transportation at the country or sub-regional level.⁴⁷

EXPRESS DELIVERY NEEDS EFFICIENT LOGISTICS

Express delivery is a good example of the need for reliable and efficient logistics to promote business competitiveness in coordination with government regulations.⁴⁸ Express operators offer guaranteed, fast, reliable, on-demand, global, integrated, door-to-door movement of shipments that are tracked and controlled throughout the trip. The express industry simplifies and speeds up the process of transporting goods. It organizes collection, generally at the end of the business day, allows the sender access to information on the progress of shipments from pick-up to delivery, and provides proof of delivery.

Where shipments cross international borders, the express industry takes care of customs clearance and the payment of duties and taxes as required. Many companies depend on express services when their products are perishable and/or time sensitive. However, express delivery services are typically expensive and may not be a viable option for many companies.

46 The World Bank's Logistics Performance Index is available at: info.worldbank.org/etools/tradesurvey/mode1b.asp

47 *Trade and Transport Facilitation Assessment: A Practical Toolkit for Country Implementation*, World Bank, 2010. Available at: siteresources.worldbank.org/EXTTLF/Resources/Trade&Transport_Facilitation_Assessment_Practical_Toolkit.pdf

48 'The Impact of the Express Delivery Industry on the Global Economy', *Oxford Economic Forecasting*, 2005. Available at: www.global-express.org/doc/Global_Express_Impact_Study.pdf

The express delivery industry enables SMEs to use high-quality and rapid delivery services that they would unlikely be able to provide by themselves. One area where express delivery services are likely to be particularly critical to economic success is knowledge-based industries, such as pharmaceuticals, biotechnology, financial and business services, as well as research and development activities. These sectors have above-average levels of dependency on express delivery services, reflecting the time-sensitive, high-value products and services they provide.

International express services are hypersensitive to government policies and restrictions that weaken their capability to function efficiently. This limits their potential to facilitate increased trade, investment and productivity across the broader economy. The restrictions faced by service providers include: anti-competitive practices of government-owned or authorized monopolies, complex licensing requirements and inefficient customs procedures, and restrictions on foreign investment. Eliminating restrictions on the express industry could promote increased trade, investment and productivity. This in turn could increase GDP, provide employment and boost government finances.⁴⁹

PUBLIC-PRIVATE COLLABORATION

The success of trade facilitation initiatives is frequently attributed to collaboration between the government and the business community. Public-private collaboration enables both parties to strive cooperatively for their mutual benefits and carry out trade facilitation projects, as well as address procedural concerns. Consultation with private sector stakeholders is one of the main methods for governments to identify operational issues, approve remedies and undertake reform. Public-private collaboration is feasible for all aspects of the logistics and trade supply chain. However, such cooperation is most common in the area of border management, where the role of the private sector is critical to the reform process. Private sector involvement in border management can benefit border agencies through the following activities:

- **Consultation.** Border management agencies can develop tools and mechanisms to consult with private sector stakeholders about reform needs and initiatives.
- **Collaboration.** Border management agencies can partner with the private sector to encourage compliance with trade controls and procedures through collaborative arrangements that motivate traders to internalize and take responsibility for meeting border control objectives.
- **Contracting.** Border management agencies can and increasingly do rely on private sector services to complement or augment government resources and capabilities. An example of effective collaboration is the successful public-private partnership for customs services in Ghana⁵⁰ (see box 30).

CONSULTATION MECHANISMS AND PROCESSES

A common approach is for private and public sector representatives to share their concerns in national, departmental and local collaborative forums where they can then jointly explore border reform options and approaches.⁵¹ In Malaysia, for example, the Prime Minister set up a special steering committee comprising various government representatives and the President of the Federation of Malaysian Manufacturers to address trade facilitation problems and take measures to solve them (see box 42).

Further mechanisms include 'arm's length approaches', such as open consultation letters inviting interested parties to express views on a given issue, and approaches driven by assessment and research, such as the investigation of private sector trade facilitation reform requirements using surveys, toolkits and commissioned studies'.⁵²

Both government and the private sector can benefit from such consultation processes. The contribution of the private sector enables enterprises to keep abreast of the latest regulatory changes and to take appropriate

⁴⁹ *Ibid.*

⁵⁰ Granger, A., 'The Role of the Private Sector in Border Management Reform', in *Border Management and Modernization*, World Bank, 2010.

⁵¹ *Ibid.*

⁵² *Ibid.*

Box 42: Malaysia: consultation mechanisms

In Malaysia, public-private sector collaboration and partnerships have become standard operating procedure. All ministries and agencies have adopted an open policy and encourage feedback from the private sector with regards to problems faced in carrying out their economic and trading activities. All ministries and agencies involved in trade-related issues are required to undertake industry consultations on a regular basis to further enhance the business environment to promote trade and investment facilitation.

At the national level, annual consultations are held to discuss trade-related issues. For example, the Annual Ministry of International Trade and Industry (MITI) Dialogue, chaired by the minister, provides the opportunity for corporate leaders and industry associations to improve the trade and business environment. Discussions on trade facilitation issues are a common and important component in almost all of these dialogue sessions.

Malaysian customs has established the Customs-Private Sector Consultative Panel (CCP) that meets twice a year at the national level. Consultative panels have also been established at the state level, and hold meetings on a regular basis, in addition to a monthly Meet the Clients Day.

Embedding reforms in the public delivery system

All issues, including observations and proposals from the consultations, are then discussed and evaluated by the relevant ministries and agencies and discussed in forums such as PEMUDAH, a Special Taskforce to Facilitate Business established in 2007. PEMUDAH brings together ministries with decision-making authority to address the issues raised during the consultations related to the specific ministries. When changes to policy, regulations and laws are required, they are submitted to the cabinet for consideration and approval. Ministries and agencies continuously monitor policy reforms and improvements to procedures and approaches. PEMUDAH also has monitoring responsibility, in order to ensure that the reforms implemented are sustained and are embedded in the public delivery system.

The Malaysian Administrative Modernisation and Management Planning Unit (MAMPU), a central agency under the Prime Minister's department, monitors and oversees overall reforms. MAMPU plans and issues guidelines and standards for public sector transformation. It provides consultancy services in areas such as strategic planning and management business process re-engineering and the use of ICT. MAMPU also monitors the implementation of transformation programmes and evaluates the effectiveness of implementation through rating mechanisms. In addition, MAMPU coordinates public awareness programmes through various media to inform and encourage the public to take advantage of the various improvements created by the government.

Source: Public-Private Sector Partnership on Trade Facilitation – the Malaysian Experience, ITC, 2010.

action. Through dissemination of information to the business community, businesses discover what incentives and assistance programmes are available. Governments are able to learn about the problems faced by businesses in their economic and trading activities. Consultation also presents an opportunity to identify the issues and devise plans to overcome them.

CONCLUSION

A diverse range of measures are needed to ensure goods are moved across borders rapidly, reliably and cost effectively. International studies show how traditional, 'narrow', approaches to trade facilitation have been inadequate because they focus primarily on border processing, clearance systems and procedures at the border. Today, trade facilitation must also take into consideration logistics services and quality infrastructure.

This 'broadened approach' to trade facilitation is supported by an abundance of high-level research showing how specific trade facilitation measures can have major impacts on improving the business environment and the expansion of competitive exports to global markets. The result of improvements could be substantial for exporters in many developing countries and LDCs.

But the benefits of progress in one area may not be realized until progress is made in all other areas. For example, poor integration among the agencies involved in border processes may offset the benefit of a customs modernization programme.

Because of this broadened scope of issues, policy responses from national governments must adjust accordingly. For example, in the area of trade logistics services, governments must foster a pro-competitive, corruption-free environment to enable the best logistics services providers to flourish, thus reducing costs for users. A trade and transport logistics audit as well as findings from major international studies, such as the World Bank's Logistics Performance Index and the World Economic Forum's Global Enabling Trade Report 2010,⁵³ can assist in identifying problems across the entire supply chain. This information can be used to identify priority areas for improving trade competitiveness.

Effective public-private collaboration can enable both private and public sector players to implement trade facilitation projects, address procedural concerns and identify policy shortfalls. Ghana's experience has demonstrated that public-private partnerships are an effective means of obtaining financing and technical expertise for customs modernization, while maintaining government control in sensitive areas.

Similarly, in Malaysia, the effective use of collaboration and partnerships has become a standard operating procedure for government entities and has encouraged feedback from the private sector regarding problems it faces and solutions in carrying out economic and trading activities. The private sector, acting through associations, can use this information to better consult with governments concerning the specific areas of trade facilitation reform with the most potential to result in export growth.

Thus a broad range of trade facilitation issues, both at the border and behind the border, need to be addressed in order to enhance export competitiveness. The range of issues cannot be handled by governments alone. Governments need to work in collaboration with the private sector to identify stumbling blocks, propose solutions, finance trade facilitation infrastructure and provide a competitive domestic environment for trade logistics services providers.

53 Available at: www3.weforum.org/docs/WEF_GlobalEnablingTrade_Report_2010.pdf.

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CHAPTER 4

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ADDRESS EXPORT MARKET ISSUES

INTRODUCTION

The roadmap to a successful export effort requires identifying market opportunities and the conditions of access, and developing a programme at government and business levels to take advantage of the opportunities. This chapter focuses on the information about export markets exporting businesses need, how to obtain that information and how to exploit the opportunities. Four points should be kept in mind.

First, export opportunities vary widely across markets and across products. Conditions change over time because of policy changes, economic developments, changes in fashion and tastes, and the development of new products and services.

Second, conditions of access may change under national programmes on trade and related policies, as well as from regional and multilateral negotiations. The treatment of different trading partners may vary across markets and in individual markets, with some exporters receiving better terms of access than others.

Third, in some sectors and in some exporting and importing countries, trade may be largely controlled by a limited number of firms whose domination is based on size (monopolies or oligopolies on the selling or purchasing side or both); economies of scale or other barriers to entry; on proprietary technologies in products, services or in production; and delivery of goods or services.

Fourth, competing exporters – countries and firms – may be using strategies and instruments to give them an advantage in foreign markets. These may simply be a sound export strategy, such as that being developed in this chapter, or it may be the use of measures such as subsidies or even competitive undervaluation of national currencies.

This chapter shows how exporters can develop a strategy to address various changing conditions to win markets. However, the principal focus of the chapter is on market access conditions and on important technical barriers to trade.

MARKET ACCESS

IDENTIFYING MARKET OPPORTUNITIES

Most countries and businesses have a good idea of their traditional markets and trends and conditions of access to those markets. However, when they seek to expand and diversify their exports, including in new markets, they need access to a much wider range of information to identify market opportunities and trends.

Today, a wide range of information and various tools are available for goods. For example:

- Trade intelligence can be obtained from the International Trade Centre (ITC). ITC was founded as a joint agency of the United Nations Conference on Trade and Development (UNCTAD) and the General Agreement on Tariffs and Trade (GATT) [now the World Trade Organization (WTO)] to be the leading international agency in the provision of such information.
- Extensive information and analysis on many countries and topics, including services, are available from the World Bank and UNCTAD. WTO Trade Policy Reviews provide broad-based surveys of individual countries, as well as specific information on goods and services.
- Official notifications of all trade rules and actions by WTO Members are on the WTO website (www.wto.org).
- World Bank and International Monetary Fund (IMF) reports provide useful general background on the economies of many countries and specific information on certain sectors.

ITC INFORMATION SERVICES

Since its founding in 1964, ITC has provided trade development information to trade support institutions and the private sector in developing countries. It provides capacity building to use this information for market development and negotiations, helping to level the playing field for developing countries that lack easy access to information about market conditions, trade trends, product developments and trade negotiations.

Over the last decade, ITC's websites (see www.intracen.org) have delivered a growing amount of trade intelligence to policymakers, trade support institutions and businesses. ITC books, its magazine and market analysis tools have been made available free online for users in developing countries. In addition to the quarterly Trade Forum magazine, ITC's oldest publication, ITC produces an extensive range of publications on various topics, including books, technical papers, directories and periodic bulletins. In the last 10 years, ITC has published some 50 and over 100 technical papers. They include trade promotion handbooks, market surveys, commodity handbooks and a range of technical materials..

The market surveys cover specific product markets, including coffee, cocoa, cotton, cut flowers, dried herbs and spices, food and beverages, fruit juices, oil cakes and meals, nuts, textiles, silk, and tropical timber. There are also many books covering market opportunities and issues in trade in services. Trade promotion topics include many publications that simplify WTO issues for the business community, and provide them with hands-on advice to improve their export competitiveness.

There are also many publications that help national trade promotion institutions and national economic policymakers shape their strategies and formulate policies for export success. The materials cover topics such as: anti-dumping, countervailing duties and safeguards in various markets; business management for international competitiveness; model joint venture model agreements; e-commerce; environment issues; export modules for individual products; foreign exchange derivatives and risk management; geographic indicators; Islamic banking; packaging information (general and product specific); product design for the fashion, textiles and clothing industry;; quality management; and trade finance.

ITC's directories and bibliographies cover importers' associations, online market research, standards, and trade support institutions. ITC also issues periodic trade information bulletins through its Market News Service, packaging bulletins, business and trade policy updates and many other topics.

ITC's suite of market analysis tools are used in over 200 countries by more than 100,000 individual users. These sophisticated electronic products include inquiry systems that enable users to make their own requests for specific information.

ITC's Trade Map provides users with indicators on export performance, international demand, attractive markets and the role of competitors. It covers more than 200 countries and territories and 5,300 products of the Harmonized Commodity Description and Coding System. Trade data is also available at the tariff-line level for 144 countries and on a quarterly and monthly basis for 86 countries. Trade Map assists firms and trade support institutions in understanding the structure and evolution of international markets, helping them to answer questions such as:

- What is the structure of the world market for a product?
- With what countries does my country currently trade?
- Where are opportunities for export market diversification?
- Which countries are competing in a specific market and globally?

Strategic market research with detailed statistical information on international trade flows helps countries answer questions on priority markets, by analyzing national trade performance, potential to increase bilateral trade, analysis of trade flows with other countries and other topics.

ITC's Country Map provides links to national trade support institutions and country-specific business information. It presents trade and market profiles based on trade statistics that benchmark national trade performance and provide indicators on export supply and import demand. Among the key indicators provided is the Trade Performance Index (TPI) which assesses and monitors various export performance and competitiveness dimensions by sector and by country.

ITC's newest database, Standards Map, provides information from most of the well-known standards organizations, including Fairtrade (FLO), Rainforest Alliance, Global GAP, UTZ Certified, Marine Stewardship Council, International Federation of Organic Agriculture Movements. It covers 20 voluntary standards and 40 product and service groups.

There are no databases for services comparable to those for goods. Data on national production of services are limited to a few broad sectors, while data on international trade in services do not cover bilateral flows. However, as discussed later in this chapter, WTO schedules of national commitments under the General Agreement on Trade in Services (GATS) show which WTO members have undertaken commitments in various service sectors.

ASSESSING MARKET CONDITIONS

It is not enough to identify country or product markets of potential export interest. It is also important to understand the conditions of access, including tariffs and a range of non-tariff measures (NTMs). These conditions of access vary across countries and products, and they can be complex. What applies to one exporter for one product may not apply to another exporter or product.

While tariff rates have declined over the years as a result of various negotiations and unilateral reforms, they remain relatively high in a number of key areas for developing countries.¹ Today, NTMs are attracting increased attention. This is partly because they have become more obvious as tariffs have declined, and partly because the incidence of certain measures seems to have increased. The Uruguay Round of trade negotiations eliminated certain NTMs and clarified the rules on the use of other measures. However, anti-dumping actions, health and safety measures, and measures to protect the environment seem to be used more frequently. In some countries, administrative procedures, such as customs formalities, also seem to have a negative effect on trade.

An exporter hoping to exploit a potentially interesting market should first obtain advice from the exporting country's commercial counsellor on the general market conditions and specific problems. The commercial counsellor should also be able to give advice on import channels and specific commercial contacts for marketing. If the advice is positive, it will likely be necessary to engage a customs agent, as well as to make other arrangements for finance and insurance. ITC's various directories are useful in this regard.

ITC's online tool, MacMap, contains information on customs, tariffs and other market access measures affecting trade in goods applied by 187 importing countries to exports from more than 200 countries and territories. It allows users to analyse market access measures by any geographic or sectoral aggregation, and also to simulate tariff reductions using various negotiation formulae.

TARIFFS

Overall, the customs duty rates for goods are now quite moderate. This has led many to dismiss the significance of tariffs, which are now low or even zero in most countries for many products. But recent research shows that on average, tariffs remain more important than NTMs, and more important for some products.² For example, textile and clothing items have rates of over 40% in the United States market, while tariffs on agricultural products – including the ad valorem³ or percentage equivalent of specific and compound rates – can rise to several hundred percent.

At the same time, in some markets NTMs on specific products are now more important, as discussed below. In brief, there is considerable variation across regions and across products. Careful product and market specific analysis is essential for individual exporters. There are a number of complications in the types of tariffs that may be applied, such as: ad valorem or percentage specific, compound, alternative, or seasonal;

¹ This is the case for both agricultural and industrial products. For more information see, ITC, *Market Access for Industrial Products*, Technical paper written by Sam Laird; ITC, *Fostering Trade through Public-Private Dialogue: WTO Negotiations on Agriculture, Commercial and Economic Implications*. Report written following an ITC Roundtable on Agriculture held in Geneva, 29 May 2006.

² Kee, Hiau Looi, A. Nicita and M. Olarreaga, 'Estimating Trade Restrictiveness Indices', *Economic Journal*, January 2009.

³ The term ad valorem is derived from the Latin ad valentiam, meaning 'to the value'. An article of commerce may be subjected to an ad valorem tax in proportion to its value, which is determined by assessment or appraisal. Duties, taxes on goods imported or brought into a country from a foreign country, are either ad valorem or specific. An ad valorem duty is one in the form of a percentage on the value of the property, unlike a specific duty that is a fixed sum imposed on each article of a class, such as all Swiss wristwatches, regardless of their individual values.

bound or applied most favoured nation (MFN) rates; preferences; rules of origin; the basis for valuation; and supplementary charges. Inexperienced exporters would likely benefit from the advice of a customs agent in the importing country.

In developed countries, the average bound MFN tariff rate – the rate set in GATT/WTO negotiations and listed in WTO member schedules of commitments – was 8.67% for agricultural products and 3.25% for industrial products ('non-agricultural products' in WTO terminology) in 2008 (see table 9). In developing countries the comparable rates were 40.38% and 17.87%, respectively.

Table 9: Average tariffs on agricultural and industrial products, 2008 (%)

Agricultural products			Industrial products		
MFN bound	MFN applied	Effectively applied	MFN bound	MFN applied	Effectively applied
Developed countries			Developed countries		
8.67	5.27	3.27	3.25	2.33	1.38
Developing countries			Developing countries		
40.38	14.77	8.18	17.87	6.14	4.56

Source: World Integrated Trade Solution, ITC, World Bank, WTO, UNCTAD.

Note: Averages are import weighted.

In practice, average applied MFN rates are much lower. This can arise where rates were not bound in the past so that there is no comparable bound rate – as is the case for a number of non-agricultural products – or where countries have chosen to reduce their MFN rates, notably in the developing countries under World Bank/International Monetary Fund (IMF) reform programmes. Thus, in 2008 the MFN applied rates of the developed countries were 5.27% for agricultural products and 2.33% for industrial products, while the comparable rates for developing countries were 14.77% and 6.14%, respectively.

Rates may be still lower under various preferential arrangements, such as the Generalized System of Preferences (GSP), special preferences for least developed countries (LDCs), European Union (EU) programmes in favour of the African, Caribbean and Pacific (ACP) countries, or United States programmes such as those under the African Growth and Opportunity Act (AGOA).

Similarly, reciprocal preferences for participants in regional trade agreements, such as the North American Free Trade Agreement (NAFTA), the European Free Trade Association (EFTA) and the Association of Southeast Asian Nations (ASEAN), can also reduce the effectively applied rates. In 2008, the average effectively applied rates of developed countries were 3.27% for agricultural products and 1.38% for industrial products, while the comparable rates for developing countries were 8.18% and 4.56%, respectively (see table 9).

There are two types of tariffs that tend on average to be higher. First, agricultural tariffs are typically higher on average than industrial tariffs because this sector has benefitted from special arrangements that effectively exclude agricultural tariffs from multilateral trade negotiations prior to the Uruguay Round of trade negotiations. Second, average rates in developing countries are typically higher than in developed countries.⁴ This is mainly because in early rounds of trade negotiations under GATT, few demands were made on developing countries to reduce tariffs, partly because their markets were small and of minor interest and partly because of provisions for 'less than full reciprocity' allowing developing countries to use tariffs for development purposes.

Average tariffs can be misleading as there is a wide spread of rates from the very high to as low as zero that may be applicable to certain products and exporters. Table 10 provides examples of products in the agricultural and industrial sector that have high rates in the major developed countries. Agricultural rates are particularly high, influenced by the fact that the rates include estimates of the percentage (or ad valorem equivalent) of rates expressed in specific rates (e.g. US\$ 10 per kilo) or compound rates (e.g. US\$ 10 per kilo and 25%). These estimates are made using techniques agreed by WTO members, based on information on unit values derived from international trade statistics that do not include direct price information.

⁴ There are exceptions, such as Singapore, Hong Kong and China, whose average rates are zero.

Table 10: Examples of products with high rates of duty

Agricultural products with high rates	MFN bound rate (%)	Agricultural products with high rates	MFN bound rate (%)
European Union		Rice in husk	770
Bovine meats (fresh or frozen meat cuts)	76-146	Husked (brown) rice	568
Hams (fresh or frozen)	40-65	Milled rice	770
Swine (fresh or frozen cuts)	11.5-45	Broken rice	693
Prepared bio meats	18-56	Fruit juices	7-43
Sheep	37-104	United States	
Turkeys	4-83	Chicken (cuts)	10.7-12.3
Ducks (fresh or frozen)	13-30	Turkey	6.8-19.7
Dairy products		Dairy products	0.4-120
– Milks and creams	7-185	Mushrooms	11
– Yogurts	3-143	Orange juice (frozen)	39
– Butter milks	7-264	Grapefruit juice (concentrated and frozen)	28.5
– Cheeses	32-100	Citrus juice (concentrated and frozen)	35.2
Dairy spreads	69-98	Cotton yarns and fibres	0.44-32
Cucumbers/gherkins	75.9-79.1	European Union	
Fresh fruits	7-49	Motor vehicles for transporting goods	22
Bananas	1.17	Chassis fitted with engines	19
Rice in husk	36-93	Footwear (various types and parts)	18
Sorghum	0.87	Road tractors for semi-trailers and motor vehicles for the transport of 10 or more persons	16
Wheat (durum)	0.8	Bicycles	15
Mushrooms	153-217	VCRs, TVs and other electrical goods	14
Processed fruits/jams	18-46	Essential oils used in the food and drinks industry	12.8
Fruit juices	13-200	Twine, cordage, ropes and cables	12
Japan		Men's and boys' apparel	12
Hams	178-252	United States	
Meat of swine	135-339	Footwear (various)	37.5-48
Dairy products	108-491	Glassware (various)	25-38
Whey	570-660	Textiles and clothing items (various)	24.9-32
Peas	1085	Goods vehicles (various)	25
Kidney beans	218		
Wheat (durum)	247		
Barley	255		

Source: Consolidated Tariff Schedules, WTO.

Note: Agricultural rates include estimates of the percentage equivalent of specific and compound rates using methodology agreed by WTO members in 2005

Eliminating these high tariffs, known as tariff peaks, is a priority on the multilateral trade agenda. It is now widely accepted among trade negotiators that a tariff peak is an individual tariff rate at least three times higher than the national average. Tariff peaks are less common in developing countries as a result of reforms under World Bank/IMF programmes, which tend to favour flatter tariff structures.

Goods affected by high rates are typically exported by developing countries. This bias in protection against developing country exports is compounded by tariff escalation, which is the increase in the level of tariff rates with the stage of processing. Tariff escalation makes it harder for exporters to develop export-oriented processing industries, for example, by increasing domestic value added to their base commodity production.

THE DOHA ROUND OF TRADE NEGOTIATIONS

The current WTO Doha Round trade negotiations could lead to a reduction in the number of high rates, particularly for non-agricultural products, where rates could be reduced to below 8% in developed countries. If these goods were included in the special sectoral negotiations, the rates could be reduced to zero. This would create market opportunities for those countries that pay MFN rates, including a number of developing countries and LDCs that do not get comprehensive preferences in the EU and the United States markets.

However, for countries enjoying preferences under unilateral schemes or reciprocal preferential agreements, there would be a major reduction in the value of their preferential margins. As a result, existing preference beneficiaries could see a decline in their exports. It is more difficult to predict what the rate will be in individual developing country markets because the current proposals in the WTO negotiations envisage important flexibilities for those countries, as well as additional flexibilities for LDCs, small and vulnerable economies, and countries where the current binding coverage is less than 35% of all tariff lines. This suggests that MFN rates could still be important in fast-growing markets, including China, India and Brazil.

Market access is more complicated for agricultural products than for industrial products. Under the current framework for the WTO negotiations in agriculture, 'tariff reductions will be made through a tiered formula. Progressivity in tariff reductions will be achieved through deeper cuts in higher tariffs with flexibilities for sensitive products.'

The main proposals by developed and developing countries include four tiers within which tariff reductions would be applied using different approaches. However, the developing country proposals also allow for different tiers and tariff reductions for developing countries.

The tiers differ under various proposals on the table. For example, the EU proposal for developed countries suggests tiers with thresholds of initial rates of 0%-30%, 30%-60%, 60%-90% and above 90%. Both groups of countries propose 'tariff caps' to which high tariffs would have to be reduced. These caps are different under the various proposals, with 100% the cap for developed countries. The cap for developing countries is 150% under the EU and Group of Twenty (G20) proposals.

These proposals could lead to substantial tariff reductions. For example, under the EU and G20 proposals, the cuts have been estimated at an average of 30% and a range of 21%-40% for developing countries, and an average of 45% and a range of 31%-46% for developed countries. Under the United States proposal, the cuts would be somewhat deeper.

However, there are provisions for exemptions to the tariff-cutting formulas that could significantly reduce the impact of the proposals. For example, the WTO July Framework⁵ states: 'Members may designate an appropriate number, to be negotiated, of tariff lines to be treated as Sensitive Products', meaning that these would be exempt from the cuts. Proposals for such exemptions range from 1%-15% of tariff lines, which may seem modest. However, the World Bank has estimated that if developed countries excluded as few as 2% of tariff lines, it would reduce their average tariff cuts by half because they have highly skewed tariff structures.

The WTO July Framework allows developing countries to exclude a number of products designated as Special Products, based on criteria such as food security, livelihood security and rural development. This could exclude as much as 20% of tariff lines.

The WTO July Framework also provides for substantial improvement in agricultural market access through combinations of tariff rate quota commitments and tariff reductions. Tariff rate quotas (TRQs), which are mostly applied by developed countries, allow a limited value or volume of imports at a low or modest tariff rate, while imports beyond that limit pay a higher rate of duty. Which source of imports benefits from the in-quota rate is left to the importing country. In practice, the quota is mostly allocated on the basis of historic market share, which is a source of concern to new exporters who seek improved and more transparent quota allocation. Out-of-quota rates would be subject to the tariff cutting formula, and there are proposals for cutting the in-quota rate, which could provide a valuable increase in market access. However, there is an expectation that most countries would designate the tariff lines with TRQs as sensitive, thereby excluding them from tariff cuts.

⁵ The July Framework is a Decision adopted by the WTO General Council on 1 August 2004. (WTO document TN/S/16), paras. 28-29.)

REGIONAL TRADE AGREEMENTS

In addition to WTO negotiations, many countries are involved in regional trade agreements (RTAs), which are reciprocal preferential agreements, not necessarily from the same geographic region. In recent years, most trade liberalization – other than important unilateral reforms in China, India and other developing countries – has taken place through RTAs. Negotiations are underway to expand the number of RTAs and to extend and deepen existing ones.

The significance of this trend can be judged by the rapid expansion in the number RTAs. As of 31 July 2010, some 474 RTAs, counting goods and services notifications separately, have been notified to the GATT/WTO. Of these, 351 RTAs were notified under Article XXIV of the GATT 1947 or GATT 1994 (RTAs in goods between developed or developed and developing countries); 31 under the Enabling Clause (between developing countries, or developed countries and LDCs); and 92 under Article V of the GATS (agreements in services). Up to 31 July 2010, 283 agreements were in force. A comprehensive list of agreements is provided on the WTO website.⁶

If account is taken of RTAs that are in force but have not been notified, those signed but not yet in force, those currently being negotiated, and those in the proposal stage, there were almost 400 RTAs scheduled to be implemented by 2010. Of these RTAs, free trade agreements (FTAs) and partial scope agreements⁷ accounted for over 90%, while customs unions accounted for fewer than 10%.

Today, RTAs span the globe. All WTO members, except Mongolia, are parties to one or more agreements. These are often overlapping, with different product coverage and implementation periods. Economists disagree about the benefits of RTAs. One criticism is that they undermine the credibility of the WTO system, which is anchored in the principle of non-discrimination.

There are some important distinctions in the WTO rules on RTAs between different groups of countries, which explain the disparate coverage and time periods. For example, the main legal texts, GATT Article XXIV and the WTO Understanding on the Interpretation of Article XXIV, concern agreements between developed countries or between developed and developing countries.⁸ They cover free trade areas, where tariffs between partners are eliminated but each partner retains a separate tariff against third countries. They also cover customs unions, where internal tariffs are eliminated and the customs union adopts a common external tariff. The main provisions are:

- Tariffs and other trade measures should be eliminated on essentially all originating trade among the parties (Article XXIV:8).
- The adoption of an RTA does not imply the application of more restrictive trade measures against other, non-party WTO members (Article XXIV:5).
- Agreements are also supposed to be implemented within a 'reasonable time', defined as 10 years.

RTAs among developing countries, including LDCs, are covered by the so-called Enabling Clause, negotiated during the Tokyo Round of trade negotiations in 1979. The requirements for such agreements are less rigorous than under Article XXIV, allowing for less coverage, partial reductions of tariffs and extended implementation periods. These flexibilities mean there is often considerable scope to widen such agreements across regions, for example the new wave of South-South agreements covering many countries across geographic regions.

Agreements may also be extended to include more products. This is important because existing South-South agreements, such as partial scope agreements that were common in Latin America, are often quite limited in product coverage. Agreement can also be deepened by further tariff reductions, some of which are currently set below MFN rates, but at a non-zero level. An important option for facilitating trade under such agreements is to streamline customs and handling procedures, which have often been cumbersome and slow in the past.

The major non-reciprocal schemes of the United States and the EU are now being converted into schemes intended to satisfy the requirements of Article XXIV. The main implication is that developing country partners

⁶ Available at: rtais.wto.org/UI/PublicMaintainRTAHome.aspx

⁷ For the most part, partial scope agreements concern RTAs concluded among developing countries.

⁸ In practice, agreements between developed and developing countries are often asymmetrical in the coverage and implementation periods, allowing developing countries more latitude than under Article XXIV.

will be required to provide preferences to developed country partners. Examples include the new generation of EU Economic Partnership Agreements (EPAs) that are replacing prior unilateral preferences for ACP countries under the Cotonou Agreement. The Cotonou Agreement is a comprehensive partnership agreement between developing countries and the EU. Since 2000, it has been the framework for the EU's relations with 79 countries from Africa, the Caribbean and the Pacific. Developing country partners are being granted extended time periods for implementation and the adjustment process is being supported with bilateral aid.

These recent developments in RTAs mean that market access conditions are continuing to evolve, with implications for parties to such agreements as well as exporters that are not parties. Obviously, countries party to the agreements expect improved access. Countries that are not party may experience negative trade diversion as sources of supply are shifted towards the participants. The business sector needs to carefully monitor developments in such negotiations and to express their views to their governments and trade negotiators.

In addition to tariffs, exporters must consider other charges on imports. In some cases, these are charges for services, including stevedoring, port handling, and customs processing. In other cases, additional charges may simply be other means of protection. These include consular or visa fees, lighthouse charges and statistical taxes. Imports may also be subject to anti-dumping duties, countervailing measures against foreign subsidies, surcharges for safeguard measures⁹ in trade agreements, or for balance of payments purposes. Some of these charges are considered NTMs, which are discussed later in this chapter.

RULES OF ORIGIN

In determining whether an exporting business will benefit from preferential treatment in foreign markets, it is important to consider the often-complex rules of origin (ROOs).¹⁰ These rules, which can vary from one tariff line to the next, are used to determine the appropriate tariff and other treatment to be afforded to imported goods coming from different sources. This is because many goods pass through several stages of processing in different countries, not all of which benefit from the same treatment in the final importing country.

There are two kinds of ROOs: preferential and non-preferential. Non-preferential ROOs are used to determine the country of origin for the application of quotas, anti-dumping, anti-circumvention, statistics or origin labelling. The basis for the non-preferential rules originates from the Kyoto Convention that states that if a product is wholly obtained or produced completely in one country, the product shall be deemed to have origin in that country. A product produced in more than one country shall have origin in the country where the last substantial transformation took place.

Preferential ROOs are used to administer preferences, whether under unilateral schemes such as the Generalized System of Preferences or under a free trade agreement.¹¹ The purpose of the rules is to prevent 'trade deflection' or simply transshipment, where products from non-beneficiary countries are re-directed through a preference beneficiary, perhaps with minimal re-labelling, to avoid payment of customs or anti-dumping duties.

The principal rules used to determine origin are: (i) the percentage of value added in the countries where processing takes place; (ii) whether the transformation of the product in the processing is 'substantial, not simply transhipped or re-labelled in the last country of shipment; or (iii) whether the transformation of the product in its processing leads to a change in its tariff heading. Some countries, such as ASEAN members, use a simple, generalized rule across all products and no one rule dominates. In this case, importing countries may use any or all of these rules, and in the case of the value added rule (ad valorem), the percentage may vary by tariff line.

⁹ A WTO member may take a 'safeguard' action (i.e. restrict imports of a product temporarily) to protect a specific domestic industry from an increase in imports of any product that is causing, or that is threatening to cause, serious injury to the industry.

¹⁰ There is considerable literature on rules of origin, particularly in relation to the use of the Generalized System of Preferences, both in explanatory material as well as economic analysis. See, for example, Inama, S., *Rules of Origin in International Trade*, Cambridge University Press, 2009. This section provides only a brief introduction to alert readers to the importance and complexity of the issue.

¹¹ In principle, customs unions do not require rules of origin because each member affords the same tariff treatment. However, it is possible for individual members of a customs union to have different tariff treatment for third countries, particularly when such unions are in the process of formation. Thus, while Turkey and the European Union have a customs union, Turkey does not afford the same treatment to third countries as the European Union, and goods arriving in Turkey from third countries do not automatically then enter the European Union free of duty.

Box 43: Circumvention through third-country assembly

In a GATT anti-dumping case concerning Brother typewriters from Chinese Taipei, the European Commission terminated investigation proceedings on the ground that the production processes in Chinese Taipei were not sufficient to confirm Taiwanese origin. The practical consequence was that the product assembled in Chinese Taipei continued to have Japanese origin, and therefore was subject to the anti-dumping duties imposed on such products originating in Japan. Subsequently, the customs authorities in some member states took the position that anti-dumping duties should be levied retroactively on prior imported typewriters from Chinese Taipei. German customs authorities ordered Brother to pay over DM 3 million in anti-dumping duties.

Source: WTO Secretariat.

Box 44: The Honda case

The complexities of rules of origin are illustrated by a dispute between Canada and the United States in the early 1990s concerning United States imports of Honda cars undergoing final assembly in Canada, with some parts from Japan and some from the United States. The question was whether the cars could be imported duty free from Canada under the North America Free Trade Agreement (NAFTA) or whether they were considered to be Japanese and subject to higher rates of duty.

Under the 1987 United States-Canada FTA* the origins of automobiles and their components are subject to a change tariff heading (CTH) test, plus a minimum 50% local content requirement. Thus, if some component of an automobile (engines in the Honda case), met the CTH test plus the 50% local content requirement in the United States, they would be considered of United States origin. When an engine was used to complete an automobile in Canada, the value of the engine as a whole (100%) would be counted as North American content and not only 50% of the United States original content, and its whole value would be added to the local content acquired in Canada to fulfil the 50% local content requirement for the complete automobile. Conversely, when the subcomponents did not require originating status, the whole value of the compound counted as foreign, i.e. Japanese.

However, in 1992 a United States customs investigation determined that Honda cars assembled in Canada and exported to the United States did not meet 50% requirement because they contained too many Japanese parts, some of which were part of the engine produced in the United States. United States customs did not treat the engines produced in the United States with Japanese parts and incorporated in Honda cars assembled in Canada as being of 100% United States origin, differing from the Canadian and Honda calculation of North American content. Honda was then asked to pay a retroactive bill of US\$ 17 million for the 2.5% ad valorem tariff Honda had 'evaded' on its exports from Canada to the United States.

According to the ruling, the whole value could not be counted as local content in calculating the required 50% local content from the vehicle. As a consequence, the complete Hondas manufactured in Canada were not considered to be North American as the automobiles no longer met the 50% local requirement, and were subject to duties as if they were exported directly from Japan.

The irony is that at the same time United States authorities were arguing that Honda cars made in the United States were of American origin and should not be counted as Japanese cars against the quota that France maintained at that time on Japanese car imports.

Source: Based on Cantin, F., A. Lowenfeld, 'Rules of Origin: The Canada-US FTA and the Honda case', *American Journal of International Law*, vol. 87, No. 3, 1993.

*This FTA preceded NAFTA, which came into effect in January 1994, and includes Mexico.

For example, in the Pan-European System of Rules of Origin there are some 200 pages of rules varying almost line-by-line. In the Singapore-United States FTA there are over 240 pages of rules. An example of how a little difference in production value-added can affect the determination of origin and hence the level of duty is given in box 44.

There are several features of ROOs that influence which origin is conferred on a product: cumulation, tolerance rules and absorption. Cumulation allows producers to import materials from a specific country or

region without affecting the origin, the most basic form occurring when the materials come from the country for which the final goods are destined. For example, under the African Growth and Opportunity Act (AGOA) an African garment manufacturer/exporter imports fabric from the United States, produces garments with the fabric, and exports the garment to the United States.

Diagonal cumulation occurs where inputs come from an approved third country or region. For example, NAFTA member Canada imports garments from NAFTA member Mexico, which uses fabric produced in the United States, another NAFTA member.

Full cumulation allows qualifying origin to be conferred even if the transformation is not sufficient to meet the normal ROO, in effect simply treating a good as if it were entirely produced in the last country of export.

Tolerance (or de minimis) rules, which relate only to substantial transformation or change of tariff heading, but not to the value added rule, allow a certain percentage of non-originating material to be used without affecting the preference. The absorption principle provides that parts of materials that have acquired originating status by satisfying the ROOs for that product can be treated as being of domestic origin in any further processing or transformation.

ROOs are particularly complex in the case of textiles and clothing, which are very important exports of developing countries and LDCs. For example, in the EU, ROOs for cotton clothing require that the manufacturing process be from yarn forward, meaning that imported fabric cannot be used and the yarn must be produced locally. The United States applies the change of tariff heading rule that precludes the use of imported cotton fabric, yarn and cotton thread, and also requires that visible lining cannot be imported. See box 45 for a discussion of the impact of the relaxed ROOs under AGOA on African countries.

Box 45: Effects of EU and United States rules of origin on African exports of textiles and clothing

Currently the European Union and the United States offer preferential market access to exports from a group of African countries. Although similar regarding the extent of preferences for apparel, a key sector for LDCs, these agreements differ regarding ROOs. The EU's Everything But Arms initiative and the Cotonou Agreement require yarn to be woven into fabric and then made up into apparel in the same country or in a country qualifying for cumulation. However, the African Growth and Opportunity Act (AGOA) grants a special regime to 'lesser developed countries', which allows them to use fabric of any origin and still meet the criteria for preferences.

A recent study found that the relaxation by the United States of ROOs for apparel from Africa under AGOA increased imports from the seven main exporters by about 300%. This large effect was considered to be particularly noteworthy because, 'an analysis based solely on the high utilization rates of preferences might erroneously conclude that the special 'double transformation' requirements in T&A (textiles and apparel) had little effect'. An analysis at the product level revealed that less restrictive ROOs are associated with an expansion of the range of exported apparel. Indeed, under preferential market access, more lenient ROOs reduce costs for exporters and may encourage export diversification or export growth at the margin.

The author claims: 'To our knowledge, this is the first research that has looked at the relationship between ROOs and export diversification.' With respect to the dynamic effects of AGOA-specific rules, the author found evidence that the uptake of preferences was gradual over time, taking place in the first three years during which a country benefits from the specific rules. The research also revealed that the impact of the AGOA-specific rules on exports was different across countries, and that the differences in ROOs accounted for differences in performance. However, the study could not fully take account of the quality of infrastructure, political and social stability, governance, and fiscal policies aimed at attracting foreign investment in accounting for the uneven effects.

The author commented that many analysts believe that the primary reason for Asian investment in apparel industries in African countries was to circumvent United States barriers to imports from Asian countries. But, he notes, the removal of quotas at end of the Agreement on Textiles and Clothing and of any other barriers will erode preferences for apparel exported by those countries in subsequent years, a fact that highlights the importance of lenient ROOs.

Source: Portugal-Perez, A., 'The costs of rules of origin in apparel: African preferential exports to the United States and the European Union', Policy Issues in International Trade and Commodities Study Series No. 39, UN, New York and Geneva, 2008.

Box 46: Implications of the absence of multilateral rules

The absence of multilateral rules of origin has allowed the United States and the EU to issue ad hoc determinations in origin disputes. In the 1980s, an investigation conducted by the European Commission at the Ricoh photocopier plant in California concluded that the photocopiers should be denied United States origin and should continue to be considered Japanese.

Subsequently, the European Commission enacted a specific regulation on the origin of photocopiers. As a result of this origin determination, anti-dumping duties imposed on direct imports of Ricoh photocopiers from Japan were extended to Ricoh exports from California to the EU, despite the fact that these photocopiers presumably included substantial United States value added.

Source: Globalization and the International Trading System, UNCTAD/ITCD/TSB/2. UNCTAD, 24 March 1998.

Currently, the United States applies liberal ROOs to textiles and clothing products from African countries covered by AGOA, but there is no certainty that this tolerance will be continued indefinitely as these rules are reviewed from time to time.

ROOs can protect domestic producers in the importing country. They may also raise the costs of supplying the markets of the importer that grants the preference by requiring changes in production that use higher cost inputs as well as in proving conformity with the rules. ROOs may be an important factor in investment decisions if they create uncertainty as to the degree of preferential access that will be available for the finished goods. ROOs may therefore determine the economic effects of preference systems. However, ROOs are irrelevant for a very large number of items that are duty free in major markets.

There are no WTO provisions on preferential ROOs. WTO members are free to apply their own ROOs, as illustrated in box 46.

NON-TARIFF MEASURES GROW IN IMPORTANCE

The ongoing decline of tariff rates has brought into sharper focus the importance of non-tariff measures (NTMs) that may be used to protect, support and regulate certain sectors. For example, agriculture often benefits from domestic supports as well as export subsidies. The services sector may receive various kinds of assistance, but most importantly is often subject to regulatory measures intended to ensure a standard of service or, intentionally or otherwise, to provide support for domestic suppliers. NTMs may be applied directly or indirectly, for example, to inputs rather than to final goods.

According to recent ITC surveys, NTMs are among the top three trade-related concerns, constituting one of the most important challenges to developing countries' exports, especially in the aftermath of the recent financial crisis. Given that access to information, technical infrastructure and capacities are more limited in developing countries, their exporters are more likely to be negatively affected by NTMs.

NTMS AFFECTING GOODS

NTMs are complex, encompassing policy measures and instruments – except ordinary customs duties – related to exports, imports and production of goods and services. In agriculture, a number of measures affect international markets for key products of export interest to developing countries. For example, the United States provides substantial support to its cotton producers, thus reducing export opportunities for poor countries that have few alternative exports. European countries and the United States offer a range of export subsidies or subsidized export credits that enable their firms to compete more effectively in international markets.

These subsidies hurt developing countries, which do not have the funds to provide similar measures, and are among the key issues in the WTO negotiations. For example, subsidized cereal exports have provided cheap food for net-food-importing countries, many in Africa. However, there is increasing recognition that subsidies discourage local production in extremely poor countries where there is high dependency on agriculture.

NTMs include instruments such as sanitary and phytosanitary measures (SPS), technical barriers to trade (TBT), quotas, anti-competitive measures, import or export licenses, export restrictions. They also include customs surcharges, financial measures, anti-dumping measures, and other charges mentioned in the previous section. In services, where there are few international rules, controls are usually exercised through regulation that may discriminate against foreign suppliers.

To better understand NTMs, international organizations have developed a classification system that allows some measurement of the incidence of NTMs and the share of trade in goods affected by them. Box 47 provides a review of the current system. Further details are provided in the annex.

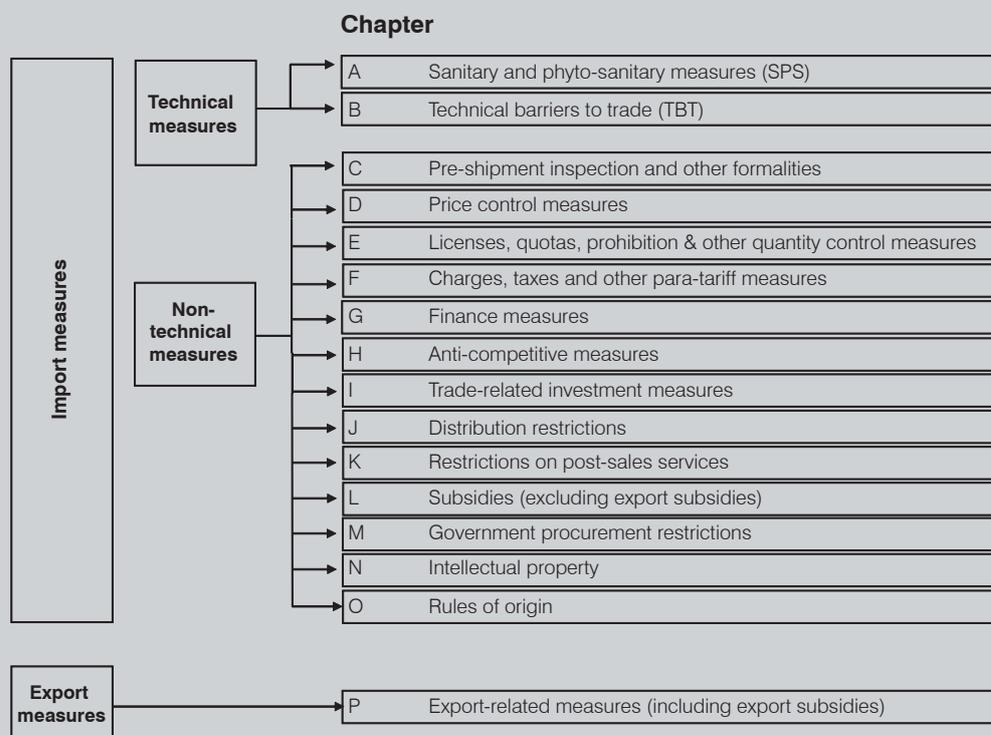
Box 47: Classification of non-tariff measures (NTMs)

In 2009, the following classification of NTMs was prepared by a group of technical experts from the Food and Agriculture Organization, IMF, ITC, OECD, UNCTAD, the United Nations Industrial Development Organization (UNIDO), the World Bank and the WTO. It will be used to collect, classify and disseminate information on NTMs applied in various countries. The goal is to create a global database on the NTMs. UNCTAD, the World Bank and ITC are working together on this project.

NTMs include SPS and TBT measures, quotas, anti-competitive measures, import or export licenses, export restrictions, customs surcharges, financial measures and anti-dumping measures.

The classification differentiates NTMs according to 16 chapters denoted by alphabetical letters, each containing sub-branches (1 digit), twigs (2 digits) and leaves (3 digits). This classification drew upon the existing, but outdated, UNCTAD Coding System of Trade Control Measures (TCMCS), and has been modified and expanded by adding various categories to reflect the current trading conditions.

No data will be collected for several chapters of the classification, including government procurement, subsidies and ROOs.



Source: UNCTAD.

NTMS AFFECTING SERVICES

This section provides a brief introduction to issues exporters of services may face. Trade in services is a highly specialized area with an abundant literature. Interested readers are referred to the websites of WTO, ITC and other major international organizations that have produced general and sector-specific information on international trade in services, some of which is designed to assist developing countries in WTO negotiations and in developing their potential for exporting services.¹²

International trade in services received little attention prior to the Uruguay Round of trade negotiations. One major accomplishment of that Round was the General GATS, intended to bring trade in services within the purview of the WTO. GATS is a framework agreement to be elaborated in future negotiations. GATS also helps to focus policymakers in defining services and how to classify commitments on services. As a result, the NTMs affecting international trade in services were written down.

The WTO classification system consists of 12 core service sectors, which are further subdivided into some 160 sub-sectors.

Business services (including professional services and computer services)

- Communication services
- Construction and related engineering services
- Distribution services
- Educational services
- Environmental services
- Financial services (including insurance and banking)
- Health-related and social services
- Tourism and travel-related services
- Recreational, cultural and sporting services
- Transport services
- Other services not included elsewhere

Under this classification system, any service sector may be included in a member's schedule of commitments with specific market access and national treatment obligations. Each WTO member submitted a schedule under the GATS. GATS spells out four 'modes' by which trade in services was supplied, depending on the territorial presence of the supplier and the consumer at the time of the transaction:

From the territory of one member into the territory of any other member (Mode 1 – cross-border trade);

- In the territory of one member to the service consumer of any other member (Mode 2 – consumption abroad);
- By a service supplier of one member, through commercial presence, in the territory of any other member (Mode 3 – commercial presence);
- By a service supplier of one member, through the presence of natural persons of a member in the territory of any other member (Mode 4 – presence of natural persons).

Box 48 gives examples of the four modes of supply.

The GATS definition of services is somewhat broader than that used for the construction of balance of payments (BOP) statistics. While BOP statistics focus on residency rather than nationality, i.e. a service is exported if it is traded between residents and non-residents, certain transactions falling under the GATS, in particular in the case of Mode 3, typically involve only residents of the country concerned.

¹² A recent publication that may be of interest: Cattaneo, O., *International trade in services: new trends and opportunities for developing countries*, World Bank, Washington, D.C., 2009.

Box 48: Examples of the four modes of supply from the perspective of importing 'country A'

Mode 1: Cross-border trade

A user in country A receives services from abroad through its telecommunications or postal infrastructure. Such supplies may include consultancy or market research reports, tele-medical advice, distance training, or architectural drawings.

Mode 2: Consumption abroad

Nationals of country A have travelled abroad as tourists, students, or patients to consume services.

Mode 3: Commercial presence

The service is provided in country A by a locally established affiliate, subsidiary, or representative office of a foreign-owned and controlled company (bank, hotel group, construction company, etc.)

Mode 4: Presence of natural persons

A foreign national provides a service in country A as an independent supplier (e.g. consultant, health worker) or employee of a service supplier (e.g. consultancy firm, hospital, construction company).

Source: WTO.

Commercial linkages may exist. A company established under Mode 3 in country A may employ nationals from country B (Mode 4) to export services cross border into countries B, C, etc. Similarly, business visits to country A (Mode 4) may be needed to provide technical back up or other support complement; cross-border supplies or, for example, to upgrade the capacity of a locally established office.

As with GATT, the main principles of GATS are MFN and national treatment. The market access available in principle was set out in a written schedule of commitments by each WTO member at the end of the Uruguay Round of trade negotiations and is now being renegotiated in the Doha Round. However, actual treatment may deviate from the commitments, as in the case of goods where applied tariffs are often lower than bound levels. The treatment afforded in practice depends on (i) whether members chose to commit to pre-existing levels of openness when they submitted their schedule of commitments; (ii) whether they have undertaken unilateral reforms, and (iii) whether they have negotiated further market opening under bilateral or regional agreements, which are called Economic Partnership Agreements in GATS terminology.¹³

The WTO provides a hypothetical example for a mythical country, Arcadia, shown in box 49.

Box 49 presents a realistic but simplified scenario. In some countries the schedules of commitments run to many pages. The example of Arcadia illustrates that in the area of services the main measures in use are forms of government regulation establishing areas where foreigners may participate and to what extent. Unlike tariffs, but similar to many non-tariff measures for goods, it is difficult to estimate the quantitative impact of service measures.¹⁴

Access to various sectors of the Arcadian market for services depends on meeting certain conditions that may not even be within the power of the foreign exporting company. By contrast, even in respect of technical barriers to trade, which is discussed later in this chapter, it is up to the foreign company to decide whether or not it will devote the resources necessary to meet a standard in the foreign market and hence gain access.

At the end of the Uruguay Round when service commitments were scheduled, researchers catalogued the existence of measures by WTO members by sector and by type of measure. An example of this effort by the

¹³ GATS EPAs are regional agreements in services only. EU EPAs with ACP partners can cover goods and services.

¹⁴ There have been attempts at estimating the quantitative impact of measures in the area of services, mainly based on gravity models that postulate that the unexplained residual error is associated with the presence of a measure affecting certain flows of international trade in services.

Box 49: Sample schedule of commitments – Arcadia

Modes of supply: (1) Cross-border trade; (2) Consumption abroad; (3) Commercial presence; (4) Presence of natural persons

Sector or sub-sector	Limitations on market access	Limitations on national treatment	Additional commitments
I. Horizontal commitments			
All sectors included in the schedule	(4) Unbound, other than for (a) temporary presence, as intra-corporate transferees, of essential senior executives and specialists; and (b) presence for up to 90 days of representatives of a service provider to negotiate sales of services	(3) Authorization is required for acquisition of land by foreigners	
II. Sector-specific commitments			
4. Distribution services C. Retailing services (CPC 631, 632)	(1) Unbound (except for mail order: none) (2) None (3) Foreign equity participation limited to 51% (4) Unbound, except as indicated in horizontal section	(1) Unbound (except for mail order: none) (2) None (3) Investment grants are available only to companies controlled by Arcadian nationals (4) Unbound	

Source: WTO.

World Bank is shown in table 11, which breaks down the number of commitments by the number of GATS sectors and by high-income countries (HIC) (i.e. developed countries in the World Bank terminology) and by low- and middle-income countries (LMIC) (i.e. developing countries). As noted in the table, these are the actual commitments that are currently being negotiated in the Doha Round, to which must be added commitments made by countries that have acceded to the WTO since the end of the Uruguay Round in 1995.

Generally, developed countries made more commitments than developing countries in almost all sectors (see table 11). Sectors with the fewest commitments were land, water and air transport, postal services, basic telecoms, R&D, education, health and social, and recreation/culture. Developing countries have some export interest in the latter three groups of services. They also have an interest in business services, computer-related services and construction, where there is a relatively high level of commitments.

There have been several studies of developing country interest in future liberalization of the services market. Estimates suggest that liberalization of the temporary movement of labour would be of particular interest, and potentially worth several hundred billion United States dollars to developing countries. However, this is a highly sensitive area and few analysts expect there to be any serious commitment to liberalization except on an ad hoc basis when it suits countries that have serious labour shortages.

Developing countries also have potential interest in transport, back-office services, and tourism. Some developing countries have become successful in retail, legal services, accounting, engineering and health services. Suggestions have been made as to how developing countries can enhance their supply capabilities for international trade in services beyond areas dependent on low-cost labour.

Few observers expect there to be important commitments to new liberalization in the Doha Round of trade negotiations, but there is some evidence of liberalization in practice. Developing countries need to seek out opportunities and determine the specific conditions that will allow them to exploit openings in the services market. Recent sectoral studies by ITC and other agencies could prove a useful starting point, supplemented with specific technical assistance.

Table 11: GATS commitments by sector

GATS Sector	Number of GATS sectors and modes of supply	Average number of commitments		Commitments/GATS items per sector (%)	
		High-income countries	Low- and middle-income countries	High-income countries	Low- and middle-income countries
Construction	20	11.2	3.3	56.0	16.5
Motor vehicle repair	4	1.8	0.3	45.0	7.5
Wholesale trade	8	4.6	0.5	57.5	6.3
Retail trade	8	4.4	0.8	55.0	10.0
Hotel/restaurants	4	2.8	2.8	70.0	70.0
Land transport	40	9.4	2.3	23.5	5.8
Water transport	48	4.4	3.0	9.2	6.3
Air Transport	20	3.7	1.5	18.5	7.5
Auxiliary transport	20	5.1	1.3	25.5	6.5
Postal services	4	1.3	0.6	32.5	15.0
Basic telecoms	28	1.5	1.3	5.4	4.6
Value-added telecom	28	18.7	5.0	66.8	7.8
Financial services	60	31.3	12.4	52.2	20.6
Real estate services	8	3.5	0.3	43.8	3.8
Rental activities	20	9.5	1.3	47.5	6.5
Computer-related	20	15.5	4.2	77.5	21.0
R&D services	12	4.1	1.0	34.2	0.3
Business services	108	56.5	12.2	47.9	11.3
Refuse disposal	16	8.8	1.0	55.0	6.3
Education	20	4.7	1.3	23.5	6.5
Health and social	24	5.0	1.9	20.8	7.9
Recreation/culture	48	13.3	4.6	27.9	9.6

Source: Hoekman, B., 'Assessing the General Agreement on Trade in Services', in Martin, W. and L.A. Winters (eds.), *The Uruguay Round and the Developing Economies*, World Bank, Washington, D.C., 1995.

This is an area where it is not possible to find customs agents who have experience in all manner of goods. Developing countries should challenge the agencies to provide practical advice in their areas of actual and potential interest in making realistic assessments of their capabilities, in identifying markets and conditions of entry, and helping them to meet those requirements. ITC and UNCTAD have already carried out a number of studies in the area of services that provide useful ideas and guidance on how to enter international markets for services.

WHY ARE NTMS USED?

Like tariffs, NTMs are used for a variety of reasons. They may be used as part of national policy to promote production generally, for example, through regional, scientific, or educational policies that provide support that is legal under WTO rules. NTMs may also be used to foster specific sectors favoured by the government. These sectors could include mining, petroleum exploration, farming, manufacture of specific goods, such as motor vehicles or aircraft, or services such as tourism and telecommunications. However, NTMs to foster specific sectors favoured by the government may or may not be permitted under WTO rules.

NTMs may be used for other objectives, such as protecting the environment or human or animal life or plants, including endangered species. Some measures are used for moral reasons, such as prohibitions on pornographic material, or, in some countries, importation of alcohol. Other measures, such as pre-shipment inspection or customs valuation methods, may be used to ensure the right duty is charged and collected. NTMs may also be used for national security reasons, such as prohibition against arms importation or in support of sanctions imposed by the United Nations.

WHAT ARE THE EFFECTS OF NTMS?

NTMs can have potentially serious effects on international trade. They impact the cost, price or quantity of the goods affected. Measures such as anti-dumping duties, countervailing measures and various other charges directly increase prices. Subsidies may directly affect production or exports as a support measures intended to reduce prices or they may operate indirectly as a subsidy on material or other inputs to production or trade. Examples of indirect subsidies are those on the use of fertilizers, water, gas or electricity or on interest rates on borrowed investment capital or export credits for trade. Measures directly affecting quantities may include prohibitions, quantitative restrictions and import licences.

However, other measures not ostensibly intended to have a direct impact on price or quantity may have similar effects. For example, TBT or SPS measures may be intended to protect health. However, public health may be used as an excuse for protecting local industries. Irrespective of the validity of the rationale, the cost of meeting these standards will raise the cost of production and the price. Experience shows that monitoring measures are often a prelude to imposing other restrictions and tend to have a ‘chilling’ or harassing effect on trade, which leads to reductions in quantity or increased prices of the exported goods as exporters try to allay fears of a flood of cheap imports. Either way, the measure will affect both price and quantity of the good concerned, and there will be consequences for trade, production, government revenues and producer and consumer welfare.

There is considerable literature on the technically complicated process of estimating the economic impact of NTMs, which is beyond the scope of this chapter. However, the economic effect of certain measures, and therefore their protectionist potential, can be very significant.

For example, research shows that NTMs contribute to a large share of trade restrictiveness across countries.¹⁵ On average, they add an additional 87% to the restrictiveness imposed by tariffs. This implies that on average tariffs are still more important in the cases covered by the research, but the contribution of NTMs to the overall restrictiveness increases with income per capita. Rich countries have a greater tendency than poor countries to impose less transparent NTMs on their imports.

However, for specific products the impact of NTMs can be higher than the average. For 55% of tariff lines the ad valorem equivalent (AVE) of NTMs is higher than the tariff, with simple average AVE ranging from zero to 51%. These results suggest that tariffs are more important for some products than NTMs, but in other cases the reverse is true – hence, the need for thorough research on market conditions.

A study using firm-level data generated from 16 developing countries in the World Bank Technical Barriers to Trade (TBT) Survey Database, finds that standards increase short-run production costs by requiring additional inputs of labour and capital.¹⁶ It also finds that the fixed costs of compliance are non-trivial; approximately US\$ 425,000 per firm, or on average about 4.7% of value added.

WHO USES NTMS AND WHAT IS THEIR EFFECT?

As shown in box 50, technical regulations and anti-dumping actions are used to a great extent by developed countries, while in developing countries customs procedures, additional charges and regulatory procedures are perceived as the main issues. The exports of developing countries seem to be particularly vulnerable to such measures in developed and developing country markets. There is considerable variation, with some

¹⁵ Kee, Hiau Looi; A. Nicita and M. Olarreaga, ‘Estimating Trade Restrictiveness Indices’, *Economic Journal*, January 2009.

¹⁶ Maskus, K., T. Otsuki and J. Wilson, ‘The Cost of Compliance with Product Standards for Firms in Developing Countries: An Econometric Study’, Policy Research Working Paper 3590, World Bank, Washington, D.C., 2005.

Box 50: Recent trends in NTMs

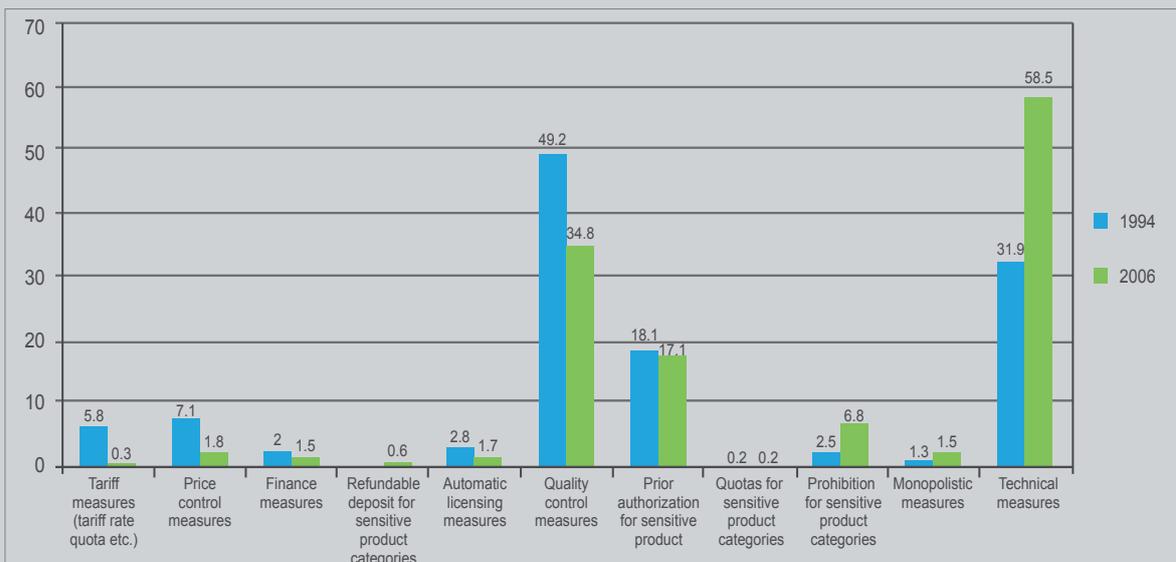
A 2008 UNCTAD survey identified trends between 1994 and 2006 in NTMs of concern to developing countries and found the following:

In accessing developed country markets the most typical barriers faced by developing country exporters are technical measures, including technical regulations, standards and SPS regulations, and price control measures, such as anti-dumping actions.

In trade between developing countries, customs and administrative entry procedures, para-tariff measures (e.g. import surcharges and additional charges), and other regulatory measures affecting infrastructure and institutions are among constraining trade obstacles.

Products of export interest to developing countries, such as agricultural and fisheries products, electrical equipment, pharmaceuticals, textiles and clothing, are the most affected by NTMs. The most recent trend indicates increasing use of technical measures, as well as quantitative measures associated with technical measures, and decreasing use of all other measures.

A report from the Imani Development Board suggests that NTMs have become significantly less identifiable. In the past, state involvement through price controls, foreign currency controls, state marketing and import licensing meant that such barriers to trade were clear. Today, most of these controls have been lifted in most countries. Existing NTMs are inclined to be more arbitrary, qualitative and often non-transparent. The lack of transparency for regulating trade between governments has increased the misuse of the system.



Source: Imani Development Board, *Inventory of Regional Non-Barriers: Synthesis Report*, 2007, UNCTAD, Development and Globalization, Facts and Figures.

developing country markets becoming important users of the anti-dumping mechanism and other developing countries being the main targets. Such measures have a chilling effect on other trading partners and similar products. If exporters see anti-dumping measures being applied against another export business in their own country or from another exporting country for the same or similar products, they may become more cautious in their pricing practices and in aggressive marketing.

There is little question that anti-dumping measures have become more widespread since the end of the Uruguay Round, as tariffs have been reduced and the use of other measures eliminated or curtailed under WTO rules. For example, textile quotas have been eliminated. Exporters should be aware of the countries and sectors that apply these measures as they have often been extended to other exporters. Exporting firms need to be sure that they are exporting at prices that are not lower than their domestic sales price. Table 12 shows which WTO countries have applied such measures by sector between January 1995 and June 2010.

Table 12: Anti-dumping measures initiated January 1995–June 2010, by reporting country and sector

Reporting country	Live animal products	Vegetable products	Animal and vegetable fats	Food, beverages, tobacco	Minerals	Chemicals	Resin, plastic, rubber	Hides, skins, travel goods	Wood, cork articles	Paper	Textiles	Footwear	Stone, ceramic glass	Base metals	Machinery, electrical equipment	Vehicles	Instruments, clocks, recorders	Miscellaneous manufactures	Total
Argentina	1				1	9	13		3	6	17	1	8	60	38	11	5	17	190
Australia		6				10	16		1	19	5		3	18	3				81
Brazil	4	2		1	5	18	17			3	15	1	1	22	9		2	5	105
Canada		4		6		3			4	1		2	2	68	2			2	94
Chile		3										1		4					8
China				1	4	69	36			10	3			11	3				137
Colombia						1	1				6		2	13				1	24
Croatia						1	1						1						3
Czech Republic					1														1
Egypt						3	15						3	9	15			7	52
European Union	4	3			3	53	19	2	9		22	7	2	102	31	7	2	3	269
Guatemala					1														1
India					10	185	71		4	9	58	1	4	37	51	2	2	2	436
Indonesia		4				9	1			4				17					35
Israel				1	3	1	3		5	1	2		2	3					21
Jamaica					3	1													4
Japan						4					3								7
Korea, Republic of						18	7		3	9	5		2	5	19			2	70
Latvia					2														2
Lithuania				1	5	1													7
Malaysia						3	6			13			1			2			25
Mexico	3	4	1	1		14	4			2	2		2	44	2			4	83
New Zealand	1			4		1				3			3	4	6				22
Nicaragua				1															1
Pakistan						5	3				9		1	6					24
Paraguay					1	1													2
Peru			1	3	2	2	1			3	8	5	2	15			2	4	48

Reporting country	Live animal products	Vegetable products	Animal and vegetable fats	Food, beverages, tobacco	Minerals	Chemicals	Resin, plastic, rubber	Hides, skins, travel goods	Wood, cork articles	Paper	Textiles	Footwear	Stone, ceramic glass	Base metals	Machinery, electrical equipment	Vehicles	Instruments, clocks, recorders	Miscellaneous manufactures	Total
Philippines						2	1				2		3	3					11
Poland						1	2				2							4	9
Singapore														2					2
South Africa	1	1				19	26			10	11		14	33	5		8		128
Chinese Taipei					2					1	1	1		7					12
Thailand						2					1		4	23	1				31
Trinidad and Tobago	1				3		1				1				1				7
Turkey						12	47		6		33		5	24	5	1	1	8	142
Ukraine						5			5		4		2	3	4			1	24
United States	11	10		8	4	41	21		2	8	9		2	156	13	1		3	289
Uruguay															1				1
Venezuela (Bolivarian Rep. of)							3				2	4		14			2		25
Total	26	37	2	27	50	494	315	2	42	102	221	23	69	703	209	24	24	63	2433

Today, exporters perceive technical measures as the biggest problem they face, while quantity control measures, such as prohibitions and quotas, have become much less important (see figure in box 50). This is because measures such as textile and clothing restrictions have been eliminated over several rounds of international trade negotiations and in RTAs. At the same time, WTO rules and rules in most RTAs permit the use of technical measures for health and safety reasons. Anti-dumping duties, countervailing measures and safeguards are also permitted to countermand what are considered to be unfair practices by other countries. This issue is discussed later in this chapter, under the section Competition from Third Countries.

Several examples of the issues at stake and some of the frustration dealing with them have been documented for Philippines exporters of agricultural products by the Philippine Institute for Development Studies, as described in box 51.

TECHNICAL BARRIERS: WHY EXPORTERS WORRY

The main concerns of exporters relate to two different types of measures: technical barriers to trade (TBT) and sanitary and phytosanitary (SPS) measures, which are covered by two WTO agreements, as discussed in box 52. These measures usually serve legitimate public policy goals, including protecting human health and safety, or the environment. The WTO does not set these standards. Most standards are set by international organizations: the International Organization for Standardization, the International Electrotechnical Commission, the International Telecommunications Union, the FAO/WHO Codex Alimentarius Commission, the International Office of Epizootics, and the International Plant Protection Convention. These international standards are then rendered in national law, which includes implementing regulations.

However, some countries may use standards that go beyond international standards for domestic reasons, and these may be permitted under WTO rules, subject to certain conditions.

WTO PRINCIPLES FOR STANDARD SETTING

The WTO does not set standards, it establishes rules or principles under which standards must be set and applied. The WTO requires that the setting of standards conform to the following principles:

- Avoidance of unnecessary obstacles to trade;
- Non-discrimination and national treatment;
- Based on scientific principles;
- Harmonization to reduce costs in production, conformity assessment, etc.

Transparency

The ideas behind these principles are that standards need to have valid scientific reasons and that standards and their administration should be fair and transparent. This is intended to protect WTO members from arbitrary decisions taken for protectionist reasons, that is, for the purposes of assisting or sheltering local industry from foreign competition, but hiding behind measures that are purportedly for health or safety reasons.

In addition to arbitrary administration of standards, exporters are concerned that technical barriers can impact negatively on the capacity of firms. Developing countries and LDCs are concerned that arbitrary administration of standards and technical barriers will prevent them from effectively exporting their goods. NTMs can influence supply capacities, export competitiveness and market access for developing countries and LDCs. For example, according to a World Bank study, a strict European Union standard allowing only 4 ppb total aflatoxins in cereals, dried fruits and nuts for direct human consumption is estimated to decrease African exports of these products by 64% or US\$ 670 million. Codex Alimentarius established a less stringent standard 15 ppb.¹⁷

¹⁷ Wilson, J. and T. Otsuki, *Food Safety and Trade: Winners and Losers in a Non-Harmonized World*, World Development Research Group, Washington, D.C., World Bank, 2002.

Box 51: Philippines: examples of NTMs affecting agriculture

Mangoes

The Philippine mango enjoys great demand in East Asia. However, to gain market entry exporters face some stringent requirements. For example, to enter Japan and the Republic of Korea, fruits need to undergo vapour heat treatment (VHT) to remove fruit flies. Government representatives from Japan and the Republic of Korea supervise the process, with the exporting company financing the entire operation, including the expenses of the foreign inspectors' stay in the Philippines. Despite these precautions, Diamond Star Agro Products, a major mango exporter, incurred a loss of approximately PHP 9 million when one of its shipments was found not to comply with Japan's chlorpyrifos residue limits. The company had invested several million pesos to upgrade and improve the testing of its products for exports. Japan intends to further lower the limits for 44 other chemicals, which results in higher costs to exporters for laboratory tests and inspections.

Tuna

The European Union submitted a notification in December 2007 that it would be reducing the maximum residue limit (MRL) of lead in tuna from the 0.5 ppm limit outlined by the internationally accepted Codex Alimentarius to 0.2 ppm. The cited reason was the negative effect of excessive lead on children's intelligence quotient. About 35% of Philippine tuna exports go to the European Union. Hence, this stringent directive alarmed the Philippines. Because the European Union was unable to present strong scientific basis for the proposal, the Philippines submitted a formal position paper claiming that the prevailing 0.5 ppm standard is sufficient to address the EU's concern. The canned tuna industry admits that an MRL of 0.2 ppm will force some exporting companies out of the trade business as natural conditions in the quality of Philippine waters would prevent them from attaining a lower level of lead content.

Chemicals in foods

Some countries impose maximum levels for, or completely prohibit, certain chemicals in foods. For instance, certain chemicals in food colouring traditionally used in the Philippines are banned in the European Union, forcing noodle exporters to alter their production practices and use of ingredients. Similarly, high levels of particular chemicals contained in soy sauce are prohibited, preventing soy sauce exporters from accessing the market. Differing requirements among countries have forced exporters to alter their formulations to suit each one, taking away economies of scale and increasing the necessary capital investment for alternative processes.

Wood packaging

Products are not the only targets of specific processing requirements. In particular, wood packaging material, such as wooden crates and pallets, are required to be fumigated prior to shipment. The Bureau of Plant Industry must certify the fumigation process. Because all accredited fumigators are currently based in Manila, transportation costs add to the exporters' financial burden. The European Union also proposed debarking in addition to fumigation, but this requirement was postponed after receiving complaints from trading partners. The additional requirement was more restrictive than international standards. From 1 January 2009, all wood packaging material imported into the European Union must be debarked.

Labelling

In East Asia, many issues involve sanitary and phytosanitary standards. But EU member states, like other developed countries in the West, are particularly strict when it comes to labelling practices. A shipment by Fiesta Brands, a long-time manufacturer and exporter of coconut products, was delayed because the packaging gave the manufacturing plant address as a particular highway, which it had done for years. However, it was not accepted as an exact address. The company was forced to ask the government for an exact official address, which took nearly two months.

Source: Philippine Institute for Development Studies, Policy Notes No. 2007-10, December 2007.

Box 52: Defining technical barriers to trade and sanitary and phytosanitary measures

Technical barriers to trade (TBT) refer to technical regulations and voluntary standards that set out specific characteristics of a product, such as size, shape, design, functions and performance, or the way a product is labelled or packaged. Also included are technical procedures that confirm products comply with regulations and standards.

Sanitary regulations restrict or prohibit the importation and marketing of certain animal species, or products thereof, to prevent the introduction or spread of pests or diseases.

Phytosanitary regulations restrict or prohibit the importation and marketing of certain plant species, or products of these plants, so as to prevent the introduction or spread of plant pests or pathogens.

Source: Organisation for Economic Co-operation and Development, Technical Barriers to Trade; OECD, Phytosanitary Regulations.

Small and medium-sized enterprises (SMEs) are more vulnerable than larger companies to the effects of trade barriers. SMEs tend to have limited resources and less ability to absorb risks, especially when operating in intensely competitive markets. When faced with trade barriers, SMEs may have to forgo a market completely, or incur additional variable costs that could impair their competitiveness.¹⁸

WHAT CAN EXPORTERS DO ABOUT TECHNICAL BARRIERS?

In preparing a strategy to deal with NTMs, there are four potential options. First, developing countries need to participate more effectively in the work of the international standards setting organizations. However, this requires a high degree of technical skills, and participation is costly and long term.

Second, developing countries may negotiate mutual recognition agreements, which would obviate the need to meet the foreign market standards.¹⁹ This may be an option where the trading partners have similar existing standards, for example, between highly industrialized countries or between developing countries that are parties to a regional agreement. However, it may not be a practical option for developing countries seeking access to sophisticated international markets.

Third, exporters can challenge the use of measures that create unjustified barriers to trade in the WTO dispute settlement process or in negotiation. An example is given in box 53.

Fourth, the most realistic choice for exporters is to try to meet the standards in the markets they seek to penetrate. This is the focus of the remaining part of this section.

Meeting international standards or setting higher national standards is not straightforward. As noted in a recent report by UNIDO, while the TBT and SPS institutional infrastructure and services are taken for granted in industrialized countries, this is often not the case for most developing, potentially exporting, countries where even the rudimentary elements of this infrastructure are missing.²⁰

Acknowledging this problem when the WTO agreements were drafted, a special clause was introduced to suggest that industrialized countries should provide related technical assistance if so requested by those countries not having the full infrastructure in place. Thus, an option is to seek technical assistance from the country whose market the exporter is trying to penetrate. Table 13 lists common needs of exporters related to technical barriers to trade/sanitary and phytosanitary measures (TBT/SPS) compliance requirements, including standards, testing, metrology, system certification, inspection, traceability, packaging and labelling. Table 13 also sets out the infrastructure and institutional services needed to support these requirements.

¹⁸ 'The Role of Trade Barriers in SMEs Internationalisation', Trade Policy Working Paper No. 45, OECD, 2006. Available at: www.oecd.org/dataoecd/34/25/37872326.pdf

¹⁹ Vergano P. and F. Vergano, *Vietnam's Fisheries Exports to the EC Public-Private Collaboration to Address Non-Tariff Measures*, ITC, 2009. Available at: www.intracen.org/btp/publications/vietnam-fisheries.pdf

²⁰ *Trade Capacity Building Report*, UNIDO, 2008. Available at: www.unido.org/fileadmin/media/documents/pdf/tcb_unido_submission.pdf

Box 53: Viet Nam: case study – private associations defend industry

The Vietnam Association of Seafood Exporters and Producers (VASEP) represents most important firms in the sector, promoting seafood exports. When the United States brought an anti-dumping case against VASEP members over catfish exports, VASEP actively supported its members. It established a dedicated fund to defend the case, assisted members to find a law firm to protect their interests, and coordinated the defence.

VASEP also provided information to members as the case developed, launched international campaigns to protect the interests of Vietnamese producers and exporters, and published a White Book to counter price estimates used by United States authorities as proof of dumping. Although its members lost the case, VASEP's campaign set a precedent for future action and was a good example for other business associations in Viet Nam.

Source: The Role of Trade Barriers in SMEs Internationalisation, *Trade Policy Working Paper* No. 45, OECD, 2006. Available at: www.oecd.org/dataoecd/34/25/37872326.pdf

Table 13: Common needs of exporters – TBT/SPS compliance requirements

Exporter's needs	Compliance requirement	Necessary infrastructure and/or service
Access to standards and technical regulations	Product standards/technical regulations, including packaging and labelling	Reference centre in standards body or other organization
Local product testing recognized by the (international) client	Internationally recognized (accredited) conformity assessment services	Testing laboratory upgrading towards internationally recognized accreditation. MRAs (mutual recognition arrangements) between accreditation bodies
Accuracy of measurement, precision manufacture	Internationally recognized equipment calibration; measurement traceability to International System of Units (SI) (measurement) standard	Metrology laboratory upgrading towards internationally recognized accreditation; inter-calibration schemes
Ensure continuity of product characteristics and quality	Enterprise Quality Management System Certification (ISO 9001)	Certification and consultancy capacity, and internationally recognized certifiers
Ensure continuity in managing environmental impact	Enterprise Environmental Management System Certification (ISO 14001)	Certification and consultancy capacity, and internationally recognized certifiers
Food safety assurance	Management system to control food contamination (HACCP)	Certification and consultancy capacity, and internationally recognized certifiers
Address consumer concerns relating to child labour, workers exploitation, etc.	Social accountability (SA8000)	Certification and consultancy capacity, and internationally recognized certifiers.
Traceability of products and inputs from fork/shelf to farm/producer	Traceability system	Certification and consultancy capacity, and internationally recognized certifiers
Examination of shipment content to order	Product inspection	Cross-border inspection services

Source: Trade Capacity Building Report, UNIDO, 2008.

For exporters to provide proof of compliance with common international standards in the TBT/SPS agreements, complex standards, metrology, testing and quality (SMTQ) infrastructure is required. This can be implemented in either a country or a region.

Countries implement these various requirements so that their exports can enter target markets. Creating domestic standards and using internationally recognized standards also helps countries avoid becoming dumping grounds for sub-standard products, upgrades their image, and increases the marketability of their products and processes.

Exporting countries need to establish two key institutions: a standards body and an accreditation body. The standards body is 'responsible for standards formulation, dissemination, consumer protection and market surveillance'.²¹ It should be a member of international standards setting organizations (ISO, CODEX), and function as the de-facto WTO TBT/SPS enquiry point. The accreditation body provides the critical conformity assessment infrastructure. Domestically, the accreditation body is responsible for accrediting laboratories, system certifiers and inspection bodies.

In some countries, national standards bodies (NSB) are called 'institutions' or 'institutes' (e.g. Sri Lanka Standards Institution, British Standards Institute); in other countries they are called 'associations' (e.g. Standards Association of Zimbabwe) or 'bureaus' (e.g. Bureau of Indian Standards).

In addition to this institutional infrastructure, enterprises also require various management system certifications. The national standards body is typically responsible for both generating awareness of these management systems at enterprise level and for training auditors.

To attain system certification, the country requires internationally recognized certification bodies. Enterprises also need testing services for chemical, microbiology, textile and leather, and other products. In the global trading environment, laboratories providing such services must have international accreditation to guarantee global acceptance of the certificates granted, and to avoid costly duplicative foreign testing.

Establishing operational systems for conformity assessment and accreditation or upgrading existing national systems to meet foreign market requirements tends to require technical assistance from relevant international agencies. When developing infrastructure for the compliance required to support a country's exports, the following steps are important:

- Identify the country's export sectors and the range of products produced;
- Identify the markets for which these products are destined and the TBT/SPS requirements that must be met in those markets;
- Determine the trade volumes and calculate the number of laboratory tests and inspections, equipment calibrations and enterprise system certifications needed to meet TBT/SPS conformity requirements.²²

The UNIDO website states the following:

'The range of identified tests defines the necessary laboratory infrastructure – calibration, microbiological, chemical, and other sector-specific testing.

Each laboratory category would respond to the identified spectrum of tests and have to dispose of the defined capacity of tests to be conducted.

Then, depending on the extent of the country export potential, key export sectors, geographic dispersion of export production, the number of laboratories required to satisfy the testing needs can be approximated.²³

Governments can use various strategies when upgrading infrastructure and seeking accreditation of existing laboratories:

- **Public-private partnerships (PPPs).** Private sector participation in the design, financing and execution of infrastructure projects is recognized as a means to reduce the large gap between infrastructure needs and limited government resources.²⁴ Public-private partnerships (PPPs) are common instruments for infrastructure projects for quality, sanitary and phytosanitary controls and compliance.
- **Attract foreign investment.** Internationally recognized laboratories could be invited to invest. Investors can generate adequate returns by charging appropriate fees for testing.

²¹ For further information see the UNIDO webpage, Standards Bodies, available at: www.unido.org/index.php?id=o72302

²² *Ibid.*

²³ *Ibid.*

²⁴ Aggarwal, R. and A. Huelin, 'The private sector: Important partners in aid for trade,' *International Trade Forum*, Issue 4/2009, ITC, 2009. Available at: www.tradeforum.org/news/fullstory.php/aid/1495/The_private_sector:_Important_partners_in_aid_for_trade.html

Box 54: Sri Lanka: internationally recognized conformity infrastructure

Sri Lanka's export sector is based on processed products such as garments and textiles, ceramics, rubber and shrimp. In the absence of internationally accredited testing laboratories able to issue globally accepted testing certificates, Sri Lankan exporters were faced with the problem of proving compliance with international market requirements and getting their products to these markets. Recognizing the importance of having testing capacities developed locally, UNIDO, with a financial contribution of US\$ 1.8 million from the Norwegian Agency for Development Cooperation (NORAD), provided significant support for Sri Lanka's conformity infrastructure.

The assistance was timely and of strategic importance, not only in cutting the high costs of testing nationally manufactured products abroad, but also in providing Sri Lankan exporters assurance of the conformity of their products with international standards and those of recipient markets.

The UNIDO/NORAD support resulted in seven internationally accredited laboratories in Sri Lanka for food analysis and chemical, microbiological and rubber/plastics testing. It helped establish and upgrade the testing laboratories following the ISO/IEC 17025 guidelines and led them towards international accreditation from the Swedish Board for Accreditation and Conformity Assessment (SWEDAC). To ensure testing accuracy and ensure reliable calibration of testing equipment, the country's metrology capabilities were strengthened by upgrading the industrial metrology laboratories in the areas of dimensional, volume, mass, thermometry, pressure and electrical metrology so as to achieve international accreditation of their services through SWEDAC.

Source: Industrial Development Report, UNIDO, 2009.

- **Business-to-business assistance.**²⁵ By establishing links between large corporations and SMEs, local firms can boost their competitiveness and become integrated into global supply chains. The main reasons given by foreign investors for low levels of purchases from local suppliers include concerns that goods and services from local suppliers do not meet their quality, price and delivery requirements. Foreign investors often regard local suppliers as unresponsive to their requests for improved quality, delivery and price. Large companies can assist in overcoming these trade barriers and act as channels for small producers to export their goods and services. They can also help small producers enhance the quality of their products through training programmes and contractual arrangements.
- **Regional cooperation.** Establishing laboratories for use by exporters from several countries can create economies of scale and maintain adequate standards. One example is the Quality Programme adopted by the Economic Community of West African States (ECOWAS), which is in the process of being enforced across the sub-region.²⁶
- **Financial and technical assistance.** Financial and technical assistance can be sought from international donors to upgrade compliance infrastructure in the areas of standards and conformity assessment – testing, calibration and accreditation. Box 54 details the benefit of donor assistance in Sri Lanka.
- **Trade advocacy.** Governments can assist exporters to overcome trade barriers by 'directly interceding on exporters' behalf with foreign government officials. This can involve various actions, including active in-market representation by consular staff, meetings by high-level government officials, or discussion in multilateral fora'.²⁷

²⁵ *Ibid.*

²⁶ Trade and Investment Conference, ECOWAS, 2009. Available at: acpbusinessclimate.org/projets/WP2.28.2-1.057/documents/WP2.28.2-1.057_brochure_en.pdf

²⁷ *Ibid.*

EXPORTING IN THE PRESENCE OF DOMINANT FIRMS

Today, a large share of international trade is intra-firm trade, which takes place within rather than between firms. As economies grow, an increasing share of their trade occurs within the same broad industry, intra-industry trade, with trade in intermediate products such as parts sent for incorporation into a final (or other intermediate) product in another country. An example is steel plate or engines for incorporation into cars.

In some areas, such as trade in fresh produce, firms have virtual monopolies as sellers, or monopsonies (a market in which only one buyer faces many sellers) as purchasers, or both. It is often very difficult for individuals or small businesses to enter such markets as independent traders. Moreover, when dealing with such large enterprises, developing country businesses may not always receive what they consider to be fair prices, which is part of the impetus for the fair trade movement of recent years. At the same time, there is widespread recognition that in the right conditions such alliances can be beneficial.²⁸

Where there are dominant firms, penetrating foreign markets may require making strategic marketing alliances or joining part of a value chain. This approach can apply to goods as well as services. Value chains are also important in trade in intermediate products, which are estimated to account for 56% of trade in goods and 73% of trade in services.²⁹ This is because inward foreign direct investment from transnational companies and sales of foreign affiliates in services – as well outward stocks and sales of foreign affiliates – also generate imports of intermediate products, which underlines the importance of vertical specialization networks.³⁰ Vertical specialization networks are production arrangements in which firms make final goods in multiple stages located in multiple countries.

THE IMPORTANCE OF VALUE CHAINS

For developing countries, these findings regarding the size of trade in intermediate products are significant because these countries are important exporters of raw materials and intermediate products, while their presence in trade in finished goods is more limited. However, there is the possibility that with training or experience they may be able to move up the production chain into more advanced manufactured products. Trade in intermediate products is highly price sensitive and it is easy for large firms to switch sources of supply. This underscores the usefulness of participating in value chains that provide stable contractual relationships.

Value chains cover the range of transactions and support services, such as finance, logistics and transport, required to bring a product or service from its origins to its end use. Thus, value chains begin with raw materials and other inputs, moving through production and processing into packaging, marketing and sales in domestic and international markets. For every product or service, value chains include all of the enterprises involved in supplying, producing, processing and buying, as well as the organizations that provide the technical, business and financial services to support the export process.³¹

In addition to the benefits of participating in trade in intermediates, participating in a value chain has several advantages for the small exporter from a marketing perspective. Value chain participation offers a package of information on the mechanics of trading, including finance, transport and customs, as well as information on packaging and labelling and market requirements. It may offer information about shifts in demand so that the exporter can adapt rapidly to change. It may also provide useful allies against protectionist threats and other changes in the conditions of access. For example, allies in the United States market helped to enact the AGOA and maintain rules of origin beneficial to African exporters.

²⁸ *Unleashing Entrepreneurship: Making Business Work for the Poor*, UN Commission on the Private Sector and Development, UNDP, 2008. Available at: www.undp.org/cpsd/indexF.html

Creating Value for All: Strategies for Doing Business with the Poor, UNDP 2008. Available at: www.undp.org/gimlaunch

²⁹ Miroudot, S., R. Lanz and A. Ragoussis, 'Trade in Intermediate Goods and Services', OECD Trade Policy Working Paper No. 93, OECD, Paris, 2009. World Trade Report 2008 – *Trade in a Globalizing World*, WTO, Geneva, 2009.

³⁰ *Ibid.*

³¹ Kaplinsky, R. and M. Morris, *A Handbook for Value Chain Research*, International Development Research Council, Ottawa, 2000. Available at: www.globalvaluechains.org/docs/VchNov01.pdf.

Deutsche Gesellschaft für Technische Zusammenarbeit (GTZ), USAID and other development organizations have also produced useful guides and methodologies on the value chain.

Another example is Thailand, which has become a hub of vehicle production for regional and global markets through its linkages with car producers and parts and components suppliers (see box 55). Thailand's business-friendly environment, important policy reforms and greater regional integration were important. However, transnational corporations at different levels of the production process and in the international marketing of the final product also played a key role.

ITC BUILDS CAPACITY

ITC assists small business by connecting them with value chains or supporting them to be able to engage in direct marketing. For example, ITC assists enterprises to connect directly with buyers and learn the precise specifications and quality requirements of major markets. ITC also sponsors exporters to prepare for and attend international trade fairs. ITC facilitates bringing buyers and sellers together in face-to-face meetings. However, success requires careful preparation, including trade flow analyses that help to identify products with complementary business interests; supply and demand surveys documenting market characteristics and business practices; and identifying enterprises most active in particular product sectors.

Box 55: Thailand: global integration of the auto industry

In Thailand, as in many other countries, the automobile industry was an early target for industrial development through import substitution. Tariffs on completely knocked down (CKD) kits were set much lower than completely built up (CBU) vehicles to encourage local assembly. Concern that the initial scheme had failed to lead to broader-based industrial development prompted Thailand to adopt a local content policy in 1975, with corresponding adjustment of tariff rates on CBUs and CKD kits to provide greater incentives to use local parts. Local content requirements were increased in the mid-1980s.

The late 1980s saw a shift from domestic market orientation towards global integration, setting the stage for Thailand to emerge as a centre of automobile and auto part manufacturing in the region. The Thai economy entered a period of rapid economic growth. Limits on the number of series of local cars and the import ban on imports of new cars were lifted. The abolition of the local content scheme from 2000 was announced as part of Thailand's compliance with the new WTO Trade-Related Investment Measures Agreement. In the area of foreign direct investment policy, all selective incentives granted to export-oriented activities and a 49% equity ownership restriction on domestic market oriented projects were abolished, with immediate effect in 1999.

In 1995, Thailand became a signatory to the ASEAN Brand-to-Brand Complementation Scheme, aimed at promoting trade in parts and components among automotive companies operating in the ASEAN region. Thailand also implemented general tariff cuts on CBU passenger vehicles and rates were also reduced in successive stages on CKD kits starting in 1992, exposing the domestic industry to increased competition.

However, the cascading nature of the tariff structure provides substantial effective protection from domestic motor vehicle production, estimated as high as 64.8%, but this has not been a binding constraint on auto exports since the local industry has become integrated in a global network.

Under the domestic reforms and the greater integration in the ASEAN and the wider Asia Pacific region, the Thai auto industry has undergone a major transformation and has experienced rapid export-oriented growth. No single factor explains this success. However, credit is given to multinational corporations that set up production plants in Thailand to service the global market.

While major companies such as Toyota and Honda use Thailand as an important regional production base for small cars, most manufacturers also use Thailand as the main base for one-ton pickups, which like the small cars are then marketed through their outlets in other countries. It is also notable that of the 1,454 indigenous parts suppliers, the large majority of first-tier suppliers operate under technology agreements with foreign producers.

Source: Athurkola, P. and A. Kohpaiboon, Thailand in Global Automobile Networks, Case Study, ITC, Geneva, 2011.

ITC then provides the platform for negotiations between ‘matched’ enterprises, which are expected to show their commitment by covering the costs of their participation. ITC also has programmes to assist small businesses in marketing using modern information technologies.

COMPETITION FROM THIRD COUNTRIES

Exporters trying to penetrate a foreign market must be concerned about competition from other third country exporters. As discussed earlier, an important factor is differing terms of access for different exporters. Some exporters may be eligible for preferential tariff treatment, more favourable ROOs, or application of NTMs whose impact may not fall equally on all third countries.

Competitors for foreign markets may use various instruments to promote national exports, some of which may not comply with international rules. For example, if the competitor is using an export subsidy, it is likely illegal for products, but unlikely to be illegal under current rules for services exports. Whether subsidies are currently legal for agricultural exports depends on whether they were declared during the Uruguay Round of trade negotiations and whether the levels fall within the scale of commitments for cutting back their use.

Exporters faced with illegal subsidies can resort to bilateral discussions and, if that fails, invoke the WTO dispute settlement mechanism. This approach was used successfully in recent years by non-beneficiary countries, mainly in Latin America, against European Union policies supporting bananas from ACP countries. However, it seems unlikely that an importing country would pursue an anti-dumping action against a business competitor from a third country for the benefit of a disadvantaged exporter.

In the case of legal supports by third country competitors, the longer-term solution is to seek to change the rules by negotiation. The disadvantaged exporting country should seek support from a coalition of other interested governments. This is what has happened with the agreed elimination of agricultural export subsidies in the current WTO Doha Round of trade negotiations, although implementation will not likely be achieved until the negotiations are concluded.

CONCLUSION

STRATEGIES FOR MARKET ACCESS

The business sector has a vital interest in shifting market trends and conditions of access, changes in trade and related policies, and negotiations affecting trade in goods and services. Developing country exports have grown at high rates in recent years, and ITC has a range of tools to help exporters identify market opportunities.

While average tariffs on agricultural and industrial goods are modest, there are important areas of interest to developing countries and LDCs where protection levels are quite high and NTMs can be important – in some cases more important than tariffs. In the case of services, it is difficult to assess the impact of trade regulations, and there have been only a few attempts to make such calculations. However, restrictions on the movement of labour seem to have a strong negative effect on the potential earnings of the developing countries. Negotiated changes in trade regimes will present new opportunities for some countries and pose challenges for others, for example, through the loss of preferences. Businesses must prepare for change.

Businesses have considerable concerns about the growing incidence of NTMs, such as TBT and SPS. Environmental measures and anti-dumping duties are also more important today. This is partly due to success in reducing tariffs and eliminating quotas and other NTMs in earlier trade negotiations. Occasionally, the issue is not the existence of such measures, which may be for socially desirable reasons, such as environmental protection, but the manner in which they are administered. WTO and most regional agreements make provision for consultations and dispute settlement procedures to resolve disagreement concerning the use of NTMs. NTMs are being discussed in several areas of the Doha Round of trade negotiations, potentially leading to further clarifications on the use of NTMs.

In December 2005, a WTO Ministerial Declaration recognized the key role ITC can play as an interlocutor for business and a provider of technical assistance. The Ministers declared, ‘We encourage all [WTO] Members

to cooperate with the International Trade Centre, which complements the work of the WTO by providing a platform for business to interact with trade negotiators, and practical advice for [SMEs] to benefit from the multilateral trading system.'

ITC disseminates information about the state of trade negotiations to the business community in the developing world. This has contributed towards enabling the business community to play a more active advocacy role with their governments, particularly in relation to sector-specific analyses where the negotiations will have a direct bearing on their future activities. Examples include new market opportunities as barriers come down in foreign markets or pressure to adjust as protection of the domestic market is reduced.

In addition to more active advocacy to promote their own interests in trade negotiations, developing countries need to position themselves to take advantage of trade opportunities resulting from trade policy changes and market developments. Identifying markets, including potential niches, and the conditions for success in those markets (such as changing trends and tastes) are essential areas where ITC provides assistance.

While WTO negotiations have moved slowly, partly due to the complexity of issues and number of participants, there has been a rapid increase in the number of regional agreements in recent years. This trend seems to be continuing. One explanation for this trend is pressure from business communities that have strong links in neighbouring countries where business can more clearly calculate the potential gains and risks from strengthening ties in wider regional markets without waiting for results from the WTO. Business needs to take an active role in all of these negotiations to ensure that the outcome facilitates trade and investment, and that bureaucratic obstacles are minimized.

WTO negotiations will lead to a loss of preferences in some key areas of interest to developing countries. For example, African countries should not expect to continue to benefit from the United States' Africa Growth and Opportunity Act to the same degree as in the past. Businesses must move from a strategy based on exploiting preferences toward one of increasing competitiveness in international markets, including by participating in global value chains. Raising productivity and reducing costs are key to increasing competitiveness. Government action is also needed to improve infrastructure, vocational training, financial markets, and legal and institutional frameworks, while reducing bureaucratic obstacles to doing business and facilitating investment.

Businesses must be alert to challenges arising from changes in trading conditions, including the emergence of new competitors and the use by third countries of various legal and illegal instruments to promote their exports. Changes in trade regimes at home and abroad may lead to increased competition. Businesses may be able to meet this competition by improving their competitiveness in existing lines of production. However, businesses may also need to adapt, for example, by shifting to alternative products based on existing technological bases.

Governments must be concerned about negative effects on the private sector as well as in the labour market. Governments may need to implement adjustment programmes, supporting retraining of workers to help them and the businesses in which they are employed to cope with changes, and, where necessary, facilitate movement into new lines of production.

Changes in trade regimes rarely occur overnight. The business community and governments normally have some time to adapt to new situations. In the WTO there is usually an implementation period of 5 to 10 years, which may require legislative action by member states. However, in the past some shifts have occurred relatively quickly and a number of developing countries have had difficulties in adapting to new situations. Assistance is available from ITC and other international organizations, through bilateral support, and from NGOs.

ANNEX: NON-TARIFF MEASURES – CLASSIFICATION FOR TRADE IN GOODS

The following taxonomy of NTMs was prepared by technical experts from international organizations, including the Food and Agriculture Organization of the United Nations (FAO), International Monetary Fund (IMF), ITC, Organisation for Economic Co-operation and Development (OECD), United Nations Conference on Trade and Development (UNCTAD), United Nations Industrial Development Organization (UNIDO), the World Bank and World Trade Organization (WTO). This classification is used to collect, classify, analyse and disseminate information on NTMs received from official sources, such as government regulations, and from perception-based data, such as surveys.

The classification differentiates NTMs according to 16 chapters (denoted by alphabetical letters), each comprising sub-branches (1-digit), twigs (2-digits) and leaves (3-digits). This classification drew upon the existing, but outdated, UNCTAD Coding System of Trade Control Measures (TCMCS), and has been modified and expanded by adding various categories of measures to reflect current trading conditions. The current NTM classification was finalized in November 2009.

Chapter A, on sanitary and phytosanitary (SPS) measures, refers to laws, decrees, regulations, requirements, standards and procedures to protect human, animal or plant life or health from risks such as the establishment or spread of pests, diseases, disease-carrying organisms or disease-causing organisms; and risks from additives, contaminants, toxins, disease-causing organisms in foods, beverages or feedstuffs. The chapter is also known as SPS.

Chapter B, on technical measures, contains measures involving technical specification of products or production processes and conformity assessment systems. This chapter is also known as technical barriers to trade (TBT). TBT measures are most often applied to industrial goods, but can be also applied to agricultural products. An NTM applied to agricultural products is classified as a technical measure if its objective is not food safety. If the objective is food safety, the measure is classified as SPS.

Chapter C, on pre-shipment inspection and other (customs) formalities, refers to checking, consigning, monitoring and controlling shipments of goods before or at entry into the destination country. Inspections and quarantine are examples of such measures.

Chapter D, on price control measures, includes measures to control the prices of imported articles to: support the domestic price of certain products when the import prices of these goods are lower; establish the domestic price of certain products because of price fluctuation in domestic markets or price instability in a foreign market; and counteract the damage resulting from 'unfair' foreign trade practices.

Chapter E, on licences, quotas, prohibitions and other quantity control measures, includes measures that restrain the quantity traded, such as quotas, and licenses and import prohibitions that are not SPS-related (SPS-related licenses and prohibitions are classified under Chapter A).

Chapter F, on charges, taxes and other para-tariff measures, refers to measures, other than tariff measures, that increase the cost of imports in a similar manner, i.e. by a fixed percentage or amount. These are also known as para-tariff measures.

Chapter G, on finance measures, refers to measures that are intended to regulate the access to and cost of foreign exchange for imports and define the terms of payment.

Chapter H, on anti-competitive measures, refers to measures that are intended to grant exclusive or special preferences or privileges to one or more limited groups of economic operators.

Chapter I, on trade related investment measures, covers measures that restrict investment by requiring local content, or requiring that investment should be related to export to balance imports.

Chapter J, on distribution restrictions, refers to restrictive measures related to internal distribution of imported products.

Chapter K, on restriction on post-sales services, refers to measures restricting producers of exported goods from providing post-sales service in the importing country.

Chapter L, on subsidies, includes measures related to domestic government support to producers, such as direct or potential transfer of funds (e.g. grants, loans, equity infusions), payments to a funding mechanism and income or price support.

Chapter M, on government procurement restrictions, refers to measures controlling the purchase of goods by government agencies, generally by preferring national providers

Chapter N on intellectual property refers to measures related to intellectual property rights in trade. Intellectual property legislation covers patents, trademarks, industrial designs, layout designs of integrated circuits, copyright, geographical indications and trade secrets.

Chapter O, on rules of origin, covers laws, regulations and administrative determinations of general application applied by government of importing countries to determine the country of origin of goods.

Chapter P, on export-related measures, encompasses all measures that countries apply to their exports. It includes export taxes, export quotas or export prohibitions, among others. This chapter has to be used when the measure is applied by the exporting country, i.e. when certain documentation has to be granted by the home country's customs, which is not required by the importing partner. All the other chapters (A to O) refer to measures that countries apply to their imports.

CHAPTER 5

IMPROVE INPUTS AND CAPITAL GOODS

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IMPROVE INPUTS AND CAPITAL GOODS

INTRODUCTION

Access to inputs of goods and services at world prices and ability to take advantage of export opportunities under given conditions of access, discussed in chapter 4, may be crucial to export competitiveness. Ultimately, given equal terms of access as competitors, competitiveness in a foreign market implies being able to deliver at a final price that is lower than that of competitors taking account of conditions of sale, quality, delivery times and, where appropriate, after sales services. This final price of the good or service is itself a composite of production costs as well as delivery costs, which may be even higher than the costs of production.

For example, the cost of production of a banana in Latin America has been estimated at as little as 10% of the final retail price in a European supermarket. The remaining 90% of the retail price is explained by the various services that are used in getting the banana from the farm gate to the supermarket shelf. For other products, the corresponding percentage likely ranges from 10% to 50%. Everything else being equal, international competitiveness depends largely on the price of imports of goods and services used not only in production but also in the delivery of the good or service to the consumer or user.

At the production level – the farm or factory gate or equivalent in services – the key factors in competitiveness are total factor productivity and the cost of inputs into the production process. In turn, productivity depends on a number of factors, such as technology, the quality of labour (the appropriate skill/wage cost combination), and management. The appropriate technology can vary according to the production scale and cost of other inputs, such as labour, energy and so on, in the producing country. For example, the appropriate technology in a small market, protected by high transport costs, and where labour costs are also low may be quite different from a large market with high labour costs in an industry subject to important economies of scale.

As an illustration, in a small country iron ingots might be produced economically in a simple charcoal foundry. At a different level of sophistication, steel might be produced in a mini-mill (depending on access to scrap metal), while in a large country a fully integrated steel mill might be appropriate. However, when it comes to exporting, the large-scale producer will likely capture the global market, but there may still be export opportunities for small-scale producers in neighbouring countries that are also distant from the large-scale producer. As a result, international competitiveness may depend on having access to technology and inputs of materials, parts and components at world prices.

However, the final retail price also depends on the costs of the services required to deliver the goods or services to the purchaser, including transport, insurance, finance and telecommunications, etc. The exporting country also needs to look at liberalization in the services sectors to ensure that its exports of goods have access to services at world prices. This is equally, if not more, important for exports of services, such as tourism, and other potential exports in business services, banking and information technology industries where some developing countries are now achieving export success.

How can developing country producers of goods and services who wish to achieve international competitiveness ensure they have access to inputs at world prices? It may well be that in the relevant sector the domestic market is highly competitive and already produces goods and services at world prices because of domestic competition. However, not all countries can achieve comparative advantage in all sectors even if they have absolute advantage in all areas, which is unlikely.

In the delivery of goods and services to international markets, does the exporter have access to the services necessary for trade at competitive prices? In the longer term, it is desirable to try to assure openness to competition from world price suppliers to keep the domestic market competitive and provide inputs at world prices for exporters of goods and services.

MARKET OPENNESS CAN REDUCE COSTS

It is generally accepted among economists that, subject to certain qualifications, openness is the key to economic growth, at least in the long term. This has been key in the policy prescriptions of international financial institutions for many years. This is based on the notion that openness leads to cost-reducing specialization, to improved allocation of scarce resources, to the improved functioning of the economy, and hence to growth.

But there are situations that may warrant some form of intervention, based on long-standing ideas in welfare economics and the so-called theory of the second-best, for example, to protect the environment.¹ There is no guarantee that the process of moving towards greater openness will be achieved quickly and without costly adjustment. This leads to the discussion in the next section as to how to reduce the costs of exporters while the move to greater openness is being phased in.

While some industrial countries have pursued more openness to trade, others pursued a more cautious approach. Many economies turned inwards in the wake of the depression of the 1930s, leaving high tariff and non-tariff barriers (NTBs) that have taken many years to reduce. In developing countries, there was also a period when the thinking in development economics was in favour of import-substitution industrialization. This was based on the work of Raúl Prebisch² of the Economic Commission for Latin America and of Hans Singer,³ then at the United Nations Department of Economic Affairs. Singer warned of a long-term deterioration in the terms of trade for developing countries, with their commodity export prices falling relative to their manufacturing import prices.

Contrary to the views of many neo-classical economists at the time, the Prebisch-Singer thesis (as it came to be called) foresaw that a continuing dependence on primary exports would lead most developing countries down the path of increasing indebtedness and would widen global income inequalities. On these terms, free trade could never be fair trade, and they called for import substitution, tariff controls and a drive for industrialization.⁴ Their work also became the basis for the Generalized System of Preferences (GSP), trying to give developing country exports an edge in major markets.

However, from the mid-1980s, the Washington Consensus on trade led to the most important trade reforms across the developing world and transition economies in recent history under International Monetary Fund and World Bank structural reform programmes. These 'autonomous' reforms among developing countries since the mid-1980s, carried out with varying degrees of enthusiasm, led to dramatic reductions in trade intervention among developing countries and increased the openness of their economies towards foreign investment.

Tariffs fell from some very high levels to moderate rates and there was substantial rationalization of tariff structures, reducing the number of bands, in a few cases, to a single level. NTBs, such as quotas, were largely eliminated. This process has continued in countries such as China and India so that their applied rates are now below 10%. Moreover, under these reform programmes, the dispersion in rates across sectors has been substantially reduced and tariff escalation is now more marked in developed than developing countries.

Apart from traditional trade theory, the reform process was justified by statistical evidence linking openness to growth.⁵ And there were some notable successes, particularly in East Asia. However, not all the successes could be attributed to the application of orthodox trade policies – there were also a number of failures,

1 British economist Arthur Cecil Pigou's *Wealth and Welfare*, published in 1912, discusses this. Pigou was later heavily criticized, although criticism of his role for the state looks weaker in the light of the financial crisis of 2008. British economist James Meade's *Trade and Welfare*, published in 1955, also discusses this issue. However, it often seems that policymakers prefer to focus on a naive, simplistic version of theory that appeals to their vision.

2 Prebisch, R., 'The Economic Development of Latin America and its Principal Problems', New York, United Nations, 1950.

3 Singer, H., 'The Distribution of Gains Between Investing and Borrowing Countries', *American Economic Review* 40, No. 2, pp. 473-485, 1950.

4 Toye, J. and R. Toye, *The UN and Global Political Economy: Trade, Finance, and Development*; Chapter 5, Bloomington and Indianapolis, Indiana University Press, 2004.

5 Dollar, D. and A. Kraay, 'Trade, Growth and Poverty', *Economic Journal*, 114: 493, pp. 22-49, 2004. However, as Dollar emphasized on a number of occasions, these were statistical results with a number of countries falling above and below the central finding. See also: Sachs, J. and W. Warner, 'Globalization and economic reform in developing countries', *Brookings Papers on Economic Activity*, 1, Washington, D.C., Brookings Institution, 1995. In 2002, Turkish economist Dani Rodrik and Venezuelan economist Francisco Rodriguez criticized the robustness of the statistical results.

especially in Africa, and there has recently been some serious rethinking in the Bretton Woods institutions about trade policy prescriptions. Many of the reforms were carried out in the face of developments in trade theory that challenged the new conventional wisdom.⁶

A reappraisal of the impact of trade reforms intensified following the global economic slowdown in the wake of the Asian, Russian and Brazilian crises of 1997-1998, some two years after the conclusion of the Uruguay Round and the establishment of the World Trade Organization (WTO). The long overdue revisiting of the orthodoxy represented by the Washington Consensus was signalled in a number of ways. First, there was the intellectual challenge by American economist Joseph Stiglitz and Turkish economist Dani Rodrik, who queried the emphasis placed on openness and the lack of attention to institutional and governance issues.⁷ Second, problems in implementing WTO agreements led to the breakdown of attempts to launch a new trade negotiating round in Seattle in 1999. Third, the 1990s saw a dramatic increase in the number of regional trade agreements. Finally, growing evidence emerged of the failure of trade reforms, especially in Africa.

In 2008, the Commission on Growth and Development (hereafter the Growth Commission) noted that relying on markets to allocate resources efficiently is clearly necessary but 'that is not the same thing as letting some combination of markets and a menu of reforms determine outcomes'. The Commission continues: 'Wedded to the goal of high growth, governments should be pragmatic in their pursuit of it. Orthodoxies apply only so far ... if there were just one valid growth doctrine, we are confident we would have found it.'⁸ The Commission noted that economists can say with some confidence how a mature market economy will respond to policy prescriptions. However, mature markets rely on deep institutional underpinnings that define property rights, enforce contracts, convey prices and bridge informational gaps between buyers and sellers, which are often lacking in developing countries.

Noting that an important part of development is precisely the creation of these institutionalized capabilities, the Growth Commission states:

'We do not know in detail how these institutions can be engineered, and policymakers cannot always know how a market will function without them. The impact of policy shifts and reforms is therefore harder to predict accurately in a developing economy. At this stage, our models or predictive devices are, in important respects, incomplete. As a result, it is prudent for governments to pursue an experimental approach to the implementation of economic policy.'

In this respect, the Commission quotes Chinese leader and reformer Deng Xiaoping's oft-quoted dictum to 'cross the river by feeling for the stones', and it argues that governments should sometimes move forward step by step, avoiding sudden shifts in policy where the potential risks outweigh the benefits. This will limit the potential damage of any policy misstep, making it easier for the government and the economy to right itself. It also notes that making policy is only part of the battle; policies must also be faithfully implemented and tolerably administered.

While the Growth Commission remarkably says almost nothing about trade policy, it touches on a number of closely related areas, including briefly on what it calls the 'great symbolic importance' of the Doha Round, apparently accepting the downgrading by many economists of its economic significance. In the areas of export promotion (including explicit or implicit subsidies, but not trade fairs, etc.) and industrial policy (in particular targeting, rather than cluster group formation, etc.), the Growth Commission indicates the various sides of the debate that were heard during its work. Orthodoxy suggests that neither export promotion nor industrial policies work. However, the Commission, in a clear break with orthodoxy, suggests that, 'If an economy is

⁶ Krugman, P., 'Scale Economies, Product Differentiation, and the Pattern of Trade', *American Economic Review*, 70, pp. 469-479, 1980. Krugman, P., *Strategic Trade Policy and the New International Economics*, Cambridge, MIT Press, 1986.

In 1992, Krugman expressed disappointment that the 'fairly radical change in the way that economists explain international trade has so far at least had relatively little impact on their recommendations about trade policy.' See: Krugman, P., 'Does the New Trade Theory Require a New Trade Policy?' *The World Economy*, 15:4, 1992.

⁷ Stiglitz, J., *Globalization and Its Discontents*, New York, W.W. Norton, 2002.

Rodrik, D., *Has Globalization Gone Too Far?* Washington, D.C., Institute for International Economics, 1997.

⁸ *The Growth Report – Strategies for Sustained Growth and Inclusive Development*, Commission on Growth and Development, International Bank for Reconstruction and Development/World Bank, 2008. Available at: www.growthcommission.org/index.php?Itemid=169&id=96&option=com_content&task=view

failing to diversify its exports and failing to generate productive jobs in new industries, governments do look for ways to try to jump-start the process, and they should.’ However, the Commission hedges its bets by arguing that these efforts should bow to certain disciplines:

- First, they should be temporary, because the problems they are designed to overcome are not permanent.
- Second, they should be evaluated critically and abandoned quickly if they are not producing the desired results. Subsidies may be justified if an export industry cannot get started without them. But if it cannot keep going without them, the original policy was a mistake and the subsidies should be abandoned.
- Third, although such policies will discriminate in favour of exports, they should remain as neutral as possible about which exports. As far as possible, they should be agnostic about particular industries, leaving the remainder of the choice to private investors. Finally and importantly, export promotion is not a good substitute for other key supportive ingredients: education, infrastructure, responsive regulation, etc.

Thus, among professional economists, science is pointing towards a more cautious approach to openness to trade or at least to unfettered, rapid liberalization in the face of adjustment costs and the existence of externalities. This poses the question as to how to reduce the burden of existing trade interventions in goods and services on exporters in the short term.

ELIMINATING ANTI-EXPORT BIAS

Apart from the general argument on the benefits of a more open economy – at least in the longer term – it has also been long recognized that protecting domestic industries can create difficulties for exporters by raising the price of inputs.⁹ In general, tariffs and other measures that protect domestic industries create disincentives to export.¹⁰ This can be explained in several ways.

First, tariffs directly raise the price of imported inputs: raw materials, and intermediate and capital goods. They also increase the profitability of the protected import competing sector, which is then able to bid up the price of other inputs, such as land, labour (wage rates) and services. This has a negative effect on exporters who have to meet those prices or bids for their inputs.

Second, as an alternative way of thinking about the issue, tariffs will likely reduce imports, with a positive impact on the balance of payments, and a consequential upward pressure on the local currency, leading to an appreciation. This means that exports become more expensive for foreigners and they are negatively affected.

Either way, protection or other forms of intervention for a preferred import-competing sector has a negative impact on the export sector, producing an anti-export bias. This applies even when the imported inputs are duty free to exporters, because they still have to compete for inputs that are not imported, but whose prices are affected by the protected or supported sector that bids up the prices of those inputs.

However, openness in itself may not be sufficient. There may be an absence of competition in the domestic market that also needs to be addressed. For example, when Argentina substantially reduced protection on cars and other goods to reduce prices as part of its anti-inflationary drive following the adoption of the Law of the Convertibility of the Austral in 1991 (a convertibility standard for the peso), it found that large domestic firms in the distribution trade did not need to reduce retail prices. This required adopting more aggressive competition law. In Colombia, following the opening of the banking sector to foreign banks in the late 1990s, the arrival of foreign banks led to an improvement in the quality of banking services, including by local banks, but there appears to be no lowering of interest rates or any other sign of price competition as a result of improved banking technologies, with foreign banks comfortably co-existing with local banks.

Only a comprehensive opening of the economy in goods and services, supported by efforts to improve competition in the domestic market, can eliminate the anti-export bias. The difficulty is that eliminating the

⁹ This has its intellectual basis in: Lerner, A. P., ‘The Symmetry between Import and Export Taxes,’ *Economica*, (New Series), 3(11), pp. 306-313, 1936.

¹⁰ Aron, J., B. Kahn and G. Kingdon, editors, *South African Economic Policy under Democracy*, New York, Oxford University Press, 2009.

measures that protect or support the import competing sector in goods or services may be difficult to reduce or eliminate in the short term without causing severe structural adjustment problems, as discussed in the previous section.

How can a government act to reduce the costs of inputs into the export of goods and services without engaging in potentially disruptive, comprehensive liberalization in the short term? The options available to governments to assist exporters are to act directly on import, export or production costs, including through some long-term measures that are not specific to international trade. However, in pursuing some of these specific measures, governments must find means that will not run afoul of WTO rules, whose reach has extended since the days of the earlier General Agreement on Tariffs and Trade (GATT). Some of the measures used by successful exporters in the past, for example, in East Asia, are no longer legally available to newer exporters. Moreover, the Doha Round could well lead to a further tightening of those rules.

REDUCING INPUT COSTS

There are a number of means that can be used to lower the costs of imported inputs for export industries, but under WTO rules some care has to be taken to ensure that these are not uniquely for exporters or there is a risk that the scheme would be considered as an export subsidy.

Some countries favour using specialized schemes because they are easier to administer than larger scale national reforms. Such schemes include using duty drawback and special import licenses for exporters, as well as specialized schemes, like bonded manufacturing and export processing zones. Developing countries can benefit using more favourable rules regarding subsidies to support local industry, such as duty drawback, special economic zones (SEZs), condoning or not collecting government revenues otherwise due, and export credits.

Governments need to further consider the merits of liberalizing on a preferential liberalization or most favoured nation (MFN) basis. Before looking in some detail at these various approaches, it is useful to briefly review WTO rules on subsidies, which cover domestic supports as well as export subsidies.

WTO RULES ON SUBSIDIES

The WTO's subsidy rules are highly complex, distinguishing between domestic supports (subsidies) and export subsidies, and providing for differential treatment of agriculture and manufactured products. Subsidies are defined as financial commitments by a government. They may take the form of direct or indirect financial transfers, government practices involving transfers, foregone revenues, provisions of goods and services (other than infrastructure), or some form of price or income support. Some subsidies are prohibited, while others are considered 'actionable', being subject to action at the multilateral level or to countervailing measures.¹¹

All 'specific' subsidies, which have to be notified to the WTO, are subsidies that are not generally available, i.e. subsidies that are targeted to particular enterprises, industries or regions, as well as export subsidies and import-substitution subsidies. The WTO Agreement on Subsidies and Countervailing Measures (the SCM Agreement) classified specific subsidies under three different categories: prohibited (red), actionable (amber), and non-actionable (green) subsidies, known as the traffic lights approach. However, the non-actionable class was eliminated on 31 December 1999. In addition, the WTO Agreement on Agriculture prohibits the use of export subsidies, except in conjunction with product-specific reduction commitments, and defines the conditions under which certain types of domestic subsidies (green box, blue box or special and differential treatment (S&D) box)¹² are exempt from reduction commitments.

¹¹ The agreement also originally contained a third category: non-actionable subsidies. This category existed for five years, ending on 31 December 1999, and was not extended. The agreement applies to agricultural goods as well as industrial products.

¹² The S&D box offers special and differential treatment for developing countries.

A WTO member can use the WTO's dispute settlement procedure to seek the withdrawal of the subsidy granted by another member or the removal of its adverse effects. Alternatively, and more commonly, the member can launch its own investigation and ultimately charge extra duty (known as countervailing duty) on subsidized imports that are found to be hurting domestic producers.

Prohibited subsidies are subsidies that require recipients to meet certain export targets, or to use domestic goods instead of imported goods. They are prohibited because they are specifically designed to distort international trade, and are therefore likely to hurt other countries' trade. Prohibited export subsidies are the subject of the Illustrative List of Export Subsidies, provided in Annex I to the SCM Agreement. These include direct and indirect subsidies linked to exports, including services in their production, transport and marketing, as well as associated export credit and insurance schemes. Also prohibited is the full or partial remission of direct taxes and social welfare charges or special direct tax deductions that are not also available to production for domestic consumption. Exemption or remission of indirect taxes must not exceed the level of such taxes paid on production or sale for domestic consumption. For example value-added tax (VAT) rebates must not exceed the normal VAT rate.

Among the prohibitions are a number of variations on 'simplified' drawback schemes, which are common in developing countries, for example providing a 'drawback' that is a fixed percentage of the free on board (FOB) value of the exports and not linked to the duty paid on imported inputs. Also prohibited is a reduction of tariffs on imported inputs up to an equivalent value of exported final goods. For example, export performance schemes that do not require the same or identical components to be re-exported may be considered as export subsidies. Some exports from export processing zones may fall under this provision.

Actionable subsidies are subsidies that cause adverse effects (injury, nullification or impairment of benefits, or serious prejudice) to a WTO member. A rebuttable presumption of serious prejudice arises in cases where the amount of the total ad valorem subsidy (based on the actual price of the good being subsidized) exceeds 5%, where subsidies are used to cover operating losses, or where there is direct debt forgiveness. The SCM agreement defines three types of damage they can cause: (i) one member's subsidies may hurt a domestic industry in an importing member; (ii) they may hurt rival exporters from another member when the two compete in third markets; (iii) domestic subsidies in one member may hurt exporters trying to compete in the subsidizing member's domestic market. If the WTO Dispute Settlement Body rules that the subsidy does have an adverse effect, the subsidy must be withdrawn or its adverse effect must be removed.

If domestic producers are hurt by imports of subsidized products, countervailing duty (CVD) can be imposed. The subsidized exporter can also agree to raise its export prices as an alternative to its exports being charged countervailing duty, known as a 'voluntary export price undertaking'. With limited exceptions, serious prejudice claims cannot be brought against developing countries. Matters related to this kind of subsidy may be referred to the Dispute Settlement Body.

Under the WTO Agreement on Agriculture, all subsidies other than 'green box' support measures are actionable through CVD measures. Green box subsidies are subsidies considered to have no or minimal trade distortion effects or effects on production and that meet programme-specific criteria. These include general services; public stockholding for food security purposes; domestic food aid; production-limiting programmes; direct payments to producers; decoupled income support; programmes related to structural adjustment, income insurance and safety nets; regional assistance; and environmental payments (Annex II of the Agreement).

Actionable agricultural subsidies include 'blue box' subsidies, covering some payments under production-limiting programmes provided they meet certain conditions. Also actionable in this way are *de minimis*, or maximum permissible level, product-specific support, valued at less than 5% of the value of production of the product, as well as non-product-specific support that is less than 5% of the total value of a country's agricultural production. In addition, CVD actions may be taken against investment and input subsidies allowed for developing countries under Article 6:2 of the Agreement (the 'S&D box').

In the past, developing countries had considerable latitude to use export subsidies for industrial goods. The Tokyo Round code formally recognized that subsidies were 'an integral part of economic development programmes of developing countries'. However, this only protected them from the application of countervailing measures if they entered into a commitment to reduce or eliminate export subsidies 'when the use of such export subsidies [is] inconsistent with its competitive and development needs' (Article 14:5). In practice, few developing countries acceded to the code because of this constraint.

Under the WTO, developing countries and economies in transition are covered by the general prohibition on the use of export subsidies for industrial goods. However, developing countries have been given a maximum of eight years to phase out export subsidies, with some possibility for an extension; economies in transition are given a maximum of seven years. Least developed countries (LDCs) and developing countries with less than US\$ 1,000 per capita GNP are exempted from disciplines on prohibited export subsidies.

Developing countries' subsidies of limited duration that are linked to privatization programmes are not subject to multilateral action under the SCM Agreement, although they may still be countervailed. Under the *de minimis* provisions of the Agreement, developing countries are exempted from the application countervailing duties when their subsidy levels do not exceed 2% (or 3% where a country accelerates the timetable for eliminating export subsidies), or import shares are less than 4%, and cumulatively among countries benefiting from this provision with less than 9% of total imports.

Measures that are not considered to be subsidies include: (i) duty drawback schemes, where the precise or lesser amount of duty is rebated on the export of a component incorporated in a final good; and (ii) the precise or lesser exemption or remission of indirect taxes that are normally payable in respect of production and distribution of like goods sold for domestic consumption, e.g. sales taxes or VAT, but not direct taxes (i.e. on wages, profits, etc.). Prior to the Uruguay Round, import duties could not be rebated on imported inputs, such as fuels, used in the production process. However, this is now allowed under the Guidelines on Consumption of Inputs used in the Production Process (Annex II to the SCM Agreement). Export credits and export credit guarantee or insurance programmes below cost are prohibited, but not if the loans are made above cost but below market rates, or, in the case of export credits, they are provided in accordance with the terms of the Organisation for Economic Co-operation and Development's (OECD) arrangement on Officially Supported Export Credits.

Box 56: The SCM Agreement: options for a developing country

If the country is an LDC or one of those countries listed in Annex VII (b) of the SCM Agreement, it could introduce or maintain grants and schemes foregoing or not collecting certain government revenue contingent upon export performance.

- It could forego, in part or totally, the customs duties payable on imports of capital goods used for the production of existing or new export products, such as banana and mango chips.
- It could forego, partially or totally, company tax payable with respect to profits obtained through the export business of agro-industrial companies.
- Other more specific schemes would include special deductions, such as double deductions, for certain activities that the authorities consider would promote exports. These could involve double deductions for all foreign advertising activities or for attending trade fairs in exporting countries.

Nevertheless, because these subsidies are contingent upon export performance, they could be subject to countervailing measures by the domestic industries of importing members if they can show injury. This applies even to LDC subsidies, although LDCs could get some protection from the *de minimis* clause. These programmes are very frequently targeted in countervailing investigations carried out by Australia, Canada, the European Union and the United States. They can also be challenged through the multilateral track. The United States Tax Treatment for Foreign Sales Corporations is one example. Countries should carefully weigh the risks entailed by these schemes when devising and implementing them.

Regardless of its status, a country could develop programmes not contingent upon export performance. These programmes could be similar to those under option one, but the export contingency requirement would be removed. The effect of these schemes would be felt across a company's entire production and would, therefore, impact its exported goods only in part. These would therefore constitute indirect export promotion measures.

Countries may devise schemes that do not fall under the scope of the SCM Agreement either by ensuring that they do not fall under any of the financial contribution categories set out in Article 1.1, or by making any scheme non-specific.

Source: De Baere, P. and C. Du Parc, 'Export Promotion and the WTO: A brief guide, 2009', ITC.

SPECIAL TARIFF RELIEF SCHEMES

There are a number of options for providing relief from payment of tariff duties that can be used to assist exporters of goods and services and that do not conflict with WTO rules. These include relief from payment of duty under certain conditions, temporary admission schemes and duty drawback schemes.

RELIEF FROM PAYMENT OF DUTY

Most countries allow duty-free entry of goods under certain conditions, for example personal effects, goods under a specified value, etc. However, some duty waiver schemes are less well known and are of potential interest to business. These include the waiving of duty if the goods are intended for certain purposes. Examples include imports for use by certain branches of government, such as the armed forces and law enforcement agencies. Exemptions also include equipment for use in hospitals, which is of commercial interest in those countries that attract foreign patients for medical treatment.

From a commercial perspective, the more interesting schemes include the import of goods used in export businesses such as tourism. Similarly, other major investment projects oriented towards exports sometimes obtain duty-free entry for capital goods. The difficulty is staying within the limits of the WTO rules as exported goods using such duty-free imports could be considered as specific subsidies and prohibited. This is not a problem so far for tourist projects or for other export-oriented services as these are not covered by the WTO SCM Agreement, the Agreement on Trade-related Investment Measures (TRIMS), nor as yet the General Agreement on Trade in Services (GATS). Duty-free admission may also be offered for temporary imports of goods for repair and re-export, and equipment for use in civil engineering projects that is intended for re-export on completion of the project. This exemption might be of interest to several export-oriented service industries.

Another scheme is the waiver of duties on goods that are not produced in the country. If the producer can show that no goods that would serve the purpose are available from local producers, an exemption may be obtained. However, this can lead to the exporter designing the export goods to ensure there are no locally produced inputs, causing distortions in the intended government incentive schemes to assist local production. For this reason, some years ago Australia abolished its 'by-law' entry scheme that was used for this purpose.

TEMPORARY ADMISSION REGIMES

Under temporary admission regimes (TARs), regular trader/producers can have the initial duty payment on imported materials waived, but they must subsequently provide proof of the incorporation of the imported materials in their exports. This has a cash-flow advantage for business, but revenue agencies are often reluctant to implement such schemes and are concerned about possible fraud. However, if suitable guarantees can be worked out, this procedure can be used to reduce the costs of doing business, pending more general liberalization.

DUTY DRAWBACK SCHEMES

Duty drawback schemes, which are more common than TAR schemes, entail the return to the importer/producer/exporter of the duty paid on materials that are imported and then incorporated in goods that are then exported. These schemes provide manufactured goods exporters with imported material inputs at world prices, thus increasing their profitability, while maintaining the protection for domestic industries that compete with imports. These schemes are particularly advantageous in countries where tariffs for intermediate products are high because the duties paid will be refunded when the product, into which the imported input has been incorporated, is exported.

Duties are initially paid as goods are landed. Refunds are provided upon shipment of export goods that include dutiable components. However, the amount refunded has to be precisely calculated so that there is no suggestion of any subsidy by the government, as has been alleged in some averaging schemes in the past.

A perceived disadvantage in the operation of some schemes is that revenue agencies are often reluctant to return the duty and there are often extensive delays in such reimbursements. In countries with high inflation rates these delays are a particular disadvantage.

- WTO members may establish duty drawback schemes provided the following:
- Customs duties have been paid on inputs used for the production of the finished product;
- The amount of drawback does not exceed the amount of duties levied on inputs consumed in the exported good;
- There is a verification system to check the inputs used in the production of the exported goods as well as amounts of the inputs concerned.

Also included in drawback schemes are 'substitution drawback systems' (Annex III of the SCM Agreement). Such systems allow for the refund or drawback of import charges on inputs that are consumed in the production process of another product and where the export of this latter product contains domestic inputs having the same quality and characteristics as those substituted for the imported inputs.¹³ The main requirement for substitution drawback systems is that the home market inputs substituted for imported inputs must be equal in quantity to and have the same quality and characteristics as the imported inputs being substituted.

For example, an entrepreneur produces PET chips using terephthalic acid (PTA) and ethylene glycol (EG). PTA and EG are procured domestically as well as imported. PET chips are sold both on the domestic market and on the export market. It so happens that PET chips manufactured by using domestically procured PTA and EG are sold on the export market, whereas the PET chips manufactured by using imported PTA and EG are sold on the domestic market. The entrepreneur can still claim refund of duties paid on imported PET and EG under the substitution drawback system under the following conditions: (i) the imported goods being substituted should normally be these two chemical substances ('same quality and characteristics'); and (ii) the domestic inputs must be used in equal quantities to the imported inputs that are being substituted.

Duty drawback schemes are implemented in different ways by member countries. Generally, in developed countries there are sophisticated means that normally allow for the establishment of clear linkages between the imported inputs for which exemption or remission of import charges is sought and the exported product. New technologies can facilitate these procedures. By contrast, developing countries have weaker customs administration and the revenue authorities are reluctant to reimburse pre-paid duties because of financial difficulties.¹⁴ In particular, some developing countries believe that implementing the procedures of developed countries would be 'impracticable' and 'places an onerous burden due to the prevalence of a large number of small and medium enterprises'. These countries consider that '[t]he administrative machinery required for such verification of inputs would be prohibitive in terms of costs'.¹⁵ To meet the criteria, some developing countries, such as India, have developed and apply what is known as standard input-output norms (SCION) or similar averaging procedures.¹⁶ However, such verification systems have been frequently rejected for not being reasonable and effective in the context of countervailing investigations.

Developing countries need to ensure that the verification systems are in full compliance with the provisions of the SCM Agreement. It may be advisable for such countries to seek technical assistance from the customs authorities of developed countries or from compliant developing countries to set up the appropriate verification systems. Although some proposals in the current round of trade negotiations call for technical assistance on this matter, such assistance has not yet been realized.

A World Bank analysis of export competitiveness and duty drawback is provided in box 57.

¹³ Annex III of the SCM Agreement.

¹⁴ More information is available from World Bank's Export Competitiveness and Duty Drawback web link: web.worldbank.org/WBSITE/EXTERNAL/TOPICS/TRADE/0,,contentMDK:20540524~pagePK:148956~piPK:216618~theSitePK:239071,00.html

¹⁵ *Ibid.*

¹⁶ Both determine the average amount of various inputs required for manufacture of one unit of the final product.

Box 57: Export competitiveness and duty drawback

Duty drawback schemes are used in highly protected economies to provide exporters of manufactured goods with imported inputs at world prices, thus increasing their profitability, while protecting domestic industries that compete with imports. The choice of export drawbacks is reinforced by international regulations, namely the GATT, which prohibits the use of direct export subsidies, but allows drawbacks.

Administrative mechanics of drawback programmes

Duties are paid as goods are landed. Refunds are provided upon shipment of export goods, which include dutiable components.

Modes of duty drawback

- Direct identification of manufacturers
- Substitution drawback
- Same condition drawback
- Shipment-by-shipment based on predetermined input/output standards
- Pre-agreed schedule (fixed drawback schedule) – a list of the fixed money value of duties to be refunded for one unit of an export commodity; countries using such schedules usually revise them every three-to-six months

Costs and negative effects of duty drawbacks

- Loss of government revenue
- Creates opportunities for cheating and abuse
- Absorbs administrative resources for its implementation
- Drawbacks do not offset non-tariff barriers against imported inputs

Lessons learned

The Republic of Korea and Chinese Taipei are notable examples of economies able to achieve strong export growth with protectionist policies. Their success is associated with a unique set of policies and circumstances not easily replicated in other countries, specifically authoritarian regimes able to suppress rent-seeking behaviour, which in turn made possible the use of other industry and trade promotion measures. Furthermore, both economies recognized the disadvantages of protection and undertook to liberalize imports.

The implementation of duty drawback programmes in developing countries has not fared very well for various reasons, including administrative weaknesses in customs administration, poor statistical infrastructure and failure of the government to reimburse pre-paid duties because of financial difficulties.

Source: Export Competitiveness and Duty Drawback, World Bank. Available at: <http://web.worldbank.org/WBSITE/EXTERNAL/TOPICS/TRADE/0,,contentMDK:20540524~pagePK:148956~piPK:216618~theSitePK:239071,00.html>.

Whether countries should embrace or abandon such drawback schemes depends on a country's development priorities and economic conditions.¹⁷ An increase in the drawback has a positive impact on export competitiveness and employment, but could lead to exports with low domestic value added. The welfare effects of duty drawback reform are ambiguous. An increase in the drawback is more likely to improve welfare if the economy is small with high input tariffs, low initial drawback, low administrative costs and leakages in the tariff collection system. For example, if China were to remove its duty drawback after meeting its WTO commitments, it would deepen its domestic supply chains and improve welfare, but hurt the country's economic efficiency, export competitiveness and real factor incomes. It is argued that further liberalization could mitigate these negative effects. However, there are arguments that, while such liberalization is a long-term goal, in the short term liberalization could cause disruptive structural adjustment problems. In essence, the argument is that all special schemes must be seen as measures undertaken pending longer term liberalization.

¹⁷ Ianchovichina, E., 'Duty Drawbacks, Competitiveness and Growth: Are Duty Drawbacks Worth the Hassle?', Policy Research Working Paper 3498, Washington, D.C., World Bank, 2005.

EXPORT RESTRICTIONS AND TAXES

Export restrictions and taxes are sometimes used to limit the exports of raw materials used in the production of final or intermediate goods intended for export. However, export restrictions are also used to reduce the costs and increase the supply of inputs of raw materials for the export of intermediate or final goods.

Under WTO rules, GATT Article XI (General Elimination of Quantitative Restrictions) prohibits the use by WTO members of prohibitions or restrictions (other than duties, taxes or other charges), through the use of quotas or export licences or other measures on the exportation or sale for export of any product destined for the market of another member. (Article XI also covers import restrictions.) However, Article XI does not extend to:

- Export prohibitions or restrictions temporarily applied to prevent or relieve critical shortages of foodstuffs or other products essential to the exporting contracting party;
- Export or import prohibitions or restrictions necessary to the application of standards or regulations for the classification, grading or marketing of commodities in international trade.

Paralleling these provisions, Article XX(i), concerning general exceptions, permits the use of restrictions 'on exports of domestic materials necessary to ensure essential quantities of such materials to a domestic processing industry during periods when the domestic price of such materials is held below the world price as part of a governmental stabilization plan, provided that such restrictions do not lead to any increase in the exports of or the protection afforded to such domestic industry, and do not depart from provisions relating to non-discrimination'.

Several developing countries have restricted exports or applied export taxes to limit the export of raw materials such as logs, raw hides and skins, and vegetable oil seeds, to ensure supplies for domestic processing industries and drive down domestic prices. Even though they reduce the domestic prices of inputs to the export industry, such measures are not considered to be export subsidies. Some WTO members consider that export taxes used in this way provide an unfair advantage to the using industries in the exporting country and there have been discussions in the Doha trade negotiations on disciplining such measures.

Other measures that have attracted attention include:

- Ukraine: export taxes restrictive investment rules and dual prices (i.e. lower prices for domestic buyers than for exports);
- Russian Federation: export restrictions, restrictive investment rules and dual prices (gas and timber);
- China: export restrictions, subsidies and export taxes;
- Gulf States: dual prices, export taxes and restrictive investment rules;
- Some African countries: export taxes;
- India: import duties, additional taxes and restrictive investment rules;
- Argentina: differential taxes.¹⁸

Other products where export restrictions or taxes are used include copper, molybdenum, and other non-ferrous metals, ammonium paratungstate (APT), metal scrap, coke, agricultural raw materials and various chemicals.

SPECIAL ECONOMIC ZONES

For many countries, large-scale trade liberalization on a national scale is not possible in both the short and medium term. Therefore, many countries, going beyond duty drawback and other special tariff regimes for exporters, choose to liberalize trade and investment in geographically delineated economic areas, such as export processing zones (EPZs), special industrial zones, special economic zones (SEZs) or export promotion zones. Some of these are specific to exporting while others take the form of industrial parks

¹⁸ The issue was discussed in an OECD workshop on raw materials. 'Economic impacts and policy objectives of export restrictions', BIAC Discussion Paper, OECD, Paris, 2009.

available to production for export or the domestic market. Recent estimates by the World Bank indicate that there are currently more than 3,000 SEZs established in some 135 countries. Overall, SEZs are estimated to account for more than US\$ 200 billion in global exports and employ directly at least 40 million workers.¹⁹

Production of goods may co-exist with operations in the area of services in such zones. Indeed, the World Bank notes that the traditional manufacturing-oriented processing zone is becoming increasingly anachronistic, despite the continued importance of global production networks.²⁰ This is so for three main reasons. First, by limiting activities to manufacturing only, EPZs restrict opportunities for investment and growth in the services sector, one of the most important opportunities for growth in middle-income and even many low-income countries. Second, the traditional EPZ tends to create an enclave that is separated from the national market, undermining its potential to create effective domestic linkages. Finally, the traditional EPZ model relies on unsustainable fiscal incentives to attract investment. As a result, there has been a gradual shift from traditional EPZs to special economic zones (SEZs), which normally cover larger land areas, offer greater flexibility for services and other non-manufacturing activities (including residential and tourism development), and include a greater mix of export and domestic-market focused activities.

Many zones have existed for a long-time. The first zone was Ireland's Shannon Airport EPZ established in 1958. However, zones are largely seen as an intermediary step towards longer term liberalization. Zones also have externalities in that they facilitate cooperation among firms in similar or linked activities, transfer of technology and management know-how. Many of the initial zones in East Asia played a critical role in facilitating industrial development and upgrading the 'tiger economies'. Similarly, the later adoption of the model by China provided a platform for attracting foreign direct investment (FDI) and not only supported the development of its export-oriented manufacturing sector, but also served as a catalyst for sweeping economic reforms across the country.

Industrial parks are not merely an interim step towards wider economic liberalization but are also a means of concentrating infrastructure in a zone, often near a major transport node (port, airport, rail head, etc.), thereby limiting expenditure. These and other SEZs also aim to overcome barriers that hinder investment in the wider economy, including restrictive policies, poor governance, inadequate infrastructure, and problematic access to land. While the features of each zone vary from country to country, SEZs tend to offer export-oriented investors three main advantages relative to the domestic investment environment:

- They offer a special customs environment, including efficient customs administration and (usually) access to imported inputs free of tariffs and duties.
- They have historically offered a range of fiscal incentives, including corporate tax holidays and reductions, along with an improved administrative environment.
- They provide infrastructure (including land, factory shells and utilities) that is more accessible and reliable than would normally be available outside the zones.

The WTO does not prohibit EPZs or other SEZs as such, but governments using or considering using SEZs must abide by WTO rules, particularly those regarding subsidies, as well as give careful consideration to their economic feasibility.

While each country has its own reasons for creating zones, they quite often involve the following objectives:

- Increase exports;
- Attract foreign capital and achieve accrued capital;
- Introduce new technology, especially in the industrial field;
- Provide employment opportunities;
- Generate a substantial skill surge.²¹

Free zones and similar schemes have become popular tools to promote exports, especially in developing countries. This is particularly true for countries in which import tariffs are, or have been, high. Companies

¹⁹ For a useful overview see: Farole, T., 'Special Economic Zones Performance, policy and practice – with a focus on sub-Saharan Africa,' World Bank, March 2011. Available at: siteresources.worldbank.org/INTRANETTRADE/Resources/Pubs/SpecialEconomicZones_Sep2010.pdf

²⁰ *Ibid.*

²¹ Objectives as cited in the website of the Ministry of Trade and Industry of Egypt. Available at www.tpegypt.gov.eg/ENG/FreeZone.aspx

operating under these schemes have traditionally been exempt from paying customs duties on imports of raw materials, and often intermediate inputs and capital goods, used for the production of exported goods. Zones can be publicly or privately owned or managed and can be 'high end' or 'low end', depending on the quality of the management, facilities and services provided. They tend to encourage the establishment of related industries to form clusters, and as they grow, tend to attract new companies operating in the specific field in which the free zone specializes.²²

Government should further provide efficient, streamlined, and prompt services for setting up and running export processing zones (approval of investment applications, customs and other supervisory institutions). Privately owned and managed zones should be encouraged. If zones are public, considerable autonomy should be granted. Zone firms exporting from one member of a trade arrangement should be aware of potentially complex rules of origin and restrictions.²³ Finally, it is important to develop special customs rules and regulations drawing upon WCO and WTO provisions, and fast-track implementation of automated customs systems, with proper inventory controls and audit systems within SEZs.²⁴

Yet, EPZs are a 'less than optimal strategy'²⁵ and should not be favoured over overall improvements to the business environment and economy-wide strategies. This is because EPZs are distortionary trade instruments and introduce an element of discretion into the policy environment. Furthermore, low levels of FDI inflow may be due to inadequate legal or regulatory frameworks or distorted economic incentives in other areas of the economy, such as private property laws.²⁶

EPZs are more likely to succeed when monetary and fiscal policies (low inflation, budget management, independent monetary policy), are sound and stable, private property and investment laws are clear, firms are free to repatriate earnings at market rates, and there are no restrictions on foreign exchange.

Box 58: Common features of SEZs

SEZs have a number of common features:

- They allow duty-free imports of raw and intermediate inputs and capital goods for export production.
- Government red tape is streamlined, allowing one-stop shopping for permits, investment applications, etc.
- Labour laws are often more flexible than for most firms in the domestic market.
- Firms in zones are given generous, long-term tax concessions.
- Communications services and infrastructure are more advanced than in other parts of the country; utility and rental subsidies are common.
- Zone firms can be domestic, foreign or joint ventures.
- FDI plays a prominent role.

Source: Export Competitiveness and Export Processing Zones, World Bank, Available at: web.worldbank.org/WBSITE/EXTERNAL/TOPICS/TRADE/0,,contentMDK:20540534~pagePK:148956~piPK:216618~theSitePK:239071,00.html

²² De Baere, P. and C. Du Parc, *Export Promotion and the WTO: A Brief Guide*, ITC, 2009. Available at: www.intracen.org/eshop/Free-publications/Export_Promotion_WTO.pdf

²³ Zones in countries that are members of preferential trade arrangements (regional or bilateral) may be more attractive to firms targeting these markets because such a membership enlarges potential market size and eases entry barriers. However, exports from these zones may face complex rules of origin regulations and restrictions.

²⁴ Special Economic Zones in Indonesia: Attracting Investment to Create Welfare for the Indonesian People, International Financial Corporation, World Bank. Available at: [www.ifc.org/ifcext/eastasia.nsf/AttachmentsByTitle/SEZ+brochure_eng/\\$FILE/Economic+Zone_english_FINAL.pdf](http://www.ifc.org/ifcext/eastasia.nsf/AttachmentsByTitle/SEZ+brochure_eng/$FILE/Economic+Zone_english_FINAL.pdf)

²⁵ Engman, M., O. Onodera and E. Pinali, 'Export Processing Zones: Past and Future Role in Trade Development,' Trade Policy Working Paper No. 53, Paris, OECD, 2007.

²⁶ Madani, D., 'A Review of the Role and Impact of Export Processing Zones', World Bank, 1999. siteresources.worldbank.org/INTRANETTRADE/Resources/MadaniEPZ.pdf

Even if export promotion is in order (i.e. WTO-compatible and deemed a solution to the country's low FDI inflow), an EPZ may not be the best instrument to achieve such a goal. If these economies are intent on establishing new zones, they should pursue minimal differential fiscal incentives compared to the national standards, minimizing their distortionary impact on the host economy.²⁷

SEZs can be useful in countries at earlier stages of development because they are usually easier to administer than full-scale national liberalization reform. SEZs can logically serve as a bridge to trade liberalization on a national basis. They reduce the anti-export bias of high tariffs by permitting an exporting company to access inputs at global prices, and therefore may aid in the creation of an export industry and improve a country's trade balance.

However, there are many examples of failures of SEZs, where investments in zone infrastructure resulted in 'white elephants', or where zones have largely resulted in industry taking advantage of tax breaks without producing any substantial employment or export earnings. Moreover, many zones that appear to have been successful in the short term have failed to remain sustainable once labour costs have risen or when preferential trade access is no longer an advantage, which is what happened in many countries with the end of the Multifibre Arrangement. In effect, new trade rules in 2006 ended this GATT-WTO provision that helped textile industries in developing countries, putting millions of workers at risk. Zone failures can be attributed to a variety of causes. Too often, zones are plagued with the same problems that hinder investment in the wider economy, such as unstable electricity, lack of water, heavy bureaucracy and inefficient and corrupt customs. In addition, broader competitiveness challenges, including policy instability, poor national governance, and low productivity, often undermine the potential of zones.

Box 59 provides an overview of some the main measures required when implementing SEZs, as well as Costa Rica's and Senegal's experience with implementing such schemes. Box 60 provides an example of how Nepal was able to use an SEZ for its textiles and clothing exports.

The experiences of Nepal and Vanuatu, small LDCs with SEZs, are discussed in boxes 61 and 62.

Box 59: Costa Rica and Senegal: experiences

Costa Rica established its first EPZs in the early 1980s in the port cities of Puntarenas and Limón, both of which were economically depressed areas. To attract foreign investment, the authorities designed a system of fiscal incentives for interested firms to locate in these zones. However, mainly due to their locations, these initial attempts were unsuccessful in attracting large investment and saw only a few firms and jobs created. The majority of companies invested in operations in private zones, which were subsequently formed in the central region of the country. These areas had better infrastructure facilities, access to specialized services, and abundant skilled workers that made the locations more attractive. EPZ investors preferred better supporting conditions than incentives.

Since 1990, export-oriented activity in Costa Rica has increased rapidly under the EPZ and the Regime of Temporary Admission (RTA). Between 1991 and 1996 employment increased annually by more than 7% and net EPZ and RTA exports increased annually by more than 14%. In 2005, 8% of Costa Rica's total export volume and 53% of total value originated in EPZs. Intel Corporation drives this value-added production as the largest exporter. In 2005 EPZs were employing around 39,000 people, 5,000 more than in 2001.

Senegal established an EPZ near the port of Dakar in 1974, but the project failed and was abandoned in 1999. At the time of closure, the Dakar EPZ had hosted only 14 active enterprises with a total of 940 employees. The principal reasons of failure included excessive bureaucracy (customs procedures, long delays in acquiring permits etc.), unfortunate location (12 km from the Dakar port), an obligation for companies to hire more than 150 people, and rigid and constraining labour regulations.

Source: Engman, M., O. Onodera and E. Pinali, 'Export Processing Zones: Past and Future Role in Trade Development,' Trade Policy Working Paper No. 53, Paris, OECD, 2007.

²⁷ *Ibid.*

Box 60: Nepal: ensuring textile and apparel benefit from SEZs

Textile and apparel comprises around 18% of the total export trade and around 30% of the third-country (other than India) trade of Nepal. The industry provides job to around 50,000 Nepalese, with women holding 50% of the jobs. With an average family size of five, around 250,000 people are dependent on this sector. The sector is reeling under difficulty with the phase-out of quotas under the Multi-fibre Agreement since January 2005. With the operation of only rail-connected ICD (inland container depot) in the border city of Birgunj, the Nepalese textile and apparel industry is seeking to succeed in the international market by reducing transaction costs and increasing competitiveness, which may be achieved by relocating the industrial establishments in the vicinity of the dry port.

There is tremendous pressure on the government to initiate the development of an SEZ in or near the dry port. Developing such a facility will help eliminate the process of duty drawback and bonded warehousing as the raw materials for producing apparel will directly land at the customs bond area. The additional transportation charges for transferring the raw materials to distant locations and re-transportation of the finished goods to the dry port for exporting abroad would be greatly reduced, thereby increasing the competitiveness of the products. The industry established in the SEZ is also expected to enjoy some other incentives in the form of taxes and credit benefits, export incentives and the flexible labour laws. The result would be reduced transaction costs and increased competitiveness of the Nepalese apparel industry. The Government of Nepal has already initiated the process of setting up such a zone for the larger interest of the export sector.

Source: Ojha P., Nepalese Experience in Liberalization of Trade Logistics Services. Report prepared by Purushottam Ojha, Joint Secretary, Office of Prime Minister and Council of Ministers, Nepal. Available at: www.unescap.org/tid/artnet/mtg/tfri_s3ojha.pdf.

Box 61: Nepal creates a business-friendly investment climate

To attract foreign and domestic investment in the industrial sector policies were simplified and clarified. The investment climate was made more conducive by introducing a number of policy measures and procedural simplifications. In addition, Nepal's government developed a package of incentives. Industries established with foreign investment in the form of joint ventures or wholly foreign owned units are entitled to the facilities and incentives.

Industries using 80% or more domestic raw materials and employing 100% locals are exempt from 10% of income tax. Manufacturing industries importing plants, machines and equipment for production with a duty rate of 5% are exempted from sales tax under certain conditions.

Tax reductions or other tax-related measures include income tax rebates of 30%, 25% and 20% for certain industries (except industries to do with cigarettes, bidis, alcohol and beer) established and operating in remote, undeveloped or underdeveloped areas of the country, respectively. Industries (other than those manufacturing cigarettes, bidis, cigars, tobacco, alcohol, beer, sawmill products and those using catechu) using more than 80% or more of the local raw materials for their production and employing all human resources from among Nepali citizens are granted a rebate at the rate of 10% of the income tax.

Further measures include duty drawback – any duty or taxes levied on the raw materials, auxiliary raw materials, etc. used for producing goods for export are entitled to a refund based on the quantity of export – and exemption from customs duties for specified manufacturing industries importing plant machinery and equipment under certain conditions. Nepal is exempt from countervailing investigations because as an LDC, WTO rules allow certain de minimis level for subsidies.

Government measures provide for various repatriation facilities. Export-oriented industrial companies can open foreign exchange accounts. Industries incorporated as 100% foreign owned or as a joint venture may also open a foreign exchange account to deposit the equity share of the foreign party in convertible currency. This can be used only to import equipment, plants and other fixed assets..

Source: De Baere, P. and C. Du Parc, 'Export Promotion and the WTO: A brief guide, 2009', ITC.

Box 62: Vanuatu promotes investments and exports

Vanuatu does not provide income tax holidays or similar type of measures because there is no corporate tax. However, it uses other measures to promote investments and exports. Most significantly, full exemptions are applied on trade taxes for manufacturing, processing and mineral exploration and extraction of raw materials and capital items. For other sectors, there is a reduction of trade taxes. In addition, the government supports and encourages all export-oriented investments and does not levy any export taxes on the export of any goods or services (this is with the exception of shells and raw logs). In addition, export manufacturers are exempt from trade taxes on their production inputs and from any taxes on exports.

Vanuatu is somewhat unusual in not imposing corporate taxes. Hence, investment and export promotion incentives focus on exemption from trade taxes, as well as institutional support for investors and exporters.

Source: De Baere, P., C. Du Parc, *Export Promotion and the WTO: A brief guide*, 2009, ITC.

REGIONAL SOURCING

Best practices suggest using regional sources of materials and goods due to shorter delivery time. For example, intermediary products such as fibres, fabrics and trims are available on world markets, but it is faster to source them from nearby countries. As a country's capacity to export grows, it needs larger quantities of production inputs. As the order value increases and government and business obtain more bargaining power with suppliers, discounts and lower prices for raw materials may be available.

One way to obtain materials at lower prices, without global liberalization, is to enter into regional trade agreements, thereby reducing tariffs. Such an agreement needs to meet WTO rules, but these are relatively relaxed for developing countries and even more so for LDCs.

However, restrictive rules of origin in foreign markets may undermine competitiveness by constraining access to the cheapest inputs. If the product does not meet these conditions, its duty-free status is lost and normal import duties will be applicable. Provisions for cumulation within regional and multilateral trade agreements lessen the impact of restrictive rules and stimulate regional integration, but such provisions are not always available as the importing country often uses restrictive rules of origin to support its own suppliers.

SUPPORTS FOR INPUTS TO EXPORTS

SUBSIDIES FOR INPUTS

Direct subsidies to exports of goods are prohibited or actionable under WTO rules. The WTO also considers support for inputs to production for export as subsidies. Thus, specific subsidies for inputs or material, components or services, such as energy, water or electricity, would be considered as subsidies for the final goods, despite the fact that at the time of writing there are no rules on subsidies for international trade in services.

EXPORT CREDITS AND EXPORT FINANCE

Export credits arise whenever a buyer or a supplier of exported goods or services is allowed to defer payment for a certain period of time. The types of export credits that involve a certain degree of official support are mainly granted to finance the export of capital goods and related services. How official support is granted varies from country to country. In most countries such support is given to the banking sector either directly or through a specialized intermediary. In other countries the funds necessary for the granting of export credits are provided directly by government agencies.

Export credits can take the form either of a supplier or a buyer credit. Supplier credits are extended by the exporting company, which then arranges refinancing. In the case of the buyer credit, the exporter's bank, or another financial institution, lends funds to the buyer in the importing market. Export credits can be medium term (two to five years) or long term (at least five years). The objective is the promotion of exported goods and services in foreign markets.

WTO rules concerning export credits are included in Item (k) of the Illustrative List in Annex I of the SCM Agreement as follows. Grants by governments below certain interest rates or payments by governments of at least part of the costs incurred by exporters or financial institutions in obtaining credits used in order to secure a material advantage concerning export credit terms are considered as prohibited export subsidies. Any member seeking to grant export credits in excess of the terms permitted under the OECD Arrangement on Guidelines for Officially Supported Export Credits, for example at lower interest rates or longer maturity, must notify this intention to all fellow members accompanied by a detailed explanation of the reasons for such deviation.²⁸

The use of export credits to support agricultural exports is being discussed in the current Doha Round, where support by the United States has been criticized by its trading partners.

Providing finance to assist exporters is not in itself an export subsidy, nor is it contrary to WTO rules. The issue is whether the finance is provided at subsidized rates. The problem in many developing countries is that small- and medium-sized enterprises (SMEs) often have difficulty obtaining access to export finance or finance for investment purposes at competitive rates. Larger firms tend not to have this problem, especially if they are affiliates of large international corporations, through which they may have access to international financial markets. However, developing country SMEs have to borrow on the domestic market where interest rates are often 30% or more. Part of the problem is financial market weakness in many developing countries.

Opening up the financial market with adequate regulatory control over capitalization is one approach to strengthening the market; however, there may also be a need to take measures to ensure competition. The entry of foreign banks may not lead to reduced borrowing costs if they enter into some form of collusion with existing local banks. A solution in some countries has been to establish a state bank for development purposes or to provide export finance at reasonable rates. An example is the Brazilian National Development Bank, which is able to borrow at sovereign rates and relends with a margin to cover costs. Mauritius also has a development bank, which is credited as being one source of the country's export success.

ATTRACTING FDI

Where conditions are favourable, governments can strategically support domestic suppliers of goods and materials with general measures that are commonly used in key export areas, avoiding specific measures that would be contrary to WTO rules. The World Economic Forum argues, 'there is an extensive range of policies, instruments and institutions involved in the public and private sectors for building competitiveness. Other than providing a supportive macroeconomic framework, there are policies to support trade and industry – covering primary, secondary and tertiary industries – that are not covered by WTO rules. For example, policies for science and technology, including technical education, are important in building competitiveness in the longer term'.²⁹ Institution building or institutional reform can help establish a more stable and secure legal framework that is friendlier towards investment by foreign firms and local investors. There is strong evidence supporting the need to tackle weaknesses in production capacities in developing countries.³⁰

²⁸ This is in accordance with the conditions set out in the OECD Arrangement on Guidelines for Officially Supported Export Credits. According to WTO case law, it is not sufficient to selectively comply with certain terms enshrined in the OECD Arrangement, e.g. the established interest rate. On the contrary, WTO members have to comply with all the criteria set out in the Arrangement.

²⁹ *The Global Competitiveness Report 2006-2007*, editors, López-Claros, A., M. E. Porter, X. Sala-i-Martin and K. Schwab, World Economic Forum.

³⁰ See for example UNCTAD's Least Developed Countries Reports for 2004 and 2006.

See also: Fugazza, M., 'Export Performance and its Determinants: Supply and Demand Constraints', *Policy Issues in International Trade and Commodities Study Series No. 26*, UNCTAD, 2004. Fugazza carried out a multi-country econometric study of the determinants of export performance and comments: 'African and Middle Eastern countries appear to have faced severe supply capacity constraints in the last two decades, while their access to foreign markets has remained largely unchanged'.

Openness to FDI can support production, including production of goods and services for export. For example, in Colombia market-seeking FDI seems to have brought about some efficiencies as foreign firms have applied their management, technical and logistical expertise in several industries, including beer, tobacco, banking and telecommunications. In telecommunications, FDI has taken over cellular companies formerly in the hands of the domestic private sector and state-run long-distance operators.

Market-seeking FDI in Colombia has also invested in greenfield operations, primarily in the retail business where large French (Carrefour and Casino), Chilean (Falabella, Sodimac) and Dutch (Makro) retailers have built new stores, which makes an impact on the retail business and the real estate market, as well as (positively) on the quality of supplies of producers.

These policies have boosted Colombia's competitiveness. The country's ranking rose from 65 in 2001 to 56 in 2002 in the World Economic Forum's Competitiveness Index. In the World Bank's Doing Business 2008, Colombia is reported to have defeated the trend in Latin America and has become one of the top-10 global reformers.

In the context of building productive supply capacities, and hence providing ready access to domestically produced inputs in goods and services, one area that merits particular attention in developing countries and LDCs is the development of the private sector, especially SMEs. ITC has a number of programmes to help

Box 63: Colombia encourages investment and export promotion

Business analysts have recognized Colombia's government policy towards investment and export promotion. According to the World Bank's *Doing Business Report 2009*, Colombia ranked in second place in Latin America in the ease of doing business. As part of its overall reform programme, initiated in the late 1990s, Colombia took the following initiatives:

- Eliminated a number of bureaucratic processes and prevented government agencies from creating new ones under the Anti-Red Tape Law (Ley Antitrámites);
- Simplified the tax structure, reducing the number of taxes, expanding electronic filing and reducing the frequency of payments;
- Provided improved investor protection;
- Undertook labour market, financial sector and trade liberalization reforms;
- Adopted a flexible exchange rate regime and strengthened financial supervision and regulation;
- Brought inflation under control (remaining at below 10%);
- Made a major effort to strengthen security and fight corruption;
- Took steps to boost competitiveness through investment in science, technology and education;
- Instigated a process of building public support for its reforms through the National Council for Competitiveness.

The government's investment and export promotion strategy uses duty-free zones to promote the industrial processing of goods and services, primarily for export, and provides tax and procedural incentives to users of the free trade zones. Important features of the Colombian investment and export promotion measures are:

- Special import and export programmes enable producers to seek duty exemption on inputs in the production of exported goods;
- The Permanent Customs Users, a programme that allows business providers to obtain duty drawbacks if their operations exceed US\$ 6 million during the previous year;
- The Temporary Imports for Re-Exporting Unaltered Products programme, which allows importers to import products duty free provided that they are re-exported in the same state as they were when imported into the country;
- The Highly Exporting Users programme, which offers a number of tax incentives to companies that export at least 30% of total sales;
- Special customs zones that offer tax benefits to companies that set up operations in designated areas;
- Sales tax (VAT) exemption, which is granted for industrial machinery that is imported into Colombia.

Source: Doing Business in Colombia 2008 and Doing Business in Colombia 2009, Washington, D.C., World Bank.

businesses, particularly SMEs striving to achieve and maintain a competitive edge in the global market. ITC works directly with these SMEs, as well as with national trade support institutions. This is vital for their sustained and improved access to trade-related services, such as financing, help in maintaining quality standards, advice on export packaging and ready information on the legal requirements of international business.

ITC's Trade Finance programme is specifically designed to facilitate access to finance for SMEs exporting from developing and transition economy countries. Another programme to promote the creation of sustainable SMEs is Empretec, a United Nations programme established by the United Nations Conference on Trade and Development (UNCTAD). Empretec supports entrepreneurs in building innovative and internationally competitive SMEs.

Participating in global value chains is another way for businesses in developing countries to find markets, as discussed in chapter 4, and to access inputs of materials, capital goods, know-how and services needed to deliver exports to world markets at competitive prices. ITC works with national institutions to improve their ability to provide consultancy support, information and training across the purchasing and supply chain. This involves: diagnosing supply bottlenecks and problems; monitoring supply markets; implementing effective purchasing strategies; optimizing the quality of goods; managing the inbound logistics process; and protecting imported goods against damage, loss and inefficient use.

CONCLUSION

Access to inputs of materials, capital, technology and a range of services is critical for international competitiveness. Thus, export success depends both on achieving economic production and being able to deliver goods and services to the world market at competitive prices.

Economists see the comprehensive opening of markets in goods and services, accompanied by measures to ensure competition, as the best means of reducing the anti-export bias associated with import protection. However, this may not be feasible in the short term for political reasons associated with the costs of adjustment, nor desirable in the presence of externalities. At the same time, there is a range of short-term and longer-term options that can boost competitiveness. In the longer term, apart from the progressive opening of markets and stimulating competition, there are also measures to improve the functioning of the domestic economy and good governance that help provide a more business-friendly environment for establishing and operating a business. Measures may also be taken to increase competitiveness more generally, such as encouraging FDI, support for SMEs and participating in global value chains.

In the short term, there are various means to reduce the costs of inputs to exporters, but the options are more limited than in the past because of the tightening of multilateral rules on the use of subsidies. The options to reduce the costs of inputs to exporters include duty waiver, duty drawback, and temporary admission regimes. Financial market reforms can also help reduce the costs of investment, complemented where necessary with the establishment of national development or export-import banks to increase competition in the quality and price of financial services. Improving the operation of financial markets can facilitate access to export credits and export insurance facilities without breaching WTO rules.

SEZs, including export processing zones and broader industrial parks, are a useful means of reducing the costs of infrastructure and services for manufactures and, increasingly, for services. SEZs have often been used to facilitate the administration of special tariff regimes and cut administrative formalities. They are seen as useful in providing externalities through the transfer of technology, as well as management and labour skills to other firms in the zones. SEZs have sometimes been effective in generating jobs in depressed regions. Although special tax incentives have been used in these zones, experience shows that factors other than tax regimes are more critical, including the availability of skilled labour, political stability and ease of doing business. In this sense, they are best seen as a model for wider reforms to be applied throughout the economy.



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