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No. 60, May 2002

Trade as Aid

Freeing Access to Canada's Markets for the World's Poor

Danielle Goldfarb

The Backgrounder in Brief

The Canadian government has proposed removing all duties and quotas on imports from least developed countries, which now face astonishingly high tariffs on their key exports such as textiles and apparel. Ottawa's proposal is good policy: increases in exports spur development and reduce poverty, particularly among women. The removal of tariffs and quotas is likely to reduce poverty in a number of the poorest Asian countries, send a largely symbolic message to the poorest African countries and perhaps improve their living standards in the longer term, and lead to lower prices and a more productive economy for Canadians. In short, in giving aid through trade, Canadians and the world's poor alike will benefit from this small step along a longer-term path of opening Canada's markets to all developing countries.

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$5.00; ISBN 0-88806-560-4;
ISSN 1499-7983 (print); ISSN 1499-7991 (online)

In the run-up to the action plan for Africa that it will announce at the Group-of-Eight (G-8) meeting in Kananaskis, Alberta, in June, the Canadian government has proposed extending "duty-free and quota-free access to Canada's imports from Least Developed Countries" (Canada 2002b, 1).[1] (See Box 1 for definitions of least developed countries and other terminology used in this paper.) The overall recommendation of this *Backgrounder* is that the government's proposal makes sense: trade as aid is good policy. It is likely to increase wages and employment and reduce poverty in a number of the poorest Asian countries, send a largely symbolic message to the poorest African countries and perhaps improve their living standards in the longer term, and lead to lower prices and a more productive economy in Canada. Canadians and the world's poor alike will benefit from this small step along a longer-term path of opening Canada's markets to all developing countries.

The Department of Foreign Affairs and International Trade (DFAIT) discussion paper on the proposal argues that:

> Canada and other developed countries have recognized the need to look beyond aid to find effective tools to address global poverty....Developing countries most successful at alleviating poverty are those whose economies grow through trade....Enabling economic growth therefore includes the important task of enhancing trade opportunities for developing countries....Market access, while not sufficient for poverty reduction, reinforces the efforts of countries to make full use of their comparative advantage. (Ibid.)

Eliminating tariffs and quotas would, therefore, be an important step toward helping least developed countries (LDCs) develop. In poor countries with export capacity,[2] trade in labor-intensive manufactures typically increases workers' incomes relative to alternatives such as subsistence farming. Furthermore, the majority of workers in these sectors are women, which has a positive impact on sexual equality in those countries.

Other countries have already begun to move in a similar direction. In March 2001, the European Union launched its "Everything But Arms" initiative, which provides duty- and quota-free treatment to LDCs for all products except arms, sugar, bananas, and rice — the last three will be phased in over several years. New Zealand granted LDCs duty- and quota-free access for all exports in July 2001; Norway has implemented a similar policy.

The author wishes to thank Alan Alexandroff, John Curtis, Michael Hulet, Ron MacIntosh, and Bill Robson for helpful comments, as well as John Richards for extensive comments and for his contribution of Box 2.

1 Such access would not, however, be provided to Canada's supply-managed sectors. Since the least developed countries export very little to those sectors in any event, this *Backgrounder* does not discuss their impact on this area.

2 A number of LDCs, particularly in sub-Saharan Africa, lack export capacity. They also face nontariff barriers to entry in Canadian markets, including rules-of-origin requirements, Canadian health and safety standards, and environmental and labor standards. This *Backgrounder* focuses, however, only on duties and quotas in response to the Canadian government's proposal.

Box 1: Glossary

Agreement on Textiles and Clothing (ATC). An agreement to bring, by 2005, the textile and clothing industry under the rules of the World Trade Organization, which does not permit quotas. The ATC phases out the 1974 Multi-Fibre Arrangement, which imposed country-specific quotas.

Generalized System of Preferences (GSP). Preferential access schemes that grant products originating in developing countries lower tariff rates than those under most favored nation status. Under GSPs, unlike under preferential trading arrangements such as the North American Free Trade Agreement, developing countries are not required to reciprocate (UNCTAD 2001).

Least developed countries (LDCs). To be classified as an LDC, a country must have low income (gross domestic product of less than US$900 per capita), weak human resources in terms of health, education, and literacy, and a low level of economic diversification. The United Nations currently recognizes 49 countries as LDCs.

Most favored nation (MFN). The principle that all imports are treated like imports from the nation that receives most favorable treatment.

Rules of origin. Rules that typically require a minimum percentage of inputs from the importing country in order for those goods to enter duty free.

Trade-weighted average tariff. The average of a country's tariffs, weighted by value of imports.

Canada's Current Policy

The labor-intensive products that LDCs tend to export and in which they have a comparative advantage still face high tariffs and, in some cases, quotas.

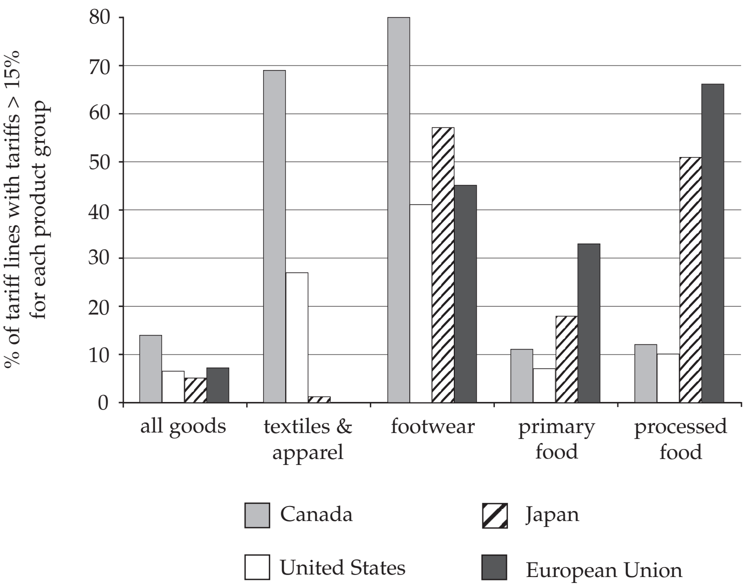
Although Canada imposes low average tariffs and has a preferential access scheme in place for LDCs[3] the labor-intensive products that LDCs tend to export and in which they have a comparative advantage — particularly textiles and apparel — still face high tariffs and, in some cases, quotas. In fact, LDCs are exempt from duties for 90 percent of possible product categories, but actual LDC exports fall primarily in the remaining non-exempt categories. This results in fewer than half of LDC exports (primarily textiles and apparel) entering Canada duty free, with 54 percent facing tariffs averaging an astounding 19 percent (Canada 2002b). This compares with a 0.9 percent average tariff facing exports from all countries to Canada in 1999 (WTO 2000b).[4]

In 2000, Canada added 570 items to the list of products that are duty free for LDCs, but this preferential access scheme does not apply to the textile and apparel industries. The special treatment accorded to LDCs applies mainly to products for which all countries already benefit from low average tariff rates; the extra margin of benefit for LDCs is not significant. Moreover, this restricted preferential treatment has the effect of encouraging LDC exports in traditional, very low value-added,

3 Burma (Myanmar), although an LDC, is not eligible for this scheme for political reasons.

4 These average tariffs are trade weighted (see Box 1 for a definition).

Figure 1: ***MFN Tariff Lines with Tariffs Greater than 15 Percent, 1999***



Source: World Bank 2002a, 45.

highly volatile, and low-growth industries such as unprocessed commodities, rather than encouraging export diversification into relatively higher-value, higher-growth, labor-intensive manufactures such as apparel.

LDCs thus face the same tariffs on textiles and apparel as do other countries that do not have preferential agreements with Canada. Moreover, those tariffs are high, relative not only to other categories of goods but also to duties other developed countries impose on such products. As Figure 1 shows, in 1999, nearly 70 percent of Canada's textiles and apparel imports and 80 percent of its footwear imports that are subject to tariffs had tariffs higher than 15 percent, which was considerably higher than those imposed by the United States, Japan, or the EU. In 1995, Canada committed to reducing average tariffs on fabrics from 20 percent to 14 percent by 2005, and on apparel from 25 percent to 18 percent over the same period (Canada 1995), but these tariff levels are still very high.

The effect of such high tariff levels on key LDC exports is exacerbated by the tendency for tariffs to rise the more processed (and, therefore, the higher the value-added) the goods. This acts as a further disincentive for developing countries to diversify their exports away from raw materials toward relatively higher-value-added items.

For some LDCs, quotas may also be a barrier to exports. For example, Canada restricts imports of certain categories of apparel from Bangladesh, Lesotho, Burma (Myanmar), Cambodia, Laos, and Nepal (Canada 2001).[5] Most of these LDCs do not export amounts close to their country-specific limits. Bangladesh, however, meets its quotas in exports of trousers and winter outerwear, and comes close in a number of other apparel categories, despite Canada's high tariffs. Trouser exports to Canada from Cambodia and Lesotho also come close to 80 percent of their respective quotas. In the absence of tariffs, LDCs that are now below their quotas would have greater incentives to increase exports and would likely meet quotas in a greater number of product categories. Furthermore, even if LDCs do not technically meet their quotas, this does not necessarily exhibit a lack of potential export capacity. Rather, it may simply reflect the fact that investments in production capacity tend to be large and infrequent. When faced with quotas, investors lack the incentive to make such a large investment if it would result in production exceeding the quota, which, in practice, would mean significant idle capacity. It may also reflect the fact that quotas create uncertainty about future market access,

5 Canada also restricts the amounts of duty-free imports of certain agricultural products, such as beef, wheat, and barley from LDCs. However, since imports of such products from LDCs have never come close to reaching these limits, the quotas are essentially irrelevant (Canada 2002b).

again reducing incentives for investment in production capacity. The removal of quotas, whether technically binding or those that have not yet been met, could thus spur LDCs' investment in some apparel categories.

Under the terms of the 1995 Agreement on Textiles and Clothing (ATC), Canada must eliminate all quotas on textile and apparel imports by 2005. Three factors, however, limit the impact of this agreement on the few affected LDCs. First, the process is "back-end loaded," meaning that quota-free access for nearly half of all imports can be delayed until 2005. In addition to constraining imports from developing countries, this imposes a cost on quota-imposing countries, which will have to adjust all at once to increased competition from imports of all developing countries.

Second, each importing country can choose which products are to be "freed" at each stage, and each country is required to free a specified number of products rather than a specified percentage of product value.[6] Canada, like other quota-imposing countries, has not yet selected many products from the higher-value product groupings, particularly apparel. For the most part, products for which LDCs meet or come close to meeting their quotas have not been freed in the first three stages.[7]

Third, quota-imposing countries can select to free products for which no quota previously existed (and freeing them means no quotas can be imposed in the future). For example, in January 2002, the Canadian government listed 40 products for the third phase of ATC quota elimination, only 25 of which were under quota at the time (Canada 2002c).

Trade as Aid

Opening markets for LDC goods fully is one small step Canada can take to help these countries develop. Of course, open markets are not a panacea for the problems of developing countries, and should be viewed in the larger context of factors affecting development — such as the quality of domestic governance, infrastructure, education, and health services.

A broad spectrum of research and opinion is coalescing around the idea that trade is essential for development.

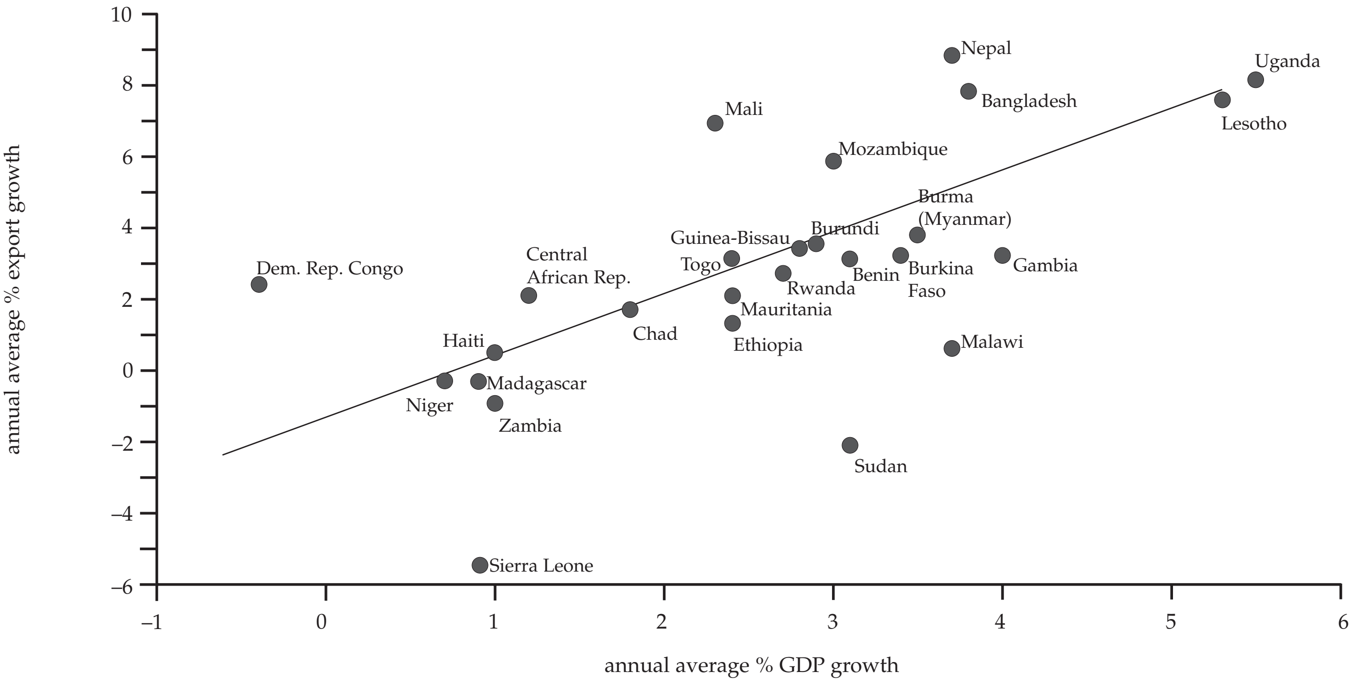
A broad spectrum of research and opinion is coalescing around the idea that trade is essential for development.[8] A number of recent studies (summarized in World Bank 2002b) show that developing countries that participate in the world economy experience stronger economic growth and faster poverty reduction than those that do not. As Figure 2 shows, LDCs with higher average annual export growth over the 1965–99 period tended to have higher average annual growth of gross domestic product over that period as well. Moreover, wages grow faster in economies that trade (Rama 2001). Exports are also associated with significant job

6 The ATC's only constraint is that the list of products to be freed at each of the four stages must include products from each of the four groupings: tops and yarns, fabrics, made-up textile products, and apparel.

7 Freeing these products for all developing countries is likely to lead to increased competition between exports from LDCs and those from less poor developing countries such as China. This is why eliminating quotas for LDCs before 2005 could give them a head start on other countries.

8 Oxfam, for example, argues that "export success can play a key role in poverty reduction," and also that "export growth can be a more efficient engine of poverty reduction than aid" (2002, 8).

Figure 2: ***GDP Growth and Export Growth in LDCs, 1965–99***



Source: World Bank 2001.

creation in the better-paying formal sector of the economy, especially in activities such as textiles, garments, and footwear. Increased exports of textiles and apparel have spurred labor-intensive growth in manufacturing in developing countries, contributing to the reduction of urban poverty, especially among women (World Bank 2002a, 40). These industries also provide incomes to middle-class managers who might otherwise emigrate in the absence of such economic opportunities. (Box 2 describes, as an example, the impact of the ready-made garment sector on living standards in Bangladesh.)

Aiding LDCs through trade has the added benefit that it avoids some of the problems associated with official development aid. Although development aid has been effective in improving economic growth and reducing poverty under a number of conditions, it may not be effective in countries that are poorly managed and highly corrupt. In such countries, competition by interest groups for aid may reduce productive economic activity, and officials may use aid for ends that have little impact on development (see Goldfarb 2001). Revenue that comes in the form of direct incomes to individuals, as trade income does, obviates some of these problems. Trade also helps to create conditions for a more sustainable path to development.

LDCs' Export Experience

The export experience of each LDC will largely determine its response to complete access to the Canadian market. Although LDCs export primarily commodities and labor-intensive manufactures, for which they have a comparative advantage due to natural resource endowments and low labor costs, their export experience is far from uniform. A small number of Asian LDCs have been able to diversify successfully

Box 2: *Trade as Aid — The Case of Bangladesh*

Bangladesh, with a population of more than 130 million, had a per capita income of US$370 in 2000.* Even by south Asian standards, it is poor country, and it has been among the most important recipients of bilateral aid through the Canadian International Development Agency (CIDA).

One of the most remarkable economic success stories in Bangladesh has been the ready-made garment sector. Virtually nonexistent at the time the country gained independence in 1971, the sector generated US$4.8 billion in export earnings in fiscal year 2000/01, two-thirds of the country's total (BGMEA 2002). Major markets for the sector are the European Union and North America. It currently employs an estimated one million people, 64 percent of them women (Mainuddin 2000, 28).

Bangladesh garment factories might be considered the contemporary equivalent of nineteenth-century England's "dark satanic mills." The key point to consider here is the alternatives available, given the country's stage of development. As the World Bank summarizes:

> Although the workers in the garment industry are paid low wages, most of them, especially the women, would earn much less in alternative jobs. Without a job in the garment industry, many would be unemployed or engaged in informal activities and live in poverty. (Ibid.)

For many countries, an expanding textile sector has been the first rung on the ladder to development. The sector provides many women their first opportunities to earn income independently. It also encourages the growth of a local managerial and entrepreneurial class: 30,000 people work in managerial jobs in the country's garment sector.

Expansion of the garment sector has prompted an important debate about appropriate social policy. Under pressure from major importing countries, Bangladesh has entered into agreements with the International Labour Organisation and UNICEF, the purpose of which is to ban the employment of children under age 14 and to encourage garment factories to construct schools for young workers.

* Data from World Bank website: www.devdata.worldbank.org.

away from reliance on slow-growth, volatile commodity exports toward faster-growth, labor-intensive manufactures. Relative to more successful Asian exporters, however, African LDCs' share of exports has declined significantly. As Table 1 shows, most of the top 20 LDCs in terms of textile and apparel exports to Canada increased their exports considerably between 1997 and 2001. Bangladesh is the leader, increasing its exports by 64 percent, although its share of total textile and apparel exports to Canada from LDCs declined from 70 percent in 1997 to 60 percent in 2001, reflecting the increased exports of some other LDCs.

Although exports by a small group of LDCs have increased significantly relative to previous levels, the increases are negligible relative to exports to Canada from other countries. As a group, LDCs represent less than one-half of 1 percent of all world exports; in 1999, they accounted for a mere 0.11 percent of total Canadian imports and 0.27 percent of Canadian imports of products that LDCs actually export (UNCTAD 2001). As Figure 3 shows, even in the textile and apparel sectors, LDCs represent only 2.5 percent of Canadian imports. Canada imports most of its textiles and apparel from the United States and China.

Table 1: *Canadian Imports of Textiles and Apparel from the Top 20 LDCs, 1997 and 2001*

	1997	2001
	(current Canadian dollars)	
Bangladesh	105,908,024	173,455,828
Burma (Myanmar)	10,796,064	45,623,279
Cambodia	3,731,659	21,610,353
The Maldives	186,365	13,137,335
Lesotho	7,920,049	9,874,530
Nepal	4,090,808	7,748,645
Haiti	2,234,219	7,655,365
Madagascar	404,626	3,574,959
Mali	13,111,539	2,522,031
Laos	1,666,454	2,421,452
Burkina Faso	1,881	820,307
Tanzania	220,073	213,412
Western Samoa	14	212,158
Chad	0	120,476
Sierra Leone	190,139	93,318
Afghanistan	63,434	49,927
Mauritania	31,187	46,343
Niger	7,511	45,975
Somalia	0	14,309

Source: Industry Canada, Trade Data Online.

Freeing Access to Canada's Markets: The Impact on LDCs

In the short term, LDCs that already export to Canada would benefit the most from duty- and quota-free access to Canadian markets. One study simulating the impact of the elimination of tariffs of more than 15 percent on LDC exports to Canada (Hoekman, Ng, and Olarreaga 2001a) concludes that Bangladesh and Liberia are the countries likely to experience the largest absolute export gains, with Haiti, Laos, and Cambodia experiencing large gains relative to their own total world exports. The largest increases are expected in apparel. Given their current low levels of exports, most African LDCs are unlikely to see large export gains. Overall, the study estimates, LDC exports to Canada would expand by US$1.6 billion.[9]

Although it is likely that LDCs that already export to Canada would experience sizable export growth in the short run if granted freer access to Canadian markets, these simulation results should be interpreted with caution. The simulations likely overestimate the export response of LDCs since they assume that apparel is homogeneous — that is, that apparel made in, say, Cambodia is perfectly substitutable for apparel made in, say, Italy. Furthermore, in the longer term, the export response of LDCs could be muted by further multilateral reductions of trade barriers, which could erode the margin of preference available to LDCs. However, once LDCs and investors have had the opportunity to adjust over the longer term, export growth could expand more significantly than in the immediate aftermath of such a policy shift.

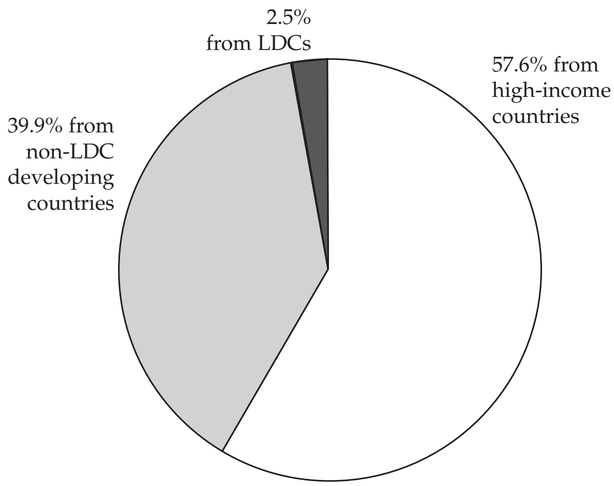
Freeing Access to Canada's Markets: The Impact on Canadians and on Other Developing Countries

Even if LDC exports increased significantly from their current base, the effect on Canadian industry is likely to be negligible, given that imports from LDCs are such a small percentage of total Canadian imports, even in the textile and apparel industries.[10]

9 The elimination of high tariffs is a useful approximation for the impact of all tariff elimination for LDCs, given that those countries primarily export products that face high tariffs. The simulation assumes that access is truly free — that is, that there are no restrictive rules of origin. The simulation also uses a simple partial equilibrium model and a conservative supply elasticity of 0.5 to reflect the difficulty many LDCs will have in generating a supply response. These assumptions, particularly the one that all LDCs have the same responsiveness of supply, suggest that the results should be viewed with caution.

10 In the unlikely event of a flood of imports, under WTO rules Canada could under certain conditions still use trade remedies such as antidumping duties, countervailing duties, or safeguards. (Safeguards are temporary actions such as quotas or tariff rate increases against imports that have caused or threaten to cause serious injury to the importer's domestic industry.)

Figure 3: Canadian Imports of Textiles and Apparel, 2001



Note: "Non-LDC developing countries" includes China, India, South Korea, Mexico, Indonesia, and Pakistan; "high-income countries" includes the United States, Hong Kong, Italy, and Taiwan.

Source: Industry Canada, Trade Data Online.

Any increase in exports that did occur could result in some short-term adjustment costs, and current labor retraining and mobility programs are likely to be adequate for any affected workers. Overall, however, any increase in exports would lead to increased choice and lower prices for Canadian consumers. It would also spur a more efficient allocation of resources, including labor, toward higher-value-added industries, translating into higher wages and living standards. It is true that tariff revenue would be lost but tariffs from LDCs are a relatively insignificant source of federal revenue.[11]

Given the relative insignificance of exports from LDCs relative to those from other developing countries, only a small amount of trade is likely to be diverted away from the latter. One reason is that exports from countries above the LDC threshold tend to be more diversified than those of LDCs. If tariffs greater than 15 percent were eliminated for LDCs, exports from other developing countries are expected to drop by only 0.3 percent (Hoekman, Ng, and Olarreaga 2001a).

Recommendations

In the light of the positive impacts of freeing access to Canadian markets for exports from LDCs, Canada should consider the following:

- *Allow all exports from LDCs to enter duty free*. This would give LDCs a head start on other countries that will benefit from future tariff reductions. A second-best option would be the removal of tariffs over 15 percent for LDC exports.
- *Eliminate fully all quotas on apparel exports from LDCs*. This would complete the elimination of quotas for LDCs and allow them to compete in the Canadian market for more than two years before quotas are eliminated under the ATC for other large apparel exporters.
- *Ensure that these are secure and permanent commitments,* in order to provide certainty to LDCs and potential investors in their export industries.
- *Include all LDCs, not just African LDCs,* otherwise the policy would not have more than a largely symbolic impact.

11 A "back of the envelope" calculation suggests that the loss in annual tariff revenues from providing LDCs with tariff-free access for their textiles and apparel, which account for the majority of Canada's imports from those countries, would be approximately $55 million, assuming a high 19 percent average tariff.

- *Complement this policy with other government policies.* This should include encouraging export and trade-negotiating capacity in LDCs. Canada has already devoted a relatively small amount of funds to improving LDCs' trade-negotiating capacity (see, for example, Canada 2002a). Canada could also ensure that nontariff barriers such as import-content requirements are not prohibitive. It could also continue to support multilateral actions aimed at creating alternatives to child labor, such as Bangladesh's current agreement with the International Labour Organisation and UNICEF.
- *In due course, Canada should consider duty- and quota-free access for all developing countries.*

Canada has an opportunity to make a simple gesture to improve economic prospects for the world's poor, with positive benefits for Canadians' living standards as well. The greatest gains would occur if Canada's policy change pushed the United States and Japan to adopt similar policies. A small step for Canadian policy could be a big step for the world's poor.

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