

## Trading Out of Poverty: Some Major Issues

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**Abstract:** What are the ways in which trade (trade liberalisation) may have impact on poverty? This paper looks at some of the findings of the analytical literature on trade-poverty linkages that operate through the impact of trade on income distribution, and through the impact of trade on economic growth. This paper further asks the question whether trade effects on poverty depend on a particular type of trade liberalisation. In particular, it exposes the weaknesses of non-reciprocal trade liberalisation. The trading preferences granted by the European Union (EU) to Pacific Island Countries (PICs) and their poverty-reducing potential are briefly examined at the end.

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**Keywords:** trade liberalisation, poverty, income distribution, regional trade agreements, preferential trading agreements

### Introduction

The World Bank is loyal to its tradition of preparing a major report on poverty alleviation every ten years. World Development Report 2000/1 is focused on attacking poverty, and should (one hopes) contain findings and recommendations which have benefited from learning in and around this area during the ten years since the World Development Report 1990 entitled 'Poverty' was published. One obvious

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novelty in this report is the involvement of consultants from a wide variety of disciplines, including the public and the poor themselves.<sup>1</sup> This changed approach towards preparing a report on poverty by an international organisation is quite telling as it signals a strong shift in the thinking of people and governments in both developing and developed countries, as well as international agencies including The World Bank, IMF, and the WTO, about poverty.

Despite this almost universal acceptance of the need to fight poverty globally, there is still great diversity in understanding poverty and its causes. From the 1960s, when the concept of poverty was mainly focused on the level of income such as GNP per capita, it was broadened and deepened first in the 1970s by including 'basic needs', in the 1980s with the introduction of non-monetary aspects such as powerlessness, isolation, security, capabilities and gender, and in the 1990s the ideas of well-being and human development came to the fore. At present we accept poverty as a multidimensional and complex socio-economic phenomenon (Mehta and Narsalay, 1999), but there is still no single 'right' definition of poverty. However, having one definition will probably mean little without understanding the causes (cf Maxwell, 1999, p.5). Specificity principle applies to interventions in the area of poverty as to any area – if the cause is missed, while intervention is aimed at symptoms, any improvement will not last. This is why, when we talk about the linkages between trade and poverty, we must understand the possible mechanisms through which trade might affect the level and changes of degrees of poverty.

What are the ways in which trade (trade liberalisation) may impact on poverty? This paper aims to provide some of the findings of the analytical literature on trade-poverty linkages that operate through the impact of trade on income distribution (Section 2), and through economic growth (Section 3). In order to do that, a money-income view of poverty is adopted. The paper further asks the question whether trade effects on poverty depend on a particular type of liberalisation. In particular, it exposes the weaknesses of non-reciprocal trade liberalisation (Section 4). The trading preferences granted by the European Union to the Pacific island Countries and their poverty-reducing potential are briefly examined in the final section.

### **Trade and Income Distributional Effects**

To draw any conclusions on the linkage between trade and poverty by looking at the income distributional effects of trade, we have to assume that there is no difference between the functional and the personal distribution of income. In other words, we assume that each factor receives income only from the sale of factor services owned (thus workers only sell labour and income consists only of wages).<sup>2</sup>

*Traditional Ideas: The Stolper-Samuelson Theorem*

Trade works through changing commodity prices. Let us describe this mechanism in a stylised economy which, for simplicity reasons, has only two sectors, exportables and import-substitutes. Other standard assumptions of the traditional Heckscher-Ohlin-Samuelson framework apply.<sup>3</sup> A country is assumed to be the price taker. Then, whether a country shifts from autarky to free trade, or from restricted to free trade, prices of tradeables will adjust so that the exportables price in terms of importables will rise. If additionally we assume that a country's exportable sector is unskilled-labour intensive, while the importable sector is capital (human or physical) intensive, as is often the case with a developing country, then the opening of trade and the resulting increase of the price of an unskilled-labour intensive commodity will result in the following adjustments (in a long run). Exportables will want to increase the production (while the import-substituting sector will be contracting), drawing more on unskilled labour and the other factor, say capital, from the other sector of the economy. Because of the different factor-intensities used in these two sectors, the importable sector will release unskilled labour and capital in a proportion per unit of production not demanded in the exportable sector – it wants more unskilled labour per each unit of capital than importables are freeing up. As demand for unskilled labour rises, the price of it (wage rate) rises, while the opposite happens with the demand and price for capital. A new equilibrium is found with both sectors using relatively more capital-intensive techniques than prior to trade. This in turn increases marginal productivities of unskilled labour in both sectors. The implication of our assumption that factors are paid their marginal products is that unskilled labour receives a higher wage in terms of both goods. As income of each factor consists only of returns it earns, we conclude that an increase in the exportables price shifts income distribution in favour of unskilled labour, a factor which is intensively used in the exportable sector. Capital, which is intensively used in import-substituting sector, loses.

The link between the level of wages for unskilled labour and poverty should be obvious. It is mostly unskilled labour that is at risk of becoming or staying poor. Thus if trade is able to improve the welfare of this labour category, it is also likely that trade (trade liberalisation) will have a poverty-reducing effect.

There are various reasons why the mechanism described above, known as the Stolper-Samuelson theorem, can be treated only as a first and very crude approximation of the possible impacts of trade on poverty (Winters, 2000a). We have already mentioned the problem with functional vs. personal distribution of income. Other problems arise mostly because of assumptions that this simple version of Stolper-Samuelson model, relies on (see endnote 3). When one or more of these

assumptions are violated, the Stolper-Samuelson theorem gets weakened or loses its potency completely.

For example if the number of goods and factors is minimally changed, traded exportables and importables are still produced but now with factors which are not all fully mobile. Say that both sectors use some of the inter-sectorally mobile capital, while they each use a fixed amount of one other factor which has specific skills to be used only in that sector. We assume that the exportable sector complements capital with some sector-specific land, while the importable sector uses capital and unskilled labour in its production. Let us introduce trade into this economy, and then follow the same reasoning of the Stolper-Samuelson theorem as before. An increase in the exportable commodity price, *ceteris paribus*, tends to increase the value of marginal productivities of factors employed in a sector. However as soon as this happens to the mobile capital, a process of re-allocation is started which finishes only when returns to a mobile factor are the same in both sectors. This in turn produces effects on the marginal productivities of specific factors and therefore their returns. In this example, exportable-specific land will benefit in terms of both goods, while importable-specific unskilled labour will experience a decrease in both nominal and real wages. As for the capital, we cannot claim an unambiguous result as in terms of the importable return to capital rises, but in terms of the exportable it falls. But what makes this example interesting is the fact that depending on where unskilled labour is used (in terms of its specificity or intensity), its position in income distribution after trade does not necessarily improve. Winters (2000a, p.25) talks about the likelihood that it will not be the least-skilled labour (that is, the poorest) that is intensively used in the production of exportables, but on the contrary such labour will either be employed in sectors which will experience price reduction and contraction in aftermath of the introduction of trade (liberalisation). In such cases trade could worsen poverty problems and introduce even sharper inequality in the distribution between skilled and unskilled.

### *New Ideas: Re-interpreting the Stolper-Samuelson Theorem*

Davis (1996) brings forward another reason why the Stolper-Samuelson theorem as described above cannot be used in a poverty discussion. He cites empirical results (Krueger, 1978; Bhagwati, 1978; Choksi et al, 1991; Robbins, 1996) which are at odds with the predictions of the Stolper-Samuelson theorem. In all of these studies, developing countries were assumed to be relatively abundant in unskilled labour compared with the global economy. Thus applying the Stolper-Samuelson reasoning, trade liberalisation ought to have resulted in an increase in the unskilled-labour wage relative to other returns. However, none of the studies listed above find strong or

unambiguous support for such a prediction. Some in fact show that unskilled labour wages fall relative to skilled labour wages, thus suggesting that trade has a potential adverse effect on poverty alleviation. Davis (p.2) qualifies these empirical results as an anomaly. He then develops a simple explanation based on multiple cones of diversification, and a differentiation between global and local factor abundance, where local factor abundance is crucial in determining the production mix relevant for determining factor prices. The point he makes is that the Stolper-Samuelson theorem ought to be formulated on the basis of a country's relative factor abundance in that country's cone of diversification. For example, we can divide all countries into two groups: capital-rich countries in group A and labour-rich countries in group B. Every country in group A is capital-rich compared to any country in group B. However, within group B, it is possible to again rank countries as capital-rich to labour-rich. Therefore a country which is labour-rich in a global sense, but is relatively capital-rich within its own cone, will experience a wages drop as a result of trade liberalisation (Davis, p.15).

This could provide some additional light on why we find such different distributional effects of trade liberalisations for East Asia and Latin America. While studies for East Asian liberalisation in the 1960s and 1970s shows positive impacts on wage dispersion between skilled and unskilled labour, results for Latin American trade liberalisation in the 1980s go in the opposite direction: they reflect widening wage differentials between skilled and unskilled labour. Trade has resulted in more equal income distribution in East Asia, while it worsened both income distribution and poverty in Latin America. If we use the Davis's (1996) argument, it is plausible to claim that Latin American countries were relatively less unskilled-labour intensive compared to China (East Asia) so that the factual changes of factor returns did fit into the factor-endowments patterns.<sup>4</sup>

## **Trade Impacts Through Economic Growth**

Economic growth can be biased in favour of or against the poor, with the anti-poor growth increasing an income-distributional inequality among the poor (McCulloch and Baulch, 1999). Nevertheless, economic growth has long been recognised and accepted as the major weapon in permanent elimination of poverty. What has not been so unanimously agreed upon, is the link between (more liberalised) trade and growth. Analytical and empirical literature on trade, openness and growth is huge but despite this there is no strong theoretical reason or empirical evidence that free trade should produce (faster) growth (see a summary of a debate in Bhagwati and Srinivasan, 1999) who conclude on a more optimistic note in favour of trade-led growth). There is no compelling evidence either against claiming that countries that

do pursue open trade regimes should not experience any growth-adverse effects. Advocates of free trade argue that liberalisation will ensure allocative efficiency, which in itself will be growth-friendly. There is indeed strong evidence that access to imports of goods, services and factors needed for technological progress is necessary to support and enhance growth. On the other hand, growth based on technological progress can occur without trade, as in case of the 'green revolution' (Winters, 2000b, p.41).

Nevertheless, it is hard to argue against the very important role of trade liberalisation and open regimes in general, in promoting discipline of the market, competition, and macro economic stability while also preventing arbitrary policy intervention. The effects of an open and transparent trade policy on restraining discretion and arbitrariness of bureaucrats is equally important as the effects of such trade policy on minimizing opportunities for rent-seeking on the part of producers. With fewer opportunities for rent-seeking, there is also less need for bribery and corruption. Any growth, which is free of those activities, should be pro-poor.

Two further questions can be raised here. First, is there any value in gradual and partial trade liberalisation, and second what is the relationship between economic growth and human development?

With respect to gradual trade liberalisation, again the literature has swollen with the former socialist countries joining the 'market-led' economies and having to open up their closed regimes. Again, economists are divided with respect to the speed and comprehensiveness of trade liberalisation (as well as overall economic reforms) in their advice to policy makers in those countries. Most (supported by the heights of Washington consensus) argued for an approach that can be called 'going all the way'. This implies the elimination of all quantitative barriers and a reduction of the tariff barriers to the most-favoured-nation level at the same time, as well as introducing other policies serving to open-up and stabilise an economy. Advocates of a gradual liberalisation were only a few in numbers. Corden (1990) introduced a need for 'transitional' protection to prevent sudden changes in production structure resulting in a too large an increase in unemployment. Mikić (1998, pp.428-31) summarises arguments for keeping some tariff protection for the purpose of sourcing government revenues, preventing fast increases in unemployment, as well as destabilising current accounts and the macroeconomic situation. It is easy to link gradual liberalisation with less adverse effects on poverty, too. In fact, empirical results show that 'all the way' or 'big bang' types of reform, including trade liberalisation are correlated with a large worsening of income distribution and the re-appearance of an army of poor people in those countries in the period following reforms (Milanović, 1999).

Accepting the definition of Ranis, Stewart and Ramirez (2000) of an improvement in human development as allowing for enlargement 'of people's choices in a way which enables them to lead longer, healthier and fuller lives' (p.197), it certainly

makes sense to prefer human development to economic growth in terms of the ability to fight poverty. On the other hand, there is widespread belief that without resources provided by economic growth, human development cannot be sustained. Ranis et. al. however demonstrate that economic growth is a necessary but not sufficient condition for achieving an improvement in human development. In fact they claim the opposite, that economic growth itself cannot be sustained unless preceded or accompanied by improvements in human development. This finding is of great importance for all transitional and developing countries, which are yet to undertake economic reforms but feel that they face a too tight budget constraint for an investment in human development. This is related to findings from already mentioned empirical studies on trade-growth links, that free trade without a strategy for an investment in human resources (particularly health and education) does not guarantee sustained growth rates.

In short, it is clear that the adoption of more outward-oriented liberalisation policies will produce some and even significant short-term adjustment (transitional) costs that might also be anti-poor. But because of the overall positive contribution openness provides to economic growth, it is likely that gains will be sufficient to help reduce poverty over the long run. This is consistent with a distribution of ordinary gains from trade over time and over groups, where in a short run there are some private groups who lose from trade (mostly through temporary unemployment), while in a long run there are social gains and the potential to make everyone better off.<sup>5</sup> Obviously these social gains might be eaten up if the adjustment period is too long and/or distribution very biased against those who pay the adjustment costs.

### **Which Trade Liberalisation: Does it Matter?**

If trade liberalisation is on average good for growth and is pro-poor, does it matter what type of liberalisation a country adopts: unilateral, multilateral, or perhaps regional with variants of reciprocal and non-reciprocal preferences.

We can answer this question by quoting statements from two studies (cf also Vamvakidis, 1998). Winters (2000b, p.35) says: 'The greatest effects of trade policy arise from what a country does to itself rather than what others do to it'. Ingco (1997, p.20) concludes her study along similar lines: '...most gains from multilateral liberalisation come from the country's own liberalisation efforts. Thus, by making zero or very limited liberalisation commitments, countries have lost one opportunity for efficiency gains'. Both studies (as well as many others) also identify the most important reasons for eventual losses from trade liberalisation are due to the existence of market failures and distortions in domestic economies. Thus it seems that the most efficient line of action would be to undertake unilateral trade liberalisation and

support it with measures that minimise domestic distortions (it is, in general, easier to correct distortions in an environment of open economies). However, since we are here mostly dealing with developing and particularly poor countries, unilateral liberalisation is not a realistic option as most of them are still developing domestic production and rely on both import protection and opening export markets. In addition, most of these country's governments are also in need of building credibility. Thus they need some sort of international contractual obligation to be able to sustain reforms once started. The choice is then narrowed to regional or multilateral (WTO driven) liberalisation. A big proportion of the WTO members are the developing countries, and most of them are still under the special and differential treatment which enables them to reduce a degree of reciprocity in their trade liberalisation efforts (in other words, they are allowed to keep doors to their domestic markets partially closed, while doors to markets for their exporters are more or less open). The extreme form of non-reciprocity in trade liberalisation has been practiced through two schemes: generalised system of preferences (GSP) and the Lomé Convention. While the GSP is unilateral in a sense that providers of preferences are not bound by any sort of contract, the Lomé preferences are contractual and therefore receivers of such preferences are more certain about their position in export markets. The next section explains the welfare consequences of such preferences.

### *Non-reciprocal Trade Preferences: Welfare Effects*

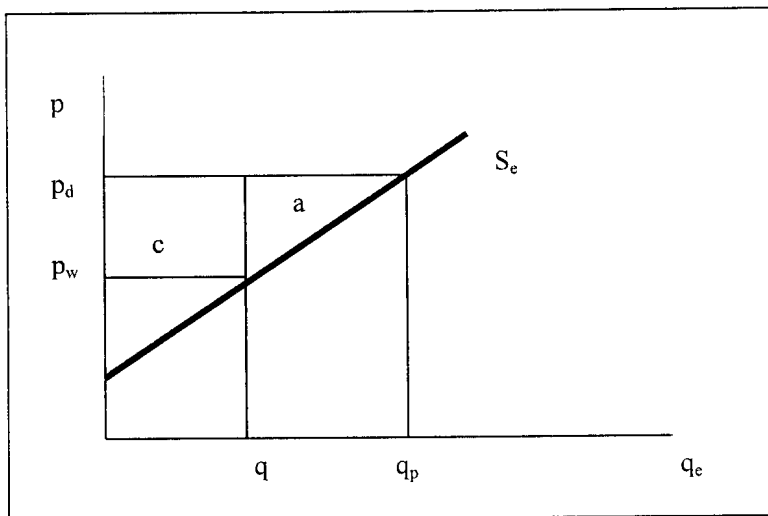
Trade preferences are the opposite of trade barriers: they work by exempting a country's exports from tariffs and quotas intended to protect producers in the importing country from more efficient imports.<sup>6</sup> The essence of the trade preferences offered under Lomé is that these preferences are non-reciprocal: they secure access to foreign markets without the need to open domestic markets to foreigners in return. This is what differentiates Lomé preferences from the ordinary preferential trade agreements or multilateral trade agreements. In either one of these arrangements, access to a foreign market is conditional upon the exporting country opening its own domestic market to foreigners at the same time (or at least in due time). In other words, those agreements are based on reciprocity.<sup>7</sup> In non-reciprocal agreements all the gains from 'liberalising' trade are derived from the ability to export, and none from what normally is perceived as the source of gains from free trade – cheap imports. Is it really the case that the countries which accept non-reciprocal trade preferences deliberately deprive themselves of a big chunk of gains from trade, or is there something else that escapes our attention?

It is illustrative to use partial equilibrium analysis looking at the export and import sector separately. Thus Figure 1 shows an excess supply of exports of say, sugar. The



curve is upward sloping reflecting less than perfectly elastic supply. The world price of sugar is given by  $p_w$  but imports of sugar are burdened by a specific import tariff so that the price for sugar in the export market is  $p_d$  (where  $p_d = p_w + t$ ). However suppliers from a country holding trade preferences are in a different position from other suppliers – they do not have to pay tariffs although they get to fetch price  $p_d$  for their sugar. Thus the difference between the two prices and the supply curve reflects the welfare effects of trade preferences enjoyed by suppliers. We can break the total area into two: a and c. Area c is really the amount of tariff revenue that the importing government would have collected if our supplier had to pay tariffs. Since they are exempted, this amount in a way is a transfer of revenue from importing country government to the exporters. This amount is also an economic rent that exporters may be able to capture which depends on whether their own government taxes rents away or not.<sup>8</sup> The other area, which we labelled as a, is the amount of producer surplus which covers the additional exports at the higher prices. Thus, clearly producers, and possibly government, in the exporting country benefit from trade preference. Without preference, exports would have been much smaller (at level  $q$ ) since marginally efficient producers would not have been able to stay in the market.

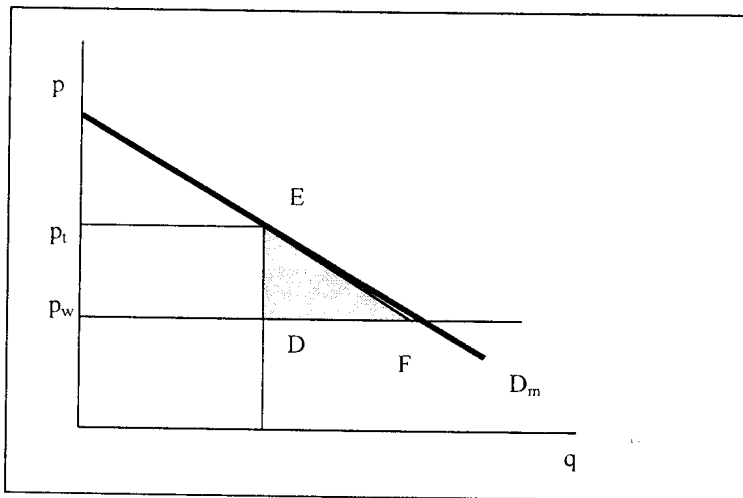
Figure 1



In Figure 2 we look at the import market of a country which holds non-reciprocal preferences. Say that this is a product that is not produced domestically, for instance, personal computers – PCs. Therefore domestic demand and demand for imports is the same thing, and it is shown as a negatively sloped linear curve  $D_m$  in our Figure 2.

Assume that the world supply is infinitely elastic and willing to supply PCs at the price of  $p_w$ . However this country does not practice free trade so there is also a specific tariff  $t$  which raises the price of every PC in the domestic market to the level of  $p_t$ . Quantity of imports is  $p_t E$ . Of course, consumers are not happy with this situation, as they are not given the opportunity to buy PCs at low world prices. The amount of income (consumers surplus) they lose is equal to the area  $p_t E F p_w$ . On the other hand, government should have no reason to complain. They get to pocket tariff revenue in an amount of  $p_t E D p_w$ . It is customary to assume the existence of so-called benevolent governments. Such governments give the total amount of tariff revenue back to consumers in the form of other benefits (say education or similar), and provision of those is assumed to be costless. Of course, in the real world a big chunk of revenues gets wasted on administration and bureaucracy. In addition to this, it is apparent from the figure that in the process a significant chunk of consumers income gets lost – the area of triangle  $EFD$ , and this is known as dead-weight loss.

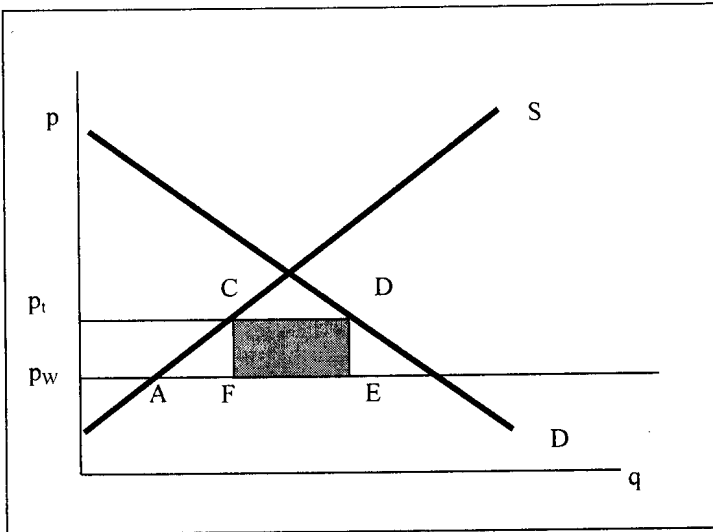
Figure 2



If this country had been in a regime of reciprocal preferences, this tariff revenue gain would have been lost to the government. Instead it would have been captured by either domestic consumers (this is a scenario which we normally assume), or by foreign suppliers (in which case they must be represented by a different supply curve). What is important to stress is that the absence of reciprocal preferences might be against the interests of consumers in countries such as Lomé Pacific. This is even more obvious if we assume that there is a positive supply of the imported product in a

local economy (see Figure 3). In this case a loss of consumer surplus will be even larger because we have to account for the quantities of domestic product sold at tariff-adjusted prices. Thus, if the domestic supply of PCs is given by  $S$ , and total demand for PCs by  $D$ , with tariffs  $t$ , imports will equal  $CD$ . From the total consumers surplus lost, portion  $CDEF$  goes to government as tariff revenue, but portion  $ptCApw$  goes to domestic producers. This amount is often called economic rent.

Figure 3



Let us now take this analysis one step further. Assume that government eliminates the tariff on imports of PCs. What are the welfare effects of that policy change? Well, now the winners are consumers who get to buy PCs at much lower world prices and therefore they reinstate their previously taken income. Losers are of course domestic PC producers as now only the ones who are equally efficient as world producers get to stay in the market. Government loses tariff revenue and therefore all services, which were previously financed from that source, lose. However, note that what has also been regained are the areas of two triangles – thus the total gains for consumers are larger than the total losses of the producers and the government. There is scope then to ask consumers to pay back part of their gains (via higher taxes perhaps). In theory this dead-weight loss is large enough to compensate losers; in reality it often is not. And this is exactly the point which is important for Lomé Pacific.

## The European Union and Pacific Island Countries

The EU has committed itself in both the Maastricht Treaty (Article 130u) and in the United Nations to fight poverty by promoting sustainable development. By redesigning the Lomé Agreements, the EU has sought to satisfy this objective, along with other objectives that perhaps appeared as more urgent (for example, making trade preferences to conform to the WTO principles). For the last 25 years, the main two instruments in the EU's fostering of economic growth and development in the developing countries, including Pacific Island Countries (PICs), were the aid and use of non-reciprocal trade preferences: the Lomé preferences for the ACP countries, and the GSP preferences for the rest of the developing countries. After the Uruguay Round, the Lomé type of preferences was challenged under the WTO system. They were renewed, in an almost intact format, in February 2000 as the 'Partner Agreement' for another 20 years.

Figure 4: Possible linkages between trade and poverty in the Pacific Island Countries

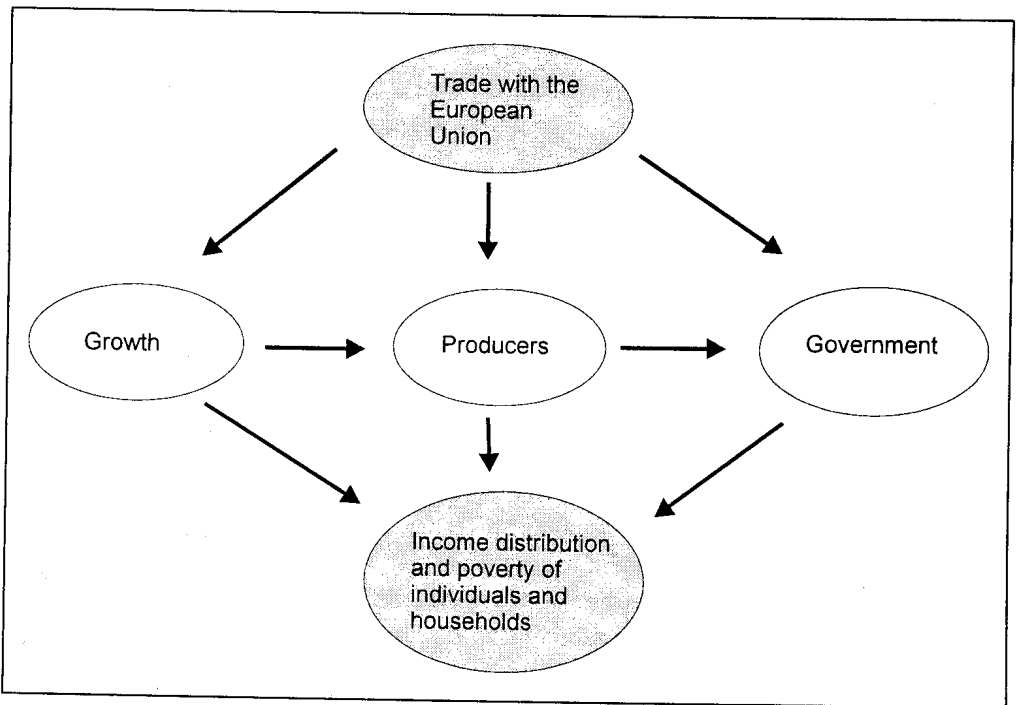


Figure 4 represents the main linkages of static effects driven by increased trade with the EU (based on trade preferences) within Pacific Island economies. This chart

ignores important feedback effects of the level of poverty and a degree of equality of income distribution on growth and trade. It also does not pay any attention to world distribution of income and poverty and its effects on trade liberalisation (which are important in so much as they have much to do with the 1999 WTO ministerial conference debacle). Trade liberalisation here comes in a one-directional form, as it is non-reciprocal preferences that drive trade flows in the direction of the EU. (We have analysed welfare effects of that particular type of liberalisation in the previous section.) As there are no quid-pro-quo market openings in the PICs, any increases of imports from the EU result from export-led growth in the PICs.

Let us first explore the effects of increased trade on producers. To simplify, let us assume that there are two types of producers: those producing for exports, and those producing for the local market. Freer access to the EU market (at the higher than world price) translates into larger export sector's producer surpluses compared with what they would have been without trade preferences. In the case of PICs, the goods that are exported under this scheme are sugar, canned tuna, textiles and clothing, cocoa, copra and some other unprocessed agricultural products. Most of these require unskilled-labour intensive methods of production (in addition to using export sector-specific land). Thus calling upon the traditional Stolper-Samuelson effects, this export-induced price increase pulls up unskilled-labour wages and returns to export-sector specific land compared to returns in other (non-traded) sectors. Given that export activities form the most important part of PICs formal economies, it is plausible to assume that overall employment and wages as well as producers' profits are positively correlated with exports to the EU.<sup>9</sup> Thus there is a static welfare-increasing effect which, depending on the distribution of obtained gains, might be used to reduce poverty in a money-income sense. (There are many more important dimensions of poverty that ought to be taken into account in order to make unambiguous statements on poverty). There is however another effect on producers here that has longer-term effects on poverty. This type of trade locks in the production structure in accordance with non-reciprocal preferences. Because of the secure export market, producers are not really competing in terms of price or quality. Therefore they are not investing in their own growth. The consequences for overall growth potential of these economies are diminished, which is reflected in extremely high aid-dependency of almost all PICs.

Turning to the effect on government, typically governments oppose reciprocal trade liberalisation because they link it to a reduction in government revenues from border taxes. One of the reasons why PICs were extremely sceptical about the initial EU's proposal to replace non-reciprocal with reciprocal preferences was the fear of a loss of revenue. As government plays a crucial role in the provision of employment and public services, such a loss will undoubtedly aggravate the poverty situation in these countries, at least in a short to medium term. However, since the preferences

have been renewed in almost the original format, PICs have bought themselves some more time before having to reduce their dependence on import taxes as revenue sources. Another source of revenue comes from export taxes which can be afforded given the secured market access in the EU and the fact that the majority of PICs are not members of the WTO. It is inevitable that PICs will have to increase their reliance on non-trade taxes in future and that a major concern in making such a change ought to be the minimisation of the adverse effects on poverty.

The link that remains is between this non-reciprocal trade and growth. As already mentioned above, there are strong reasons to believe that trade preferences weaken incentives for investment into improvement of productive efficiency. If that is the case, and if there are no other stimuli to invest in diversification of production structure, the potential for growth gets really diminished. Therefore, prospects to alleviate poverty without or with less international aid are really slim.

It is clear that non-reciprocal trade preferences are not sufficient to promote the smooth and gradual integration of Lomé Pacific countries into the global economy or to fight poverty. There are several reasons for this. First of all, securing access to EU market does not necessarily prepare producers to face competition in the global market, given that the CAP in the EU resulted in much higher prices for many goods that Lomé exported than the world market is ready to pay. Of course often a question is raised about how much access was really provided (both sensitive sectors and the MFA come to mind immediately). Obviously, impediments on the supply side in Lomé economies are not to be ignored. So if preferences were going to work at all they have to be helped by some other development instruments to increase supply capacity and overcome supply side constraints. The new agreement extends non-reciprocal preferences until 2007, giving the PICs some time for capacity building.

Of course, there should also be better co-ordination of trade and development policies at the EU level, which would enable the EU to provide better assistance in improving infrastructure and the facilitation of trade. Product development and improved legislation as well as expertise in trade issues should be supported with special provisions at the national as well as regional level. Increased foreign direct and local investment is necessary to boost the private sector (in particular SME which are credited with being the most dynamic in most economies).

## NOTES

<sup>1</sup> First draft of the WDP 2000-1 is available for public discussion on the web site of The World Bank. However this version of the report is still labelled 'not for quotation' and therefore this paper does not comment on the content or conclusions of the report.

<sup>2</sup> In the real world of course things are not as simple. Income depends on returns from the ownership of various factors of production. See Lloyd (1998).

<sup>3</sup> Typically assumptions relate to dimensionality (2 sectors and 2 factors of production), mobility (free and costless inter-sectoral mobility of all factors), non-specialisation (each country must be producing all goods at all times), production (constant returns to scale with smooth substitution between factors), market structure (perfect competition in all markets with all goods being traded goods and homogeneous across domestic and foreign suppliers).

<sup>4</sup> There are of course other factors contributing to these different outcomes including different characteristics of labour markets, endowments of natural resources, timing of liberalisation episodes, etc.

<sup>5</sup> Note that some sort of compensation (lump-sum or a mechanism of costless taxes) is needed to redistribute some of the gains from winners to losers so that nobody is worse off even in the long run.

<sup>6</sup> They can also be offered in terms of a minimum import price. This is how trade preferences were defined for sugar, and other agricultural products in the Lomé Agreements.

<sup>7</sup> Preferences under the GSP are also non-reciprocal. The difference between Lomé and GSP, among other things, is that GSP is non-contractual.

<sup>8</sup> As Kreinen (1973) shows, there is also a possibility that this amount of rent is also re-captured by the importing country government.

<sup>9</sup> There are many activities, which are not effected by the market in these economies. We ignore them in this simple schematic representation.

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