The Negative Impact of GSP and Trade Liberalization on Developing Countries:
A Review of the Economic Literature

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The United States government has pursued trade liberalization for several decades. A substantial driver of this liberalization has been the assumption that more global trade would help developing countries become wealthier. However, there is considerable research that shows how trade liberalization policies have not always been the best tool to help support economic growth and reduce poverty among developing countries.

The Generalized Schedule of Preferences (GSP) program is a form of trade liberalization initially launched in the 1974 Trade Act. One of several so-called trade preference programs, GSP unilaterally eliminates tariffs on thousands of products sold by "beneficiary countries" to the U.S. without a trade agreement with reciprocal tariff cuts. The website of the Office of US Trade Representative describes the program as one that helps grow developing country economies, diversify their trade and climb out of poverty.[1]

The GSP has been renewed periodically since 1974, however the potential negative effects are not often discussed. Because Congress is currently considering another renewal, this article reviews the economic literature on the impacts of trade liberalization, as well as GSP, on developing countries. The purpose of this article is to examine the substantial number of studies which found economic harm.

Those studies included the following findings:

- Trade liberalization can increase domestic consumer prices, exacerbate inequality, worsen the trade balance, impede poverty reduction and deprive developing country governments of needed tariff revenue.
- The GSP can distort domestic economies and reduce long-term export prospects.

Policy makers should consider whether other initiatives should be pursued that provide more confidence in the quest to alleviate global poverty.

Trade Liberalization and Income Inequality in Developing Countries

A number of studies found that trade liberalization can have negative effects on developing countries. An increased volume of trade does not necessarily lead to greater economic welfare in developing countries. There are two common ways in which trade liberalization can make developing countries worse off: one is by changing what economists call the "terms of trade," in other words, export prices and import prices. If a country's export prices fall more than its import prices, then the country will be worse off because its ability to purchase imports falls. The second way is if trade liberalization reduces the welfare of individuals, such as through higher inequality and poverty. Studies have found evidence of both of these effects in developing countries.

[1] https://ustr.gov/issue-areas/trade-development/preference-programs/generalized-system-preference-gsp

Removing barriers to trade can change the relative price of goods and even worsen the trade balance. Research has shown that while trade liberalization increases trade, it tends to reduce the trade balance terms of trade for developing countries.[2] A widely cited paper by Santos-Paulino and Thirlwall found that trade liberalization caused a decline in the overall trade balance of developing countries.[3] Their study covered 22 developing countries for over roughly 20 years, and while they found that both exports and imports increased, the net effect was a decline in the balance of trade because imports grew more than exports.

The price of basic goods can increase in a developing country because of trade liberalization. A highly cited paper by Bezuneh and Yiheyis showed how trade liberalization reduced food availability.[4] The paper which covered 37 countries, showed that trade liberalization increased the price of food imports and led to the decline of food availability. Further, studies have shown that trade liberalization can reduce poor people's access to once existing low-priced subsidized goods such as basic foods in developing countries.

Income and wage inequality can be exacerbated by trade liberalization.[5] A pivotal paper by Meschi and Vivarelli shows that income inequality increased from trade liberalization through both import and export channels.[6] Their study covered 65 developing countries between 1980 and 1999. They found that inequality grows when developing countries trade with countries that are more technologically advanced. Other studies have shown that trade liberalization has increased wage inequality, where wage inequality increased because trade liberalization led to a fall in the relative price of labor-intensive goods.[7] [8]

Poorer households in developing countries are less able to protect themselves from the economic frictions created by trade liberalization.[9] Trade barriers tend to protect industries heavy in low-wage unskilled labor.[10] Noting that wage premiums also tend to fall the most in industries most affected by trade liberalization, removing trade barriers can negatively and

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[2] Ashok Parikh, *Relationship between Trade Liberalisation, Growth and Balance of Payments in Developing Countries: An Econometric Study*, International Trade Journal, Vol.20, Iss.4, 2006

[3] Amelia Santos-Paulino and A. P. Thirlwall, *The Impact of Trade Liberalisation on Exports, Imports and the Balance of payments of Developing Countries*, The Economic Journal, Vol. 114, Iss. 493, February 2004

[4] Mesfin Bezuneh and Zelealem Yiheyis, *Has Trade Liberalization Improved Food Availability in Developing Countries? An Empirical Analysis*, Journal of Economic Development, Vol. 39, Num. 1, March 2014

[5] Jorge Rojas-Vallejos and Stephen J. Turnovsky, *Tariff Reduction and Income Inequality: Some Empirical Evidence*, Open Economies Review, Vol, 28, 2017

[6] Elena Meschi and Marco Vivarelli, *Trade and Income Inequality in Developing Countries*, World Development, Vol. 37, Iss.2, February 2009

[7] Harald Beyer, Patricio Rojas, and Rodrigo Vergara, *Trade liberalization and Wage Inequality*, Journal of Development Economics, Vol. 59, Iss. 1, June 1999

[8] Gordon H. Hanson, *What Has Happened to Wages in Mexico since NAFTA?*, NBER, No. 9563, March 2003

[9] L. Alan Winters, Neil Mcculloch, and Andrew Mckay, *Trade Liberalization and Poverty: The Evidence So Far*, Journal of Economic Literature, Vol. 42, No. 1, March 2004

[10] Pinelopi Koujianou Goldberg and Nina Pavcnik, *Trade, Inequality, and Poverty: What Do We Know? Evidence From Recent Trade Liberalization Episodes in Developing Countries*, NBER, No.10593, June 2004

disproportionately affect poorer households.[11] [12] Further, advanced countries are in a better position than developing countries to be competitive in and adapt with new technologies. Advanced countries tend to have a more educated workforce and can shift resources more easily to compete in new markets.[13]

Trade liberalization effects are unevenly distributed and can impede poverty reduction. A ground-breaking paper by Topalova looked at India after the trade liberalization of the early 1990s and found that trade liberalization contributed to poverty.[14] [15] The impact of trade liberalization on poverty came from the removal of tariffs on agricultural goods. Where the price of agricultural goods fell from trade liberalization causing job losses within the poorest areas in India. Wrote Topalova: "trade liberalization led to an increase in poverty rate and poverty gap in the rural districts where industries more exposed to liberalization were concentrated. The effect is quite substantial." [16]

Another paper by Castilho, Menéndez, Sztulman on Brazil showed that while *export* growth from trade liberalization can have a positive effect on poverty, the effect on *imports* has increased poverty.[17] Similar to the Topalova paper, Castilho, Menéndez, Sztulman show that urban areas most affected by tariff cuts saw the least reduction in poverty and inequality.

Trade liberalization will eliminate tariff revenue and reduce government revenues. According to the Peterson Institute of International Economics, poorer countries rely more heavily on tariff revenue for government revenue than other countries.[18] This means that eliminating tariffs will disproportionally hurt poorer countries who rely on this revenue for government services, social safety nets, and frictions induced by trade liberalization. Further, it is more difficult for developing countries to recover these tax revenue losses over the long-term, if at all.[19] [20] For instance, a widely cited IMF report covering over 100 countries over 25 years showed that recovery of lost tariff revenue has been disproportionately difficult for developing countries.[21]

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[11] Harald Beyer, Patricio Rojas, and Rodrigo Vergara, *Trade liberalization and Wage Inequality*, Journal of Development Economics, Vol. 59, Iss. 1, June 1999

[12] Sebastian Galiania and Pablo Sanguinettib, *The impact of trade liberalization on wage inequality: evidence from Argentina*, Journal of Development Economics, Vol. 72, Iss. 2, December 2003

[13] Elena Meschi and Marco Vivarelli, *Trade and Income Inequality in Developing Countries*, World Development Vol. 37, Iss.2, February 2009

[14] Petia Topalova, *Trade Liberalization, Poverty and Inequality: Evidence from Indian Districts*, NBER, March 2007

[15] Petia Topalova, *Factor Immobility and Regional Impacts of Trade Liberalization: Evidence On Poverty From India,* American Economic Journal: Applied Economics, Vol. 2, No. 4, October 2010

[16] Ibid, pg. 293.

[17] Marta Castilho, Marta Menéndez, and Aude Sztulman, *Trade Liberalization, Inequality, and Poverty in Brazilian States*, World Development, Vol. 40, Iss. 4, April 2012

[18] Chad P. Bown and Douglas A. Irwin, *Mainly Poor Countries Use Tariffs as a Major Source of Government Revenue*, PIIE Charts, July 2019

[19] Thomas Baunsgaard and Michael Keen, *Tax revenue and (or?) trade liberalization*, Journal of Public Economics, Vol. 94, Iss.9–10, October 2010

[20] Barsha Khattry and J.Mohan Rao, *Fiscal Faux Pas?: An Analysis of the Revenue Implications of Trade Liberalization*, World Development, Vol.30, Iss.8, August 2002

[21] Thomas Baunsgaard and Michael Keen, Tax Revenue and (or?)Trade Liberalization, IMF Working Paper, No. 05/112, June 2005

The combination of these effects above can explain the poor economic and social outcomes that follow trade liberalization. For instance, research by Dix-Carneiro, Soares, and Ulyssea on trade liberalization in Brazil showed that regions more exposed to trade liberalization experienced an increase in crime. This was due to the factors described above. Trade liberalization causes shifts in labor markets, government services, and inequality that can lead to poverty, unemployment, and crime.[22]

Generalized System of Preferences

The GSP program is based on congressional legislation that reduces import tariffs for developing countries that sell to the U.S. Initially launched in the 1974 U.S. Trade Act, policy makers hoped to encourage economic growth and reduce poverty in developing countries. Specifically, the GSP had been championed as a tool to help uproot poverty by providing trade rather than aid for developing countries. Despite its ambitions, the GSP has not achieved its policy goals due to its complexity and conceptual economic issues resulting from trade liberalization.

Key research on the GSP shows that it is not beneficial for the exports of developing countries in the long-run. An influential paper by Herz and Wagner attributes this to the distortionary effects created by the GSP program.[23] This paper, which covers 184 countries over a lengthy time period, 1953 to 2006, finds that distortionary effects come from the frequent and unpredictable changes in GSP regulations and products.

Herz and Wagner summarized their study this way: "Our empirical results indicate that GSP type trade preferences are not an appropriate instrument to promote the economic development of low-income countries, but might cause negative distortions of their economic structure." [24]

A major distortion caused by the GSP program on developing or recipient countries is the unpredictable changes in the GSP regime. These changes are in response to decisions made by political authorities in GSP donor countries, which are usually the U.S. or a European nation. Recipient countries are often given short notice of changing product exclusions. This leads to developing countries losing time and money with investments targeted at a GSP program that has changed by the time production is ready. It is often difficult for developing countries to re-mobilize resources, so these setbacks can take time to recoup. These effects can limit a developing country's ability to exploit its full potential and maintain competitiveness in an international market.

When compared to other U.S. preferential trade agreements, the GSP was the only one that did not benefit recipient countries. Whereas roughly one quarter of U.S. imports fall under preferential trade agreements, all except the GSP program have shown to benefit recipient

[22] Rafael Dix-Carneiro, Rodrigo R. Soares, and Gabriel Ulyssea , *Economic Shocks and Crime: Evidence from the Brazilian Trade Liberalization*, American Economic Journal: Applied Economics, Vol. 10, No. 4, October 2018
[23] Bernhard Herz and Marco Wagner, *The Dark Side of the Generalized System of Preferences*, Review of International Economics, August 2011
[24] Ibid, pg. 9.

country exports. A research paper by Lederman and Özden evaluated several U.S. preferential trade agreements and found that the GSP program actually hurt developing country exports.[25] This was not the case with free trade agreements, which often allowed the increase of exports to the U.S.

The complexity of the GSP program has limited its effectiveness by limiting the number of products that qualify. For instance, only 10% of all imports from developing countries to the U.S. fall under GSP.[26] Imports are further restricted by requirements on the value, market share, and rules of origin for goods.

Further, countries have performed better after being removed from the GSP program. According to research by Özden and Reinhardt, removed countries tend to subsequently adopt more liberal or pro-growth trade policies.[27] For example, after South Korea left the GSP program, they modified their economic policies and grew much faster. Overall, this research suggests that the GSP is not setup to best encourage economic growth in developing countries.[28]

Conclusion

The history of U.S. trade liberalization GSP programs are not the resounding success that many policy makers have assumed. The goal of alleviating poverty and encouraging economic growth is admirable, however there is a considerable volume of economic research that finds these policies can be harmful to developing countries. Specifically, a growing body of research shows that not only can long-term exports fall from trade liberalization but other welfare measures, such as income inequality, poverty, and crime can actually worsen. As a result, public policy should consider its attention to other global poverty alleviation and economic growth programs that show a clearer benefit.

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[25] Daniel Lederman and Çaglar Özden, *Geopolitical Interests and Preferential Access to U.S. Markets, The World Bank*, Policy Research Working Paper, No. 3531, 2005

[26] Kara M. Reynolds, *The Erosion of Tariff Preferences*, American University - Department of Economics, August 2005

[27] Çaglar Özdena and Eric Reinhardt, *The perversity of preferences: GSP and developing country trade policies, 1976–2000*, Journal of Development Economics, Vol. 78, Iss. 1, October 2005

[28] Caf Dowlah, *The Generalized System of Preferences of the United States: Does It Promote Industrialization and Economic Growth in Least Developed Countries?*, The Law and Development Review, Vol.1, No.1, 2008