Testimony of Grant D. Aldonas[1]
Before the Senate Committee on Finance
Oversight Hearing on U.S. Trade Preference Programs
June 12, 2008

Introduction

Mr. Chairman, Senator Grassley and Members of the Committee, I want to thank you for the opportunity to appear before the Committee today to discuss the operation of our trade preference programs. As reflected in my testimony, I think our preference programs can play a critical role in our trade and development policies, but that, as currently structured, they work at cross purposes with our goals in both areas.

By way of introduction, I am currently the founder of a global trade and investment consulting firm that is, in part, dedicated to mobilizing investment for entrepreneurs at the bottom of the economic pyramid in the developing world. I also chair a non-profit microfinance fund – Synapse, Inc. – that is developing innovative approaches to financing farming operations in the developing world, principally Africa, and linking those operations to the global supply chains operated by Fortune 1000 companies. In both capacities, our trade preferences play a role in our decisions regarding the projects in which we choose to invest.

My experience with respect to our trade preference programs is one of longstanding. While at the State Department in the early 1980s, I played a role in the creation of the original Caribbean Basin Initiative ("CBI"), which, at a later stage at USTR, I was responsible for implementing. For over a decade after leaving USTR for private practice, helping U.S. investors invest in emerging markets formed an important part of my law practice and our preference programs played an important role in the advice I provided.

More recently, I was fortunate enough to serve as the Finance Committee's Chief International Trade Counsel, when, in the late 1990s, the Committee succeeded in securing the passage of the Trade and Development Act of 2000, which significantly expanded the original CBI and created the African Growth and Opportunity Act. During my tenure, the Committee also worked on renewal of the Generalized System of Preferences and the Andean Trade Preferences Act.

[1] Principal Managing Director, Split Rock International, and Senior Adviser, Center for Strategic and International Studies; Under Secretary of Commerce for International Trade (2001-2005); Chief International Trade Counsel, Senate Finance Committee (1997-2001); Partner, Miller & Chevalier (1986-1997); Director for South American and Caribbean Affairs, Office of the United States Trade Representative (1984-1985); Special Assistant to the Under Secretary of State for Economic Affairs, U.S. Department of State (1983-1984).

While serving as Under Secretary of Commerce, I played a significant part in the development of our trade policy, the launch of the Doha Development Agenda in the World Trade Organization ("WTO"), and the negotiation of a series of bilateral free trade agreements with trading partners that otherwise benefitted from our preference programs. I was also involved in the creation of the Millennium Challenge Corporation and served on the board of directors of the Overseas Private Investment Corporation, which insures and finances U.S. investment in developing countries where such investment makes a demonstrable contribution to the recipient country's economic development.

I will divide my testimony into two parts. The bulk of my testimony will focus on the premises on which our preference programs are based and what changes are needed to ensure that they contribute to, rather than conflict with, our broader trade and development policy goals. I will, however, also offer my thoughts on how our preference programs and our trade policy might be reformed to produce a better result from the perspective of both development and trade policy interests of the United States.

Rethinking the Bases of Our Preference Programs

When I first started studying economic development in the international relations program at the University of Minnesota in 1972, there was a wonderful professor there at the time by the name of Ed Coen. Ed was British and by nature a skeptic. He believed in examining the facts and trying to draw conclusions from them, rather than grand theories – which is why I have always wanted to go back to ask Ed why everything he taught us about economic development has proved wrong.

We now have roughly 60 years of experience with development finance through institutions like the World Bank, almost 50 years of experience with bilateral assistance via the Agency for International Development ("AID"), and going on 40 years of experience with our trade preference programs. In each instance, our approach has failed to deliver the promised spur to economic development among beneficiary countries.

Today, the most successful developing countries, which have lifted hundreds of millions of people out of poverty, tend to be those that were least dependent on World Bank lending, AID programs, or trade preferences for attracting investment capital and stimulating development. From Korea to China to Taiwan and much of Southeast Asia, none of the champions in the development race relied on either source as the main driver of its economic development.

By contrast, those countries that did rely heavily on the World Bank, our bilateral assistance, and trade preferences remain significantly behind the leaders in terms of development. That remains true today even after nearly a decade of experience under Europe's "everything but arms" trade preference program and the implementation of our own African Growth and Opportunity Act.

The Committee's oversight of our preference programs should, as a consequence, start with a simple question – why have they failed? Why haven't they done a better job of fostering both trade and economic development?

The answer lies in three inter-related flaws inherent in our approach to trade and development – they start from the wrong premise; they do not reflect the changing nature of trade in a global economy; and they conflict with the goals of our trade and development policy goals.

Starting from the Right Premise

Our preference programs, like World Bank lending and AID assistance, largely ignore what we have learned over the past half-century of misguided development policies. They think of "development" as the sum of various government policies, rather than the result of individuals engaged in the simple human act of exchange – trading goods and services freely in the marketplace for mutually beneficial gain.

That problem is endemic among theorists of development economics, from Rostow to Singer and Prebisch to more modern advocates like Jeffrey Sachs. It leads to simplistic solutions like Sach's recent call for significant wealth transfers to governments in the developing world, as if cash were the missing yeast in the recipe for development. Accepting that conclusion would, of course, ignore 60 years of development cakes that failed to rise.

In the 1990s, Nobel Laureate Amartya Sen debunked the enduring myths of development theory by pointing out that all development flows from (1) expanding an individual's freedom to create their own economic future and (2) providing the tools or capabilities to effect that outcome. Implicit in Sen's critique of longstanding development theories was the notion that the most effective measure of development policies lay in the extent of their contribution to those two goals.

Seen in the light of Sen's insight, economic development is best understood as a process of economic change – one involving the transition from a state in which an individual's ability to trade the value of his or her labor or output fairly is constrained to a state in which the individual is free to exchange his or her labor or output in return for the goods and services of others.

The work of another Nobel Laureate, Douglas North, explains that the process of economic change depends heavily on changing the incentives for various market participants in ways that yield the outcome you seek. What that means, in the case of economic development, is changing the incentives facing market participants in developing countries in ways that ensure broader economic opportunity via access to markets, both locally and globally.

The question the Committee should ask, therefore, is whether our preference programs significantly change the incentives facing market participants in the beneficiary countries in ways that ensure broad economic opportunity, both locally and globally, for the poor.

Putting it that way would, I believe, inform the Committee's exercise of its oversight responsibilities in that the paradigm Sen and North suggest offers both a measure of the distance many potential beneficiary countries have to travel and a measure of the extent to which our preferences contribute to their progress in their journey.

Our goal should be to offer the broadest possible opportunity for the poor to engage in trade. In return, we should ask that beneficiary countries create the conditions necessary for local markets to flourish – private property rights for the poor; ensuring both freedom of contract and the enforceability of such agreements; and the ability to protect those rights against the predations of government power, to name but a few.

The implications of that approach are significant because they help illuminate the flaws in our current system of preferences that prevent it from making a more significant contribution to development. Consider, for example, what that means for the competitive need limits and product exclusions of our current Generalized System of Preferences ("GSP"). It is hard to escape the conclusion that those conditions on our preferences discourage, rather than enhance, the opportunities for trade.

The same holds true for the process by which we ask foreign governments to apply to add specific products to the list of goods eligible for duty-free treatment. That condition puts the power over the use the preferences in the hands of the politically powerful who can exercise their economic demands through the political process, rather than enhancing the opportunities for the poor to engage in exchange, both locally and globally.

Those specific examples suggest a broader lesson the Committee can use as a part of its work. We should ensure that our preference programs maximize the market opportunities for the poor in their own countries, both as producers and consumers, and, ultimately, link those markets to the global economy. Our preferences would, in the process, create incentives that enlarge individual economic freedom and encourage its exercise.

Reflecting the Changing Nature of Trade in a Global Economy

The second flaw in our current system of preferences is one that is endemic in our trade policy as a whole. Our trade policy, preference programs included, simply does not conform to the reality of how trade operates in today's global economy,

The construct on which our trade policy and our preference programs are built is dated. It thinks of trade as an arm's length sale between independent buyers and sellers in different countries. In reality, that sort of transaction represents a smaller and smaller portion of world trade.

The technological revolution in computing, communications and transport that is driving global integration has fundamentally reshaped the way we trade. In essence, those technological changes have conquered economic geography. Distance is no longer a barrier preventing the organization of production on a global basis.

The changes in technology that have made global supply chains possible have also made them a competitive necessity. Even small firms in the United States, for example, find it necessary to source globally in order to remain competitive and to sell globally in order to gain the scale they need to survive.

That effect was best captured for me a couple of years ago when the head of a Grand Rapids, Michigan, auto parts manufacturer explained that he no longer thought of exporting to Japan or Korea or China. Instead, he was intent upon "exporting" to General Motors and Toyota. What he meant by that was he wanted to ensure that his products were integrated in the supply chains of both General Motors and Toyota so that those two firms would take his product global through their sales in Japan, Korea and China.

What that means in practice is that trade is increasingly dominated by competition between supply chains. Barriers to market access as traditionally defined (e.g., tariffs; quotas, subsidies and other non-tariff measures) no longer represent the most significant barriers to global markets.

Today, the principal barriers to trade are the commercial standards that exporters must satisfy in order to become a supplier integrated into a global supply chain that serves customers all over the world.

Now, consider what that means for a system of trade preferences that are based largely on the elimination of tariffs on imports into the United States. Helpful, certainly, but those preferences do not come close to helping the individual asparagus producer in Malawi find his or her way to our market. To do that, our preferences would have to help that entrepreneur and exporter satisfy the product quality and safety standards demanded by U.S. grocery manufacturers.

Preferences alone will not meet that challenge. What we must do is ensure that we are coordinating our preference programs with our development assistance, whether that takes the form of bilateral assistance via the Millennium Challenge Corporation ("MCC") or AID or takes the form of lending and other forms of assistance through multilateral institutions like the World Bank.

Adopting that approach would, of course, signal big changes in our approach to development assistance as well as our preference programs. Just like our preference programs, our development assistance should focus on connecting people to markets, both locally and globally, because that is the surest route to expand the economic freedom of the poor in the developing world.

We would not, however, be alone in adopting that approach. Japan, during Prime Minister Koizumi's tenure, shifted the focus of much of its development assistance filling in the institutional and educational gaps that prevent producers in developing countries from participating in Japanese companies' supply chains. Those reforms are worth looking at as the Committee rethinks how our current preference programs operate and what they will need in the way of reinforcement from our development assistance programs in order to succeed.

I recognize that the approach I suggest would raise potential jurisdictional conflicts, both in terms of authorization and oversight. But, those problems are not insuperable. This Committee already has significant experience in doing just that in the context of our preference programs.

The current Chairman and Ranking Member and their staffs were both instrumental in engaging the Foreign Relations Committee in the effort to shape the Senate's version of the African Growth and Opportunity Act. The Senate bill that ultimately passed bore the mark of both Committees, even though the Finance Committee held sole jurisdiction over its subject matter because it was a revenue measure related to trade.

The jurisdictional conflicts in Congress, moreover, often have a way of becoming disabling conflicts among separate agencies in the Executive. The surest way to avoid that problem and ensure that our trade preferences and development assistance work together, rather than in potential conflict, would be to ensure that they operate under a single set of criteria for bestowing the benefits of either our trade preferences or our cash. It makes sense, as well, to create a single coordinator for development policy capable of ensuring the two strands of our development policy worked together in practice, as well as on paper.

Neither the Finance Committee nor the Foreign Relations and Foreign Operations Subcommittee of Appropriations need lose oversight responsibility in the process. I know from experience that joint oversight can not only work, but can improve the way an agency operates. As Under Secretary of Commerce for International Trade, I administered an agency that was subject to the jurisdiction of both the Finance and Banking Committees and frankly I benefitted from the involvement of both Committees in our work.

Ensuring Consistency with Our Trade Policy Goals

There is one other challenge the Committee must confront in its oversight of our preference programs. That is the conflict between our preference programs as currently structured and the broad goals of our trade policy.

Properly understood, the goals of our preference programs and our trade policy should be entirely consistent. For the poorest countries, our preference programs offer a means to encourage investment in new enterprises by virtue of the export opportunities our preferences create. Our efforts to negotiate further trade liberalization serve the same purpose, albeit by a different route. They create similar sorts of investment opportunities as a result of mutually agreed commitments to a reciprocal lowering of trade barriers.

What's more, both strands of our trade policy can contribute significantly to economic development. Both expand the freedom of the poor in the developing world to participate in the global economy. In the case of our trade agreements, our trade policy allows the poor to benefit as consumers as well as producers.

There is, however, no doubt in my mind that our preference programs have, in practice, eroded the incentive to negotiate further trade liberalization among a number of rapidly rising developing countries. In Doha, at the outset of what became the Doha Development Agenda or "development round," I was responsible for negotiating the text of the declaration on "rules" (i.e., subsidies, other forms of unfair competition, and the domestic remedies the WTO allows to combat them).

Early in the week, we held consultations with a wide variety of countries to assess their interest and stake in the talks over rules. The discussions with our Indian counterparts were the most instructive. I was told that our Indian counterparts had no interest in negotiating because they were entirely content with their access to our market and their success in bringing the United States before the WTO Dispute Settlement Body when India felt its access to our market threatened.

Despite the fact that India was, at the time, and still is the world's most prolific user of trade remedies, they felt they had no stake in the talks because of the market access they already enjoyed in the U.S. market and the special and differential treatment they received under provisions of the Subsidies and Antidumping Agreements. The Indians never did participate in the rules negotiations and were, in fact, the last obstacle to the launch of a round that was expressly intended to benefit the developing world.

Now, economists have a phrase for the error we make when we try to reason from our own individual experience to a general rule. It's called the fallacy of composition. Not wanting to fall prey to that error, I thought I would check to see whether the economic literature contradicted or confirmed my anecdotal experience.

Recent research by World Bank economists strongly suggests that my experience in Doha was symptomatic of a broader problem. Our preference programs have, in fact eroded the incentive to engage in further liberalization.[2] Indeed, the evidence further suggests that "graduation" results in a shift of the graduating country's trade policy in favor of further trade liberalization.[3]

What that suggests is a relatively easy fix that would ensure that our preferences focused on those countries where they were most needed. That would involve making our trade preference programs available solely to the least developed countries in the world.

Focusing our preferences in that manner would also be broadly consistent with the original intent of our preference programs, Part IV of the GATT and the Enabling Clause which makes such preferences possible in a world trading system based on the most-favored-nation principle. The original intent behind the preferences was to encourage investment in developing countries, together with the employment and wealth creating effects such investment brings, in an era when most developing countries were largely excluded from access to global capital markets.

Significantly, while the least developed countries remain largely excluded from global capital markets, except to the extent they are significant exporters of commodities, the rapidly rising developing countries like China, India, and Brazil now have access to such markets and are significant recipients of foreign direct investment.

The point is that the rapidly rising developing countries like China, India and Brazil no longer need the incentive provided by trade preferences to attract investment capital. Indeed, to the extent that we offer preferences to India and Brazil at this stage of their development, we are allowing them to crowd the least developed countries out of potential export markets.

---

[2] See, e.g.,, C. Ozden and E. Reinhardt, The *Perversity of Preferences: GSP and Developing Country Trade*, Journal of Development Economics 78 (2005) 1–21 (arguing that preferential tariff treatment may retard trade liberalization in beneficiary countries preferences reduce the incentive that export industries in developing countries have to lobby for trade liberalization at home as a step toward gaining greater market access abroad).

[3] Id.

Having said that, I also think that we can and should use the other strands of our trade policy to do a better job of encouraging the more advanced developing countries to liberalize and to meet them half way in that process. We should, for example, consider how to create an incentive for their export industries to take on the entrenched interests that seek continuing protection in their home market.

One way to do that is to pivot from our current approach to the Doha negotiations towards a deal that would encourage significant liberalization on the part of the rapidly rising developing countries. The current Doha declaration calls for a single undertaking by all WTO members, which gives every member a unit veto over any progress as a result. We need to free ourselves from that particular shackle and take the lead in pressing for serious liberalization that would benefit both U.S. commercial interests and the developing world far more than anything currently on the table in Geneva.

A 6-Point Agenda for Achieving Our Trade and Development Goals

Toward that end, and in the interest of achieving our broader trade and development policy objectives, I would suggest the following integrated approach.

First, I would recommend that the Committee expressly limit the availability of our preferences to the least developed countries in the world. That would enhance the benefit of the preferences as a tool for attracting investment to the poorest countries in the world (i.e., those that lack access to global flows of private investment capital). Limiting our preferences would also limit the "free rider" problem we face where developed countries lack any incentive to negotiate further liberalization, whether within the framework of WTO, regionally or bilaterally.

Second, I would recommend that the Committee work with its colleagues on the Foreign Relations Committee to create a single set of criteria for gaining access to both our preference programs and our development assistance. Adopting a single set of criteria would ensure that our trade preference programs and our development assistance, whether offered bilaterally or through multilateral development banks, reinforced each other, rather than operating on separate and, at times, inconsistent tracks

Third, in the same vein, I would encourage the Committee to work with their colleagues on Foreign Relations to adopt a single process for consideration of potential beneficiary countries under both our preference programs and our development assistance in order to encourage a more consistent development strategy from the potential recipient country. I would also adopt an integrated approach to the grant of our preferences and assistance so that both strands of our development policy could be drawn together for the benefit of the recipient countries.

Fourth, while access to our preferences and development assistance ought to be assessed in terms of the needs of a particular country, which of necessity will require discussions with governments, our development assistance should not flow through the recipient governments hands. Our development assistance should be geared toward expanding the economic freedom that individuals in the recipient country enjoy and enhancing their ability to exercise that freedom to build their own economic future.

What that means in practical terms is that we should concentrate on financing private investment and, where needed, building the physical and institutional infrastructure needed to connect people to markets. We should, as the Japanese have increasingly done, focus on connecting firms and workers in the developing world to the global supply chains that will allow them to benefit from the growth in the global economy.

Fifth, to gain greater operational consistency, I would combine the administration of our preference programs, our development assistance programs (i.e., AID, MCC, etc.), and the responsibility for oversight of our participation in multilateral development banks in the hands of a single administrator. The current incoherent mess that is our trade and development policy will remain the underperforming failure it is until we confront the need for a single point person responsible for developing our approach, implementing it, and being held accountable for it.

Finally, we need to recognize that our preference programs do not exist in a trade policy vacuum. We must match the reform of our preference programs with reform of our trade policy objectives in order to deliver on the promise trade holds for the poorest in the world.

Toward that end, I would recommend a grant of negotiating authority to the President to pursue the following objectives –

- Harmonizing our preferences for the least developed countries with our developed country trading partners and making them permanent so that entrepreneurs building businesses in Africa, for example, would know that they could sell as easily in Athens, Georgia, as they could in Athens, Greece;

- Negotiation of a free trade area within the WTO among developed countries willing to move rapidly toward that goal, which would include an accelerated removal of tariff barriers on industrial and agricultural goods, the immediate elimination of agricultural export subsidies, and an immediate delinking of existing agricultural subsidies from production.

The net effect of this last step would be to create a significantly broader market into which the least developed countries could sell, while providing a significant incentive for the more advanced developing countries to join the United States and other developed countries in moving toward free trade.

Thank you, Mr. Chairman and Members of the Committee. That concludes my testimony.