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Trade Facilitation: Challenges and Opportunities for Latin America and the Caribbean

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Key Facts

1. Ambitious trade facilitation reforms could boost LAC countries' exports by up to 38%. They could increase GDP by up to 8%.
2. Implementation of the WTO's Agreement on Trade Facilitation is important, but is just a starting point for broader reforms to reduce the transaction costs associated with importing and exporting.
3. Areas that need particular attention in LAC include customs and border procedures—an area where the WTO Agreement can help—and trade and transport-related infrastructure.
4. The private sector is a key actor in trade facilitation reforms. It can be an active partner in infrastructure development and operation, as well as a source of information on key chokepoints in need of government attention.
5. In addition, the private sector stands to reap major benefits from improved trade facilitation. Reforms could help more medium sized enterprises export, as well as boost participation in global and regional value chains.

1 What is Trade Facilitation?

The term *trade facilitation* takes on different meanings in different contexts. In a narrow sense, it refers to improvements in customs and other border procedures, with the aim of making it easier for businesses to import and export. This sense is the one typically used in trade agreements, including the new WTO Agreement on Trade Facilitation (TFA).

However, other international forums have used the term more broadly. The Asia-Pacific Economic Cooperation (APEC), which includes some economies from the Latin America and the Caribbean (LAC) region, is commonly associated with this broader approach. In APEC, trade facilitation can refer to any policy designed to reduce the transaction costs associated with importing and exporting goods, which economists refer to as *trade costs*. Trade costs drive a wedge between the price received by the producer at the factory gate, and the price paid by the final consumer. Included in the concept are costs associated with domestic and international transport, logistics operations, and wholesale and retail distribution, in addition to customs and other border procedures.

The concept of trade costs encompasses much more than just traditional border measures like tariffs. Measured in this broad way, trade costs can appear very high—all the more so given that tariffs in most countries are relatively low by historical standards. But high trade costs reflect the fact that although global and regional market integration has been taking place rapidly, most economic activity remains domestic. It is still considerably harder for a company to do business overseas than at home, even in highly integrated regions like the European Union. Informal, and often unintentional, trade barriers remain plentiful: differences in regulations and institutions, differences in language, and differences in consumer tastes, to name but a few. As a result, it is typically only the largest and most productive firms that export, and only the largest and most productive among that subset that export multiple products to multiple destinations.

Box 1: Trade Facilitation—Two Relevant Paradigms for LAC

The two senses in which trade facilitation is commonly used are both relevant to LAC governments and businesses. On the one hand, the TFA represents a set of potentially binding obligations in the area of customs and border procedures. On the other, Chile, Mexico, and Peru are member economies of APEC, and other LAC economies could conceivably join that forum in the future. How do the two paradigms work together, and what role can LAC businesses play in framing the many reform initiatives underway?

The most important difference between the TFA and APEC is that the former is framed in legal language and is intended in parts to be binding, to the extent accepted by each developing country signatory. APEC, by contrast, does not draft internationally binding agreements. It is a forum for exchange and cooperation in areas of mutual interest. For trade facilitation, APEC economies' approach has been to set overall targets—such as a reduction in trade costs of 5% in five years—with each economy left free to design its own strategy to achieve the collective goal. The WTO approach, by contrast, does not specify overall goals, but instead provides a framework for implementing common means forward, such as harmonization and upgrading of key processes.

Although the two paradigms may seem to be competing, they are in fact highly complementary. In both cases, business has an important role to play in helping governments identify key reforms, namely those with the highest benefit-cost ratio. Businesses import and export goods every day, and so are best placed to provide information and advice to governments as to blockages at key chokepoints in trade facilitation systems. So trade facilitation is not just a public sector agenda—it is very much a private sector one too, particularly under the APEC paradigm.

2 Why does Trade Facilitation Matter for LAC Businesses?

Successive rounds of multilateral trade liberalization, combined with regional approaches, have meant that tariff barriers—the traditional focus of trade policy—are relatively low by historical standards. That is particularly true for industrial products, and large, developed country markets. Many countries in the LAC region benefit from preferential trade agreements that ensure duty-free access to key regional markets.

In an environment of relatively low and declining tariffs, other sources of trade costs become more evident, and more of an issue for business. As noted above, even the absence of tariffs is not enough to make the cost of doing business abroad the same as the cost of doing business at home. Many other factors are at play. Breaking into foreign markets still requires a considerable investment that is typically outside the reach of most companies, particularly smaller ones. Taking steps to improve market access beyond tariff reductions is therefore now of real importance to business, especially larger and more productive small and medium enterprises (SMEs). Medium enterprises are often in a position to seriously contemplate exporting to geographically close markets, so reducing trade costs can benefit them significantly, and provide a real boost to intra-regional trade.

In addition to making it easier to move goods across borders, trade facilitation can benefit LAC businesses by making new forms of organization possible. Global and regional value chains (GVCs) rely on the rapid movement of component parts to a final assembly location, and then on to the consumer. The GVC business model is only feasible when companies can keep operating costs down by running low inventories. That means that they need to move key inputs quickly, reliably, and at minimum cost. Trade facilitation can help provide the right enabling environment for value chains to grow and prosper. It can also support the expansion of this business model to countries and sectors that have not traditionally been heavily involved.

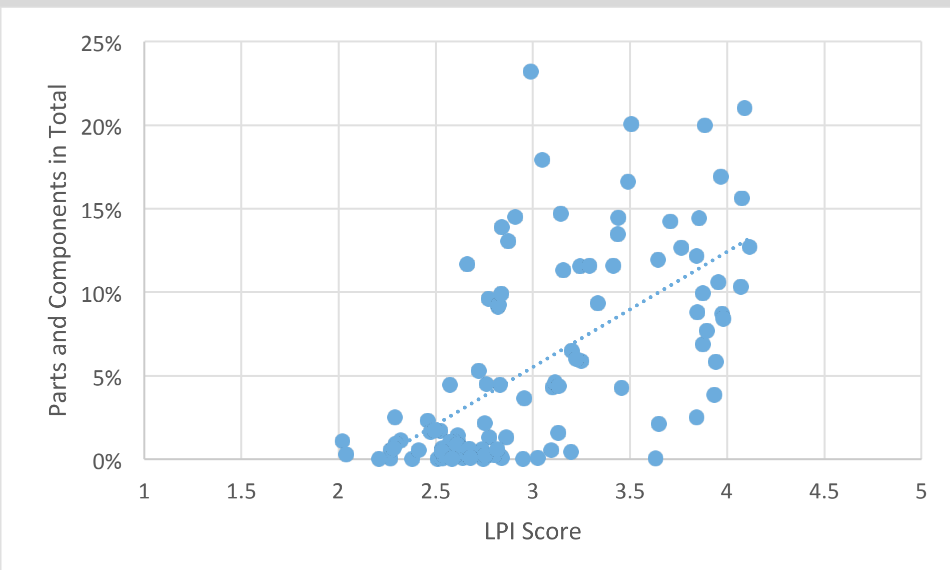
Box 2: Trade Facilitation and GVCs

Discussions on broad sense trade facilitation started first, and are most developed in, the Asia-Pacific region, as well as in the European Union. The Asia-Pacific also stands out as a region with particularly active value chains in sectors such as consumer electronics. There is clearly an association between these two facts: trade facilitation is of special importance to GVCs. The business model is simply not competitive in an environment where trade transaction costs are high.

Figure 1 shows the correlation between trade facilitation performance (as measured by the World Bank's Logistics Performance Index; LPI), and the share of parts and components in total manufactured goods exports, which is one indicator of a country's degree of value chain integration. The association is positive: countries with better trade facilitation tend to export relatively more parts and components. Of course, correlation is not causation. But more detailed analysis supports the robustness of this association. Quantitatively, trade in parts and components is nearly 50% more sensitive to improvements in trade facilitation than is trade in final goods.

For governments and businesses, the implication is clear: trade facilitation must be a key element of any broader strategy to increase integration into GVCs.

Figure 1: Trade Facilitation Performance vs. Share of Parts and Components in Manufactured Exports, 2010.



Source: Saslavsky and Shepherd (2014).

3 Current State of Play in the Region

Trade facilitation in both senses is clearly important for LAC: it is prominent on the economic policy agenda, and it matters for the ways in which business structure transactions and relationships every day.

What do the data say about LAC's performance in this key dimension of trade policy? This section presents a few key indicators by way of overview.

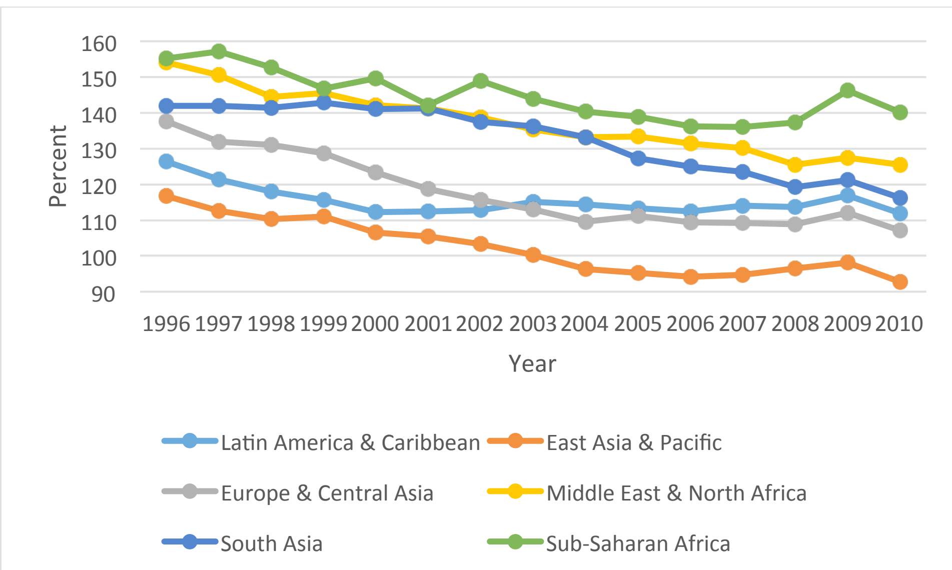
3.1 Trade Costs

Broad sense trade facilitation focuses on the concept of trade costs—the full range of factors, both those related to policy and those driven by history and geography—that drive a wedge between producer and consumer prices.

Figure 2 presents the evolution of trade costs by geographical region for the years 1996-2010. LAC is a mid-range performer, a position that is quite consistent through the sample period. Its level of trade costs is 20% lower than what is observed in Sub-Saharan Africa, the highest cost region, but about 20% higher than the best performing region, East Asia and the Pacific. The comparison with East Asia and the Pacific is perhaps even more striking because by comparison with LAC, the region is relatively remote from the main developed markets of Europe and North America, a factor that should tend to push trade costs up, rather than down.

To complete the picture of LAC's performance on this overall metric, it is important to analyze the dynamic aspect. Trade costs in LAC have been falling in recent years, by around 11% over the 1996-2010 period. That is an encouraging trend. But it is important to keep in mind that the rate of change has been even faster elsewhere: 22% in Europe and Central Asia, 21% in East Asia and the Pacific, and 18% in both the Middle East and North Africa, and South Asia. Only Sub-Saharan Africa has reduced trade costs more slowly than LAC.

Figure 2: Trade Costs for Manufactured Goods, by Country Group, Percent Ad Valorem Equivalent, 1996-2010.



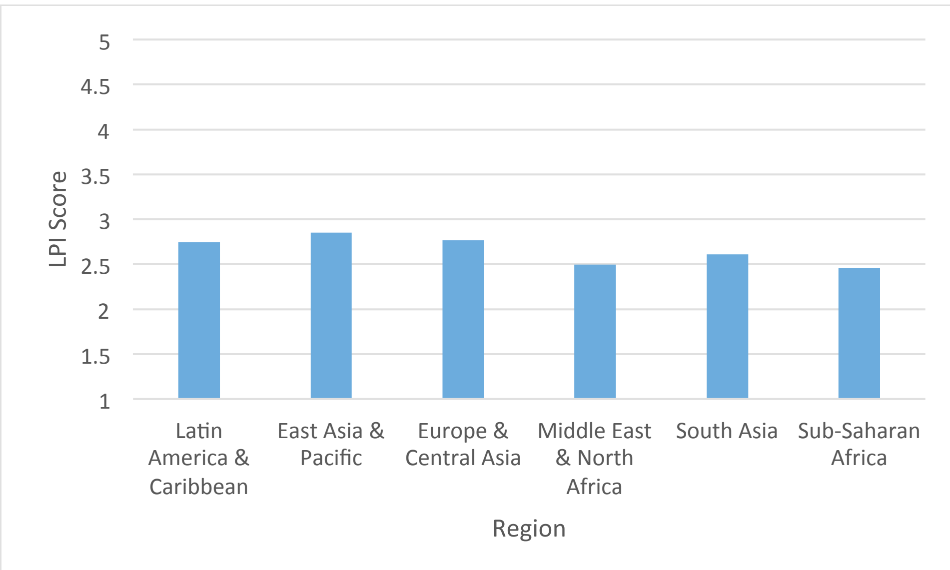
Source: Arvis et al. (2013; revised 2015).

The general picture that emerges from this review is that LAC continues to face considerable trade facilitation challenges. Although there has been some success in reducing trade costs, they remain middle of the road in comparative terms. Indeed, in an international trade and investment environment that is increasingly competitive in the GVC era, the comparative dimension is particularly important. LAC governments—driven by the private sector—need to be more active in designing policies to facilitate trade and foster greater integration both regionally and with global markets.

3.2 Determinants of Performance

Trade costs and facilitation are important issues that clearly need further attention in LAC going forward. But these areas are broad. Which factors most immediately require attention? Figure 3 shows that as in the case of trade costs, LAC's logistics and trade facilitation performance is, on average, middle of the road: it is the third highest ranked region out of six. Its score is 11% higher than Sub-Saharan Africa's, but 4% lower than East Asia and the Pacific's. The difference between LAC and the leading region appears small, but the LPI is measured on a five-point scale, and results are typically tightly bunched, particularly in the middle of the pack. As a result, small differences in score can be associated with major differences in relative perception in the minds of global logistics professionals.

Figure 3: Overall LPI Score, by Region, 2014.

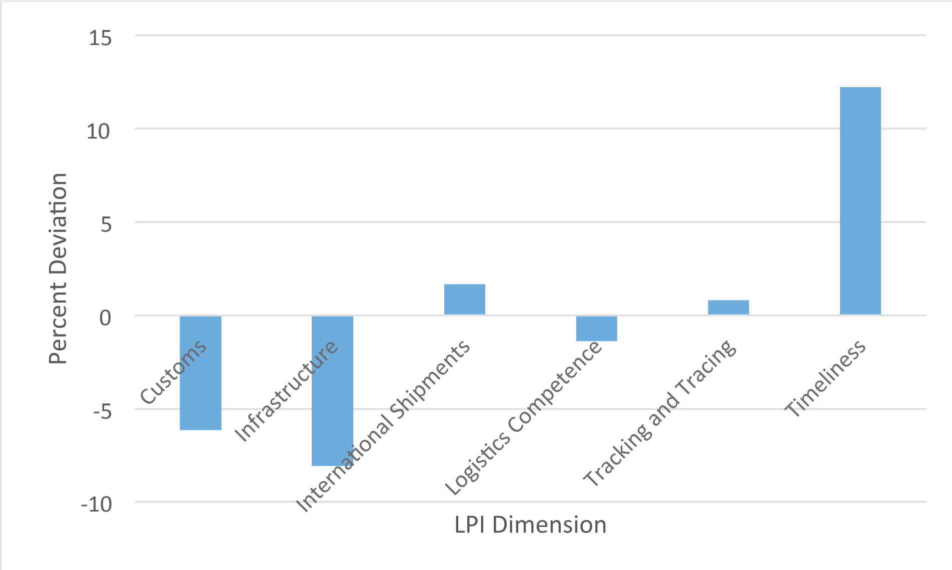


Source: Arvis et al. (2014); World Bank Logistics Performance Index.

It is important to breakdown the overall score presented in Figure 3 into its six component parts. The purpose of doing so is to identify areas of relative strength and weakness in LAC. Figure 4 shows scores for the six LPI dimensions expressed as percentage deviations from the region's overall score. A positive bar indicates that performance in that area is stronger than the overall score, and a negative bar indicates weaker performance.

Three of the six dimensions shown in Figure 4 are tightly clustered around LAC's overall score, which means that they are not elements of particular strength or weakness. On the other hand, timeliness of delivery is an area in which LAC performs very well relative to its overall baseline: the dimension score is 12% higher than the region's overall score. By contrast, customs (-6%) and infrastructure (-8%) are areas in which more work is needed—they pull down the region's overall score.

Figure 4: Scores on Individual LPI Dimensions, Percent Deviation from Overall Score, 2014.



Source: Arvis et al. (2014).

4 Moving Forward: Challenges and Opportunities

Where should the LAC region be going with trade facilitation in the short to medium term, and what is the role of the private sector? Of course, it is hard to generalize. LAC is a diverse region economically, and country performance on trade facilitation varies widely, as is evident from the IDB's Freight Logistics Statistics Yearbook. Ultimately, reform needs to be tailored to individual circumstances, which means that trade facilitation constituencies in each country need to be active in providing information to the public sector to help identify and prioritize the most pressing needs. With that caveat, the remainder of this section draws some general lessons from the review of the current state of play in the region presented in the previous section.

A first priority for LAC is ensuring implementation of the WTO's TFA. The text of the Agreement provides developing countries with many flexibilities. However, LAC is home to large middle income countries that have the human, technical, and financial capacity to deal with many, if not all, of the TFA's provisions. As mentioned above, customs is a relative weakness in the region as a whole. The TFA provides the framework for a number of reforms, such as National Single Window systems, that could significantly upgrade customs performance. It is important to keep in mind that available assessments are not typically referring just to national customs agencies when they assess performance: in fact, it is often other border agencies, such as health and SPS/quarantine agencies, that pose the biggest problems to logistics operators, not customs in a narrow sense. Coordination of border agencies and rationalization of procedures are key priorities for the LAC trade facilitation agenda.

There is already important progress in this area that LAC countries can build on going forward. The International Goods in Transit (TIM) initiative, sponsored by the Inter-American Development Bank, introduced an electronic system for dealing with goods in transit (Sarmiento et al., 2010). It allows for harmonization and streamlining of procedures, and has greatly improved transit times: implementation at one border crossing significantly reduced average clearance times. Econometric analysis suggests that use of the TIM system is associated with increased export growth (Carballo et al., 2014). The story is told by participants in the process at https://www.youtube.com/watch?v=LxTHWrJeABs.

Another example of a concrete initiative that can help streamline border procedures is the use of Authorized Economic Operator systems. These systems allow operators with a history of compliance to cross borders more rapidly, with a reduced incidence of inspections. They can be part of an overall risk management strategy that concentrates customs inspection resources where they are most needed. Ford Mexico, for example, has found that country's system to be of significant commercial advantage: https://www.youtube.com/watch?v=06zf9Xxl6b0&feature=youtu.be. Risk management is an important way of improving customs efficiency: inspection is strongly associated with additional delays (Volpe et al., 2015), so it should be limited to cases justified by underlying risk criteria.

A second priority is infrastructure, another area identified as a relative weakness in the region. The design of infrastructure systems is primarily an area of public sector responsibility, but many countries around the world are increasingly finding that public private partnership models can be effective ways of mobilizing the necessary financing for major infrastructure projects. In many cases, an effectively regulated private sector can also be more efficient than a state monopoly in the provision of infrastructure services. The key in both cases is for the private and public sectors to work together effectively so that important spillovers can be generated for the economy at large, while maintaining operational efficiency and providing for adequate upkeep and maintenance.

In addition to these two challenges, it is also important to add the issue of private sector development in transport and logistics services. There is considerable room for improvement in many LAC countries. For example, trucking markets in some countries are fragmented, and rely on ageing vehicle fleets that are both inefficient and generate unnecessary levels of greenhouse gas emissions. Building a competitive private sector can help boost trade facilitation performance in many areas. The public sector can help by establishing a stable and efficient regulatory environment. However, it is also important to ensure an adequate degree of competition in key markets, which includes openness to foreign direct investment in relevant sectors. Foreign investment has the potential to bring many positive spillover effects with it, not least of which are improved technology, human capital upgrading, and the development of more efficient organizational forms. In shipping markets, for example, various firms, including foreign ones provide efficient services linking LAC with important Northern markets, including through new "post-Panamax" vessels.

If LAC can effectively manage these challenges going forward, there is significant evidence that it will benefit through increased intra- and extra-regional trade. More trade combined with the elimination of economically wasteful sources of trade costs has the potential to boost GDP. The World Bank and World Economic Form estimate that ambitiously reducing supply chain barriers to trade—analogous to broad sense trade facilitation—could potentially boost exports in the region by up to 38% for some countries, and GDP by up to 8%.

There is also the specific opportunity of encouraging the spread of GVCs in the region. For example, investment reforms and improved trade facilitation in Costa Rica have been associated with stronger links to a number of GVCs. Although relatively well developed in some sectors in LAC, such as transport equipment, GVCs are underdeveloped in others, such as electrical goods. Given the proximity of North America as a source of final demand, as well as the significant size and increasingly robust income growth in some regional economies, there is great scope to expand the GVC model in the region by improving trade facilitation performance.

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