6 Options for Creating Regional Trade Preferences Among Developing Countries

How regional trade preferences are provided among developing countries involves a range of issues. There are four main options: (a) bilateral preferential trade agreements; (b) customs unions; (c) free or preferential trade areas; and (d) a *variable geometry* approach. To achieve the full benefits from any of these approaches, investment flows (and ideally, though this may be more difficult, labour flows) also need to be facilitated, which implies some form of a common market.

The Role of Bilateral Agreements

A number of long-standing bilateral agreements already exist between countries in many developing regions. Others are rapidly developing in response to changing circumstances. Typical safeguard clauses are embodied in most of these agreements relating to dumping, subsidies and, – in the context of RIAs – to imports that threaten domestic producers with serious injury. Not all the bilateral agreements which have been negotiated are equitable or even. The competitive capabilities of neighbours are often a factor in determining the favourability of reciprocal terms.

How should such developments be viewed in terms of a strategy for market unification and integration in different developing regions? If the preferences offered by the industrially more advanced members of a region are smaller than those they receive and, in the limiting case, are zero, this would seem to offer one way of promoting an equitable distribution of the benefits of market integration. The main impact of preferential trade agreements is, however, to improve the terms of trade of the preference receiver rather than to promote closer integration. Even then, in practice, the incidence of any such benefit is likely to depend on the degree of competition in import-export trade.

Beyond this, it is doubtful whether bilateral agreements would, by themselves, be perceived as constituting a sufficiently significant added incentive for foreign direct investment to serve the wider market created under such agreements. There are two main reasons to support such a conclusion. First, the lack of full reciprocity that typifies bilateral arrangements would render any concessions particularly vulnerable in the face of economic difficulties in the country granting them. Second, such agreements do not specifically address non-tariff barriers to trade, production and invest-

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ment which are the most important constraints presently affecting RIAs among developing countries.

The experience of most developing countries with extended bilateral agreements – for example under the Generalised System of Preferences among such countries agreed under UNCTAD and the concessions offered to African Caribbean and Pacific (ACP) countries by the European Union under successive Lomé agreements – has been quite disappointing. These two instances underline the deficiencies of preferential trade agreements in themselves as instruments for expanding trade and investment, and for promoting internal market completion.

The Role of Customs Unions

A substantial degree of intra-regional trade and market integration can take place without the support of a customs union, free trade area or bilateral trade agreements. Nevertheless, a complete customs union (CU) can make a substantial contribution to market unification, particularly if it eliminates all internal fiscal frontiers. Moreover, by reducing private and public administration costs, minimising the need for special transit arrangements, and by avoiding revenue losses from smuggling, CUs have other important advantages as well.

For a CU to be an appropriate form of cooperation for a group of countries, there should be a willingness to regionalise (i.e. to integrate) customs administration.[25] Operational reasons require that tariff rates in a CU must be unified as well, although duty drawbacks and refunds of limited scope

25 Experience in Africa, for instance, supports that view. For example, consider the effectiveness of SACU, the EAC and the Francophone unions during their periods of greatest effectiveness. SACU is the only properly functioning customs union in Africa at present though it has its own stresses and strains. Its 1969 provisions embody a CET, and provision is made for sharing the revenue derived from this source (and from excise and sales duties) amongst the governments of the member states on whose consumers these taxes fall. Excise and sales duties were harmonised under the 1969 agreement and subject to the same sharing principles; the replacement of sales duties by the GST in 1978, and its subsequent replacement in 1991 by VAT, have eroded the consumption tax union. Provision is made in the agreement for compensation for disparities in the distribution of the costs and benefits of integration reflected by the division of revenue shares of RSA's partners. These shares are based on consumption of dutiable imports plus dutiable domestic production. The inclusion of the latter can be regarded as compensation for the costs of trade diversion. The so-called enhancement factor provides further compensation for the loss of fiscal discretion and the costs of polarisation. The agreement also contains provisions to enable the less-developed members to protect their infant industries against competition from their more-advanced neighbours, but the Secret Memorandum of Understanding largely ruled out recourse to those provisions. The same revenue-sharing principles have also been applied to the 'homelands' (TBVC) within South Africa, and to Namibia.

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might be workable. To the extent that consumption taxes now form a large part of total tax revenues in many developing countries, harmonisation of consumption taxes in a CU becomes essential if its full advantages are to be secured.

Could a customs union have a role in an integration strategy for developing countries? If so, there would be much to be said, in principle, for learning from the existing RIAs which invariably incorporate some form of compensatory arrangements, as well as mechanisms for the enhancement and stabilisation of revenues. Divergent views are held on the compensation, revenue enhancement and stabilisation arrangements for achieving equity under the present CU arrangements in different developing regions. The industrially more advanced countries in a grouping usually take a budgetary perspective rather than an overall economic cost-benefit approach and thus see current patterns of revenue distribution as overgenerous. Occasionally they attempt to link compensation specifically to the financing of investments in the less developed members of the grouping, rather than providing it for general budgetary purposes.[26] Such compensation, for a period, might conceivably be envisaged as one element of the *regional adjustment programmes* which have often been suggested for African countries.

The basic problem confronting the adoption of CU arrangements on a wider basis concerns the distribution of costs and benefits among members. In a CU, trade imbalances in regional products that compete with dutiable imports from the rest of the world are likely to be reflected in revenue losses for net deficit countries. In the absence of non-tariff barriers, these will usually correspond to real income losses. Revenue-sharing formulae incorporated in some CU agreements attempt to deal with this particular element of the problem. But internal lobbies in the more advanced members of an RIA often see such a formula as too generous to the smaller less developed members. Even when the more advanced members in a CU wish to bolster the prosperity of their neighbours, their financial ability to make direct transfers may be circumscribed by the worsening of their own economic conditions.

Fiscal reforms involving a substitution of consumption taxation for import duties in developing countries, and external liberalisation coupled with the tariff convergence that structural adjustment programmes imply, should reduce this problem, but such changes in tax structures cannot eliminate it altogether. Unless future CUs are based on a non-redistributive attribution of revenues, i.e. on a *clean* basis, they might become much less acceptable to the more advanced members.

26 In CEAO, part of attributable compensation which is based on revenue losses goes, not to the general budgets of the net benefiting partners, but to FOSIDEC, a solidarity fund which funds investment projects of regional development interest.

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For a CU *without* compensation to be a feasible option, a reduction in protection or, at least, a switch from price-raising forms of protection to direct assistance would probably be necessary. An accord on regional *trade-related investment measures* (TRIMS) and harmonised investment codes might then become key components of CU agreements. If such a switch were not negotiable, fiscal frontiers would have to be retained in any wider or closer grouping, and tariff-free trade would have to be excluded.

In the longer-term context of reform and liberalisation, if regional groupings of developing countries were willing to regionalise customs administration and harmonise tariffs, as well as rates of consumption and excise taxes, the introduction of some form of CU would merit consideration. The regional adoption of a computerised system for processing customs declarations, controlling the clearance of goods, and producing trade and fiscal data – such as the ASYCUDA system devised by UNCTAD – would be an indispensable aid to such an initiative, involving the simulation of the effects on revenues, consumption, and prices for all prospective participants.

The Role of Preferential and Free Trade Areas

It is difficult to envisage a complete unification of tariffs under full CUs among developing countries in different regions except in the long term. The alternative would be to aim at preferential or free trading areas (PTAs or FTAs). In such areas, each country retains its own external tariff, but trade within the area is wholly or partly tariff-free. In principle, such PTA-FTA-based RIAs for a selected group of countries have many advantages. While they are capable of capturing many of the benefits of full regional market integration, PTAs-FTAs reduce demands for compensation, either for revenue losses, or for the loss of fiscal discretion and autonomy that may both be entailed in a CU. At the same time, the harmonisation of customs and consumption tax schedules, documentation and procedures that occur under such RIAs still yields substantial benefits by reducing administrative barriers and costs to cross-border trade and investment and, at the same time, reduces fiscal incentives to illicit trade.

Furthermore, the PTA/FTA approach enables a *variable geometry* and/or *multi-speed* approach to be taken towards closer (and eventually full) integration. The adoption of such approaches may be vital if integration is to proceed at a pace faster than that of the slowest country. If market integration through trade preferences or other means is to proceed on a uniform basis in the sub-region, it is likely to be at the pace of the slowest. A more flexible approach would be, for instance, that a core group implements or maintains a customs union with a common external tariff, while a wider group at the periphery constitutes itself as a free trade area and links itself with the core

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group in a free trade agreement on the lines of the EU-EFTA (European Free Trade Association) arrangement. Other flexible forms of RIAs, for instance those involving public sector investment and operation – e.g. involving joint or coordinated operation of utilities or telecommunications and transport companies –, might be handled similarly, with cooperation for particular purposes involving overlapping groups.

The PTA/FTA approach has many advantages but, as the experience of several such arrangements show, its implementation is not easy. For it to succeed, the prior fiscal reforms outlined above for the customs union have to be adopted. If these have not been undertaken, the problem of compensation will arise in any event.

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