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FORMULATION OF INCENTIVE PROGRAMMES WITHIN THE FRAMEWORK OF A STRATEGY FOR EXPORTS

(summary)

by the

Trade Policy Division

Working document

This text is a summarized version of the document with the same title (ST/ECLA/Conf.37/L.10). Both texts are subject to revision.

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1. Introduction

The document summarized is intended to provide a framework for the preparation of direct incentive programmes for exports, showing the relation of these to other features of an over-all strategy for the development of the external sector, and criteria that might serve as a guide for the formulation of such programmes in relation to the following tasks:

(a) Establishing the targets for the export sector;

(b) Checking the nature of disincentives that hinder exports at present;

(c) Determining the nature and levels of the direct and indirect incentives that may seem desirable and feasible for enterprises with regard to the private sector of the economy. In relation to the public and mixed sector, determining specific amounts and allocation of public investments;

(d) Appraising probable economic and social costs and benefits of the incentives, in the light of other objectives and other programmes for development and industrialization;

(e) Preparing a draft programme of incentives and the rules for its implementation on the basis of the afore-mentioned appraisal;

(f) Studying and revising the draft programme and introducing conditions to safeguard the programme and make it more flexible, to ensure that it does not come up against practical difficulties.

(g) Implementing the programme to be carried out;

(h) Appraising the working of the programme regularly and introducing any necessary or advisable changes.

2. Objectives of export development policy

Export promotion objectives and the entire strategy for implementation naturally depend upon the way in which export promotion is defined. In the majority of the developing countries, the basic problem of the policy for industrial export expansion is that of producing sufficient supplies for export. The two elements of export expansion - supply and marketing - are closely linked in countries which have serious difficulties in producing sufficient export surpluses. Marketing programmes frequently have to be adapted to the products that are available for export or will be available at a future date. On the other hand the conclusions drawn in the studies on present conditions and prospects for demand in the largest potential markets, for competition in those markets, and the nature, extent and adequacy of the various export incentives that could be granted are factors which should be borne in mind when decisions are made on the creation and subsequent expansion of export productions.

The objectives of export incentive policies are characterized by their close relationship with other economic policies, such as those concerning industrial development, taxation, employment, etc. This interdependence is inevitable, because all these policies are aimed at the same final results, and the way in which one policy is implemented affects the success of another.

Another characteristic of these objectives is the fact that they vary according to whether they are short-, medium- or long-term. One of the main reasons for taking the long term into account is the need to establish targets that will encourage investment in new export industries. Although on a short-term basis, there may be possibilities for increasing exports through the use of existing idle capacity, and on a medium-term basis existing industries can be expanded and relatively simple new processes can be introduced, over a longer term the countries will want to take better advantage of world demand, reshaping the structure of their exports towards more highly processed goods. In addition, some export industries cannot develop unless other processes needed for their full realization are in operation.

Another vital characteristic of the objectives of export promotion policy is that they should be realistic; they should be established bearing in mind that the producers' and exporters' capacity to fulfil them is limited. These producers and exporters must take part in the determination of national objectives that will affect their respective industries.

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It should also be noted that each objective should be compatible with the others, i.e., it should be possible to implement them harmoniously.

There will be some objectives that each country will have to identify and quantify and others that most Latin American countries and, generally speeking, all developing countries will have in common. The former can be called specific objectives and the latter general objectives. Within the over-all goal of expanding exports to the limits laid down by economic, social and political plans in each country, the realization of following general aims will be sought:

(a) Lowering present and future export production costs;

(b) Calculating and/or making new investments in export production;

(c) Ensuring that the quality of export goods conforms to the requirements of the world market;

(d) Directing exports towards the products and markets that suit the country best, in accordance with its over-all economic, socal and political objectives.

(e) Eliminating the obstacles and disincentives that now hinder the fulfilment of the objectives listed.

The specific targets will be concerned with individual industries (volume of export products considered to be a reasonable target). The specific national targets will be the sum of the aims of individual producers and exporters, and at the same time they will form part of the country's industrial programme. Thus it can be seen that the task of fixing the specific objectives requires far-reaching prior surveys which include an industrial census, since export programming must be linked with industrial planning and programming; this task begins with an initial selection of the industries which appear to merit and need special incentives for production and export, in addition to the direct and indirect incentives granted to industry in general.

In making this selection the government will take into account the prospects for the primary products and manufactures traditionally exported by the country and those exported sporadically, analysing the possibilities for expanding these exports and the resources needed to do so. It will find out which industries have a dynamic demand on the world

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market, it will determine the country's potential, with the resources available, for producing those goods that show dynamic demand on the world market or which could do so if a new product were offered. It will study the special advantages the country may have for supplying certain specific products in world trade (resources, climate, trained labour, etc.) and will carry out research on the potential world demand for such products. It will also find out which industries have idle capacity and which could increase their unit profits through exports, since they would not need to raise their fixed costs to increase production in sufficient quantities to provide export surpluses.

The government should distinguish between the industries it wants to develop as long-term exporters and those that should or could only export over a short period. For example, it is conceivable that a government might wish to develop on a short-term basis, a certain industry that would absorb a considerable amount of manpower, but that, over a long term, it might prefer to replace this industry by another that would bring greater value added in terms of the over-all value of exports.

In fixing marketing targets, it should be borne in mind that the general composition of exports from the developing countries will vary according to their destination, since the countries will tend to send their more processed products to other developing countries, and their more traditional products to the developed countries, barring exceptional cases which it is hoped will increase in the future. It should also be taken into account that manufactured products go through different stages in their marketing. It sometimes happens that, as a result of discoveries, inventions or innovations, only one country or one producer supplies a given product for a certain period. In a later stage the number of countries supplying such a product will probably increase as a consequence of some kind of transference of technology; and finally the stage is reached when a large number of producers or countries can supply a practically identical product. The factors that determine the decision to import, and therefore control the international marketing of the product, will vary at each stage and this is an important fact that exporters and the government should bear in mind.

/3. Preparation

3. Preparation of a programme of incentives to increase and diversify exports

Once the government has established and quantified the objectives of the export promotion programme, it will examine the disincentives that are currently preventing the expansion of its foreign trade. It is advisable to try and estimate or quantify the true effects of such disincentives. The document summarized here contains a list of the obstacles that occur most frequently in the developing countries. It also contains a kind of inventory of all the *instruments* available to governments for developing exports. In preparing the inventory some problems of definition and classification are bound to arise. Not all these instruments are "incentives" in the normal sense of the word. If the most common practice is followed they should be divided into the following categories: (1) incentives; (2) physical infrastructures for exports; (3) adequate legislation; (4) governmental framework for administration and control, and (5) services. All these factors, however, can promote exports and are needed, to a certain degree, as an incentive for their satisfactory expansion. Thus, from the functional point of view, they can be called "incentives".

In practice, a distinction is generally made between the incentives that provide an advantage or a financial relief for exporters designated to receive them refund of customs duties, export credit, exemption from, or refund of, taxes, retention of foreign exchange, preferencial exchange rates, etc.) i.e., those that are properly called incentives, and the services established for the entrepreneurs and exporters in general and that do not bring about a direct and immediate improvement in the financial position of the individual entrepreneur. In the inventory mentioned above, the former figure as "direct incentives" and the latter as "indirect incentives". Indirect incentives provide the basic framework for the effective function of direct incentives, but they do not provide an immediate financial stimulus to the exporter. This framework would include the provision of the infrastructure needed to expand exports, the development of trade policies favouring export promotion, the institutional machinery to develop exports and the services provided by the government for the exporter.

/The inventory

The inventory referred to above lists twenty-two different instruments as direct incentives and sixteen elements that operate as indirect incentives. The selection of the appropriate instruments, as well as the determination of the levels and characteristics of the incentives, would depend on the nature and level of industrial development of the country using them. For example, the refund of domestic taxes to the exporter will raise the problem, in certain countries, of evaluating the incidence of the tax on the export product, and, when there is a system of multiple taxes and a product has gone through various phases of processing in an industry that is not vertically integrated, the problem becomes more complicated. In the case of financial incentives, some countries will prefer to concentrate their credit resources in the marketing phase of the product, while in others (the majority of the developing countries) there are more pressing demands at the capital formation stage, i.e., so as to be able to produce goods for export. Furthermore, in determining the use of exchange rates as an instrument for export promotion, both the export policy, and the other major economic policies of the country are important, because, in addition to trying to increase exports, Governments are attempting to check inflation and satisfy domestic economic and political demand.

The incentives include open subsidies, even though governments generally try to avoid the payment of subsidies that only offset the inability to compete rather than a specific disadvantage (such as high taxes, excessive costs for energy or local raw materials for which the user pays more than the international price). Subsidies may have two significant disadvantages. First, in the case of exports to a member country of GATT, compensatory or anti-dumping duties may be applied if the transaction disrupts the market of the importing country. Secondly, a country can lose more than it gains if it pays a subsidy that is not needed to reach the target set, when there is no possibility of reaching it by means of a subsidy or when the subsidy compensates for nothing more than inefficiency.

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Once the incentives a government might apply to exports have been established, their probable levels in specific cases must be fixed, in order to bring together the elements that will subsequently serve as a starting point for the cost-benefit analysis of proposals. At the same time as the levels are calculated, the probable duration of the application of the incentive should be estimated, bearing in mind the relationship envisaged between this point and the quantitative objectives already established, and taking into account the fact that the continuity and stability of the policy should be maintained so as to foster export consciousness on the part of the private sector. Among the factors which should be considered in determining the levels of direct incentives are the effects on unit costs of the production expansion needed to provide the desired export surpluses, the effect of direct and indirect taxation on the fixing of export prices, the external diseconomies affecting enterprises whose exports would be promoted, the effects of other disincentives (interest rates and over-valued exchange rates), transport and insurance costs, profits that would be considered reasonable and the price of the product on the world market. Emphasis should be laid on the importance of relating the levels of the incentives to the new structure of unit costs and prices resulting from the increase in production needed for the exports envisaged. With regard to the importance of possible disincentives to exports, it should be indicated that a product with a unit price of 10 dollars on the world market which, with an exchange rate over-valued by 20 per cent (say 80 pesos per dollar instead of 100), is sold with a total incentive (or subsidy) of 15 pesos, is receiving <u>partial</u> compensation because of the over-evaluation, and not a true subsidy.

In order to determine the levels of the incentives, certain governments use the value added to the product as a yardstick. It is easy to make mistakes in dealing with the relationship between this value and the incentive level.. To begin with, the concept of value added varies from one survey to another and it is frequently not clear exactly what this value includes, especially if the concept covers profits. Further, the value added that includes labour costs will reflect the efficiency or inefficiency of the labour in an inverse proportion. In addition, the

/value added

value added will appear high if the price of the product includes relatively expensive local raw materials. Another factor that should be considered is that a product with a relatively low value added can be exported on a scale that may bring the country a sizable income in foreign currency, even after deduction of the foreign currency spent on importing the intermediate product. For all these reasons, the percentage of the value added to the product in any country should not be taken as the only criterion in fixing incentive levels.

So far in this survey it has been assumed that export industries are financed with private capital. It should be pointed out, before continuing with other features of the preparation of a programme of incentives, that some industries may be financed with public or mixed funds. In certain countries development corporations invest in productive activities that can create exports. Although many of the government services provided for private industries can be extended to industries in the public sector, certain incentives (for example fiscal and financial incentives) cannot be applied to the latter sector.

4. Cost-benefit analysis of incentives

If a government wishes to use its resources economically and avoid an excessive tax burden, it will have to take care not to establish more export incentives than are needed. These must be sufficient to achieve the desired effects, but at the same time they should not bring abour a disproportionate rise in social costs as compared with the benefits received.

There are two very important concepts that should be borne in mind in estimating the economic and social costs and benefits of a draft export incentive programme:

(a) The main purpose of the incentives is to bring about an effective expansion of the country's exports, and not merely to increase the income of the exporters, and

(b) The incentives should not divert resources from activities which might be of greater benefit to the country economically.

/The study

The study of the costs and benefits of the incentives should include an analysis of their relation to other economic activities and objectives, and in practice there are bound to be conflicts between different economic objectives. The economic aims of a country generally include a rise in the levels of living and a more equal income distribution. These over-all objectives are backed by other auxiliary targets: full employment, balance-of-payments equilibrium, accelerated development of heavy industry, development of the more backward regions of the country, control of inflation, expansion and diversification of exports, improvement of social services for agricultural and other workers, etc.

The conflicts referred to in the preceding paragraph may arise between the policy for protection of the local production of raw materials and the policy for expansion of exports of the goods in which these materials are used. Furthermore, there may be a conflict between the desire to achieve full employment and the goal of exporting more highly processed goods. Other conflicts may arise in connexion with: (a) policies and programmes to improve income distribution, which may not coincide with the target for increasing production efficiency to expand exports, and (b) the need to invest considerable resources in the development of the more backward regions of the country, when such investments do not bring about a corresponding expansion of the country's exports over a short or medium period. Finally, there will be some conflicts between short-, medium- and long-term goals. The work of harmonising these aims has to do with the fixing of priorities, subordinating short-term targets to long-term aims and objectives, and, where necessary, compromises between goals that have immediate and unavoidable priority.

To the extent possible, the cost-benefit analysis of proposed incentives should be based upon estimates for specific products. Not all the elements included in the analysis can be expressed in terms of quantity, since some are qualitative, but an effort should be made at least to provide a rough estimate of their favourable and unfavourable effects on the objectives in view.

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Among the costs of incentive programmes are the following: (a) financial losses falling upon the Government revenue; (b) new administrative costs falling on the government; (c) new inflationary pressures likely to be generated within the national economy as a result of incentive payments and the impact of such pressure upon production costs, both for the domestic and the export market; increase of prices of imported products following a possible change in the exchange rate; (d) costs to the national community of any worsening of the distribution of income that might result from the application of general or specific incentives; (e) diversion of resources from other industries and a new order of priorities; (f) possible scarcity in domestic supply as a result of exports expansion; (g) possibility that the importing country may apply anti-dumping measures or compensatory charges if the incentive is considered to be a subsidy under GATT ruling; (h) any other cost to the community at large, to the Government revenue, or to any special producer or consumer group within the national economy.

On the other hand the benefits include: (a) increased flow of foreign exchange and enhancement of import capacity; (b) reduction of costs of production and prices on the domestic market; (c) expansion of productive employment for labour and of latent techniques and capacity; (d) improvement of these techniques and capacities, including those of management; (e) multiplier effect of exports on the economy and the benefits of any of their effects in relation to the vertical structure of industry (backward and forward linkage); possible advantageous structural changes within the industrial sector as a result of exports; (g) diversification of export products and export markets anticipated; (h) impact upon the flow of foreign capital and technical progress within the industrial sector; (i) any other benefits flowing to the community, to the Government revenue or to any producer or consumer group within the national economy.

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5. The implementation of an export promotion programme

In drafting the regulations for the legislation on export incentives, the obstacles that may arise in implementation should be borne in mind, and the following ideas are useful in this respect: (a) the incentive programme should not inflict a further burden of red tape on the exporter; (b) the programme, or its administration, must take into account certain special characteristics so as to be able to allow for the different conditions affecting exporters. If there were provision in the rules for machinery to make an adequate study of specific needs, inflexibility could be avoided; (c) the institutional framework for export promotion should be established in such a way as to avoid rivalry between government departments, which could endanger the efficiency of the administration of incentives; (d) new incentives must be compatible with commitments contracted in international trade agreements, particularly those concerning economic integration and free trade areas; (e) the system of incentives must be devised and organized in such a way that any subsequent financial demands do not result in a decline in services or a reduction of the amount of the fiscal, credit and other incentives, which together constitute the minimum required to justify the existence of the system and ensure that it produces favourable results; (f) in preparing the regulations and provisions reference should be made to the list of disincentives to exports set out previously, to ensure that everything is being done to eliminate or offset them to the required extent; (g) there should be harmony between the export promotion programme and the fiscal policy of the country in general; (h) even though the continuity of the system is important in that it maintains an atmosphere of mutual confidence between exporters and Government and prevents the harmful effects of sudden changes, it should be realized that there are different stages in the export process and that exporters may need greater encouragement during the first year or two of selling abroad; a satisfactory balance between continuity and flexibility must be maintained; (i) it may be that in practice problems arise as a result of the lack of trust between the public and private sectors. As already explained, one way of

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cultivating such trust would be to maintain the necessary continuity of the measures adopted and to establish machinery for consultation and collaboration between the two sectors. In certain stages of the preparation of the incentive programme (for example, in considering the practical problems of implementation and the safeguards needed for the effective operation of the programme) it is useful to consider the opinions of the exporters from small and medium enterprises, as well as those of new and potential exporters. Although an export incentive policy is a long-term instrument, the functioning of the programme of incentives should be examined from time to time and any advisable changes should be introduced. Any appraisal should be aimed at measuring the effects of the policy on the development of the national economy in general, and should not merely be limited to an analysis of what has happened with regard to specific products.

Any effective measure for the promotion of exports must be based upon a full understanding of the importance of this task and upon the firm resolve to accomplish it; that is to say an attitude of exporting awareness must be created.

For a full understanding of the need to increase and diversify exports, the President, the ministers for economic affairs, industry, external and domestic trade, the president of the central bank and other officials must communicate the idea that the increase of industrial exports is an important national objective. In this way, export promotion will become a vital feature of economic development planning, and a co-ordinated export strategy covering the short-, medium- and long-term will be drawn up. At highest executive regional, and industrial levels and at various working levels there must be government-enterprise councils to give advice on programmes and governmental measures to promote exports. In fact the governments will have to evaluate and revise the economic, industrial, fiscal, monetary, national and foreign investment, foreign trade, regional integration and other policies, in order to support the expansion and diversification of exports effectively.