



USAID
FROM THE AMERICAN PEOPLE

CAFTA AND POVERTY REDUCTION ISSUES FOR HONDURAS

A RAPID APPRAISAL WITH RECOMMENDATIONS FOR USAID/HONDURAS

Borany Penh
USAID/EGAT/PR/PASSN
December 2004



CONTENTS

INTRODUCTION	1
POVERTY IN HONDURAS	1
TRADE AND POVERTY ISSUES IN HONDURAS	2
MACROECONOMIC ISSUES.....	2
Economic Growth	2
Volatility and Adverse Shocks.....	2
Government Revenue and Spending	2
MICROECONOMIC ISSUES.....	2
Transmission of Border Price Shocks	2
Household Response	3
SETTING THE POLICY REFORM AGENDA	3
TRADE THAT PROMOTES PRO-POOR GROWTH	3
NECESSARY COMPLEMENTARY POLICIES	3
SAFETY NETS	4
CONCLUSION	4
ENDNOTES	5

INTRODUCTION

Trade policy can be a powerful tool against poverty. Evidence of the economic gains from greater trade openness is indisputable. However, as Mexico's experience with the North American Free Trade Agreement (NAFTA) demonstrates, trade policy may not necessarily result in poverty reduction without pursuing the broader development agenda. In discussing how Honduras can benefit from the Central American Free Trade Agreement (CAFTA), the "National Action Plan for Trade Capacity Building" explicitly interprets "benefit" to include: "increased and more equitable distribution of the benefits of free trade," increased market access for marginalized sectors of the population (especially in rural areas), and additional assistance to sectors of the economy that are most likely to be adversely affected initially by CAFTA.¹ The stated goals are encouraging. They reflect a realization that, while CAFTA may be an opportunity for prosperity, it will not automatically result in poverty reduction without attention to the issues that particularly affect the poor. This paper outlines these issues and provides recommendations to USAID to help Honduras realize broad benefits from CAFTA.²

POVERTY IN HONDURAS

In making poverty reduction one of the Millennium Development Goals, the international development community recognized that poverty is a serious and difficult problem requiring special attention. Poverty is also a complex problem for Honduras even though it qualifies as a low-to-middle-income country. In 2003, about two-thirds (63.9 percent) of Hondurans were poor and nearly half were classified as extremely poor (63.5 percent).³ In addition to income poverty, other facets of poverty are apparent in Honduras. Poor quality and access to education, health services and other public services contribute to Honduras being ranked 115th out of 177 countries in the Human Development Indicators.⁴ The low level of human development is reinforced by a culture of inequality and lack of voice among the poor.⁵ Effective poverty reduction policies will need to take into account the multidimensional and mutually

reinforcing nature of poverty in Honduras.

In addition to the aggregate picture, it is important to understand that the poor are not a homogeneous group. While there are a range of common causes for poverty, different causes will affect different groups differently. The different prevailing causes for poverty result in different types, levels, and locations of poverty (extreme, chronic, transitory, etc.). As with most developing countries, poverty is most prevalent in rural areas. With nearly 75 percent of Honduras' rural households below the poverty line, the National Action Plan (NAP) declared rural poverty "perhaps the most critical problem facing Honduras today and represents the greatest development challenge facing the Government."⁶ However, urban poverty is on the rise due to migration pressures. Gender and ethnic factors also delineate different

poor groups. As in most developing countries, gender disparities are widespread in economic opportunities, access to and control of resources, in power, and political voice.⁷ This is one reason why gender-equality and women's empowerment were singled out for inclusion as a Millennium Development Goal.

Finally, understanding the specific income and consumption patterns of the poor is important in formulating policies that help to lift them out of poverty. Food typically comprises the largest proportion of household expenditure among poor groups. The price of staple foods, particularly maize, is thus an important issue for poor households in Honduras. On the income side, it is useful to remember that poor households employ complex asset management strategies, including diversification of income sources, as a hedge against risk.

TRADE AND POVERTY ISSUES IN HONDURAS⁸

How can CAFTA benefit Honduras in the broad manner stated in its National Action Plan? Because the linkage between trade and poverty reduction is indirect, various issues should be considered. While they overlap, they are categorized here as macro and microeconomic issues.⁹ Macroeconomic issues are important to consider as they deal with systemic issues. Additionally, their interaction with the income, employment, and consumption behavior of the poor, which is a microeconomic focus, is also important.

MACROECONOMIC ISSUES

Economic Growth

Greater trade openness is associated with greater economic growth, however, the structure of growth matters for poverty reduction. “Pro-poor” growth where the poor participate in and benefit from growth is critical.¹⁰ While new investments in capital-intensive and high-skill labor activities can help economic growth, they will not necessarily have the same direct effect on poverty as activities where the poor can employ their assets, most notably low-skill labor.

Agriculture and textiles (maquilas) are labor-intensive sectors in Honduras with the potential to expand under CAFTA. The agriculture sector is Honduras’ largest employer (about 40 percent

of the workforce, 75 percent of the rural population).¹¹ Negative ramifications for the textiles industry from the expiration of the Multi-Fiber Agreement are expected to be mitigated by CAFTA although this question does not seem to have been empirically explored yet in a robust way.

Volatility and Adverse Shocks

Implementation of CAFTA will require Honduras to introduce policy reforms that in the short-term will likely cause macroeconomic volatility and the elimination of some firms. Stiglitz argues that the burden of macroeconomic reforms fall on the poor, who are the least able to cope with more risks.¹² This is because they possess few assets and are most likely to be self-insured. Small farmers and women, plus micro, small and medium enterprises, are thought to be the groups most vulnerable to adverse shocks under CAFTA. Research is required to confirm the size of these groups, where they are, and the extent of possible adverse effects before appropriate policy responses can be crafted.

Government Revenue and Spending

Trade reform may lower government revenues and subsequently government spending on social programs that benefit the poor. Whether or not trade reform

leads to lower government revenue is an empirical question. Reform of the tax system can create alternate, less distorting sources of revenue. The extent to which policy changes in taxation or expenditures affect the poor will be a political decision. In Honduras, HIPC and donor funding appear to be sufficient to ensure that social expenditures will be protected in the future. However, the degree to which social expenditures actually target the poor should continue to be monitored and evaluated.

MICROECONOMIC ISSUES

Transmission of Border Price Shocks

Prices for goods at the border may not necessarily translate into local prices due to mediating domestic factors such as the exchange rate, competitiveness in marketing, infrastructure, regulations and taxes. Welfare effects for households through the price channel will depend on the prevailing mediating factors, if the household is a net producer or net consumer, and their degree of market connectivity.

According to the World Bank’s “Doing Business in 2005” report, Honduras’ microeconomic regulatory regime is much worse, for example, than Mexico’s.¹³ This suggests that Honduras’ burdensome regulations could be a serious obstacle to producers’ ability,

particularly PIMYEs, to respond to new economic opportunities under CAFTA.¹⁴ On the consumption side, CAFTA is expected to lower the prices of food imports but mediating domestic factors could prevent poor households from benefiting from these lower prices.¹⁵ The monopolistic power of the tortilla cartel in Mexico inhibited lower consumer prices despite a 50 percent reduction in maize prices.¹⁶

Household Response

Poor households with little productive assets and low risk behavior cannot readily respond to greater supply opportunities. Poor groups in Honduras typically suffer from extremely low education levels, uneven access to credit, lack of market information and a weak voice in the democratic policy

making process. Women, in particular, are among those most disadvantaged in this respect. Set within an environment of likely adjustment shocks and burdensome regulations, as discussed above, these constraints could seriously inhibit the poor from transitioning to more productive activities under CAFTA.

SETTING THE POLICY REFORM AGENDA

Several authors have tried to use cross-country evidence to demonstrate how trade leads to economic growth. Questions about the validity of this methodology have led most experts to conclude that trade's effect on economic growth is largely country-specific. The significance of this observation is that while a country can learn from the experience of other countries, it is up to the country to address its own institutional, political, and economic issues in order to benefit from trade.¹⁷

TRADE THAT PROMOTES PRO-POOR GROWTH

As low-skill labor is typically the greatest productive asset of the poor, economic growth in sectors that utilize low-skill labor is critical for pro-poor growth. A World Bank study found that the Honduras could significantly increase its agricultural exports to the United States with comprehensive elimination of trade barriers under CAFTA.¹⁸ However, the sector

requires reforms to deal with major problems of scale, access to capital and technology, little possibility for diversification, natural disasters and declining prices.¹⁹ Reforms are underway but there is some doubt as to these reforms benefiting groups beyond large producers.²⁰ Efforts should also take into account the rise of super markets and how their consolidating power could affect the ability and terms of small producer engagement.²¹

However, agricultural production may not be the only pro-poor growth opportunity for rural households. The IDB suggests that rural non-farm activities are becoming increasingly important for poor households in Central America. Moreover, women are more likely to be employed in non-farm activities. Currently, rural non-farm income comprises 22 percent of rural income in Honduras.²²

Maquilas are another important sector for low-skilled workers in Honduras. A World Bank model

estimates that the elimination of U.S. tariffs under CAFTA could result in a short-term increase in manufacturing exports of 25 percent (\$559 million) compared to their current level.²³ Nearly all of the gains would likely occur in the apparel sector (99 percent). The accuracy of this prediction has yet to be seen but this is good news for Honduras.²⁴ It may also be an opportunity to gradually convert low-skill maquila workers to more high-skilled industries.

NECESSARY COMPLEMENTARY POLICIES

The East Asian experience is often cited as the classic example of how countries can “trade out of poverty.” But studies have shown that trade was only one element of the development strategies of these East Asian countries. Egalitarian policies in land reform and education played important roles in positioning the countries to take advantage of their new outward orientation. The need

for complementary reforms is also evident in Mexico's experience under NAFTA. Esquivel et al (2002) found that the southern states that benefited least from NAFTA had low levels of infrastructure, education, and institutions.²⁵ Moreover, complementary reforms and innovation must be continuous in order for countries to move from one-off static efficiency gains after trade liberalization to dynamic long-term growth.²⁶

The crucial lesson for Honduras is that greater trade opportunities is only one aspect of the development picture and complementary reforms must accompany CAFTA in order for the country to progress developmentally. Reforms in areas complementary to trade are planned or underway in Honduras either as part of the Poverty Reduction Strategy Paper (PRSP) or Millennium Challenge Account (MCA) process. Investments in education, health, and infrastructure are some examples. These investments are being made mostly through the central government at the macro level. Given Honduras'

struggle with good governance, the challenge will be ensuring that these investments positively and meaningfully affect the poor at local levels. Linkages between the CAFTA and PRSP processes may help keep policy reforms focused on poverty reduction.²⁷

As mentioned above, a critical public good for broad-based economic growth is strong institutions. There is some hope for improved governance in Honduras under CAFTA. Implementation of CAFTA will require the government to introduce a range of reforms, for instance in customs. These efforts could reduce opportunities for corruption and improve transparency. Mexico's experience, however, is cautionary. Despite early progress, a stalled reform process and contract enforceability problems inhibited Mexico from fully benefiting from NAFTA. This is one of the reasons why a World Bank report on lessons from NAFTA concludes that free-trade agreements are complements and not substitutes for a friendly policy and institutional environment.²⁸

SAFETY NETS

Adjustment assistance policies are important for helping the poor overcome adverse shocks. They not only can arrest a household's decline into poverty but can also help bring them out of poverty if a transition component is included (often called productive safety nets or "cargo nets"). An ideal model for rural households would be programs that "incorporate the diversity of rural household activities and aim for long-run economic growth and vitality."²⁹ Adjustment programs should also be well-targeted as they can be captured by the non-poor and can become disincentives to productivity.

Honduras' budgetary constraints make this policy area a challenge. However, as Mexico's experience under NAFTA shows, the absence of adequate adjustment assistance can result in greater poverty, increased pressure on natural resources, and increased migration.

CONCLUSION

Poverty is a broad and complex problem in Honduras. As in most countries, causes for poverty are multi-dimensional and involve not only economic but social and political constraints. CAFTA represents new opportunities for poverty reduction in Honduras. However, greater trade openness is only one aspect of the development picture. Complementary reforms, particularly in infrastructure, governance, and education, are necessary to allow the poor in Honduras to participate in economic growth. Pro-poor growth or where economic growth is structured so that the poor are able to utilize their assets and benefit from growth is also very important for policy makers to keep in mind. Finally, while CAFTA will bring new opportunities, Honduras should expect some adverse effects as part of any adjustment with trade liberalization. Safety nets, especially productive safety nets, are important in helping the poor overcome these adverse shocks. Productive safety nets can even help them move into economic activities that could lift them out of poverty.

ENDNOTES

¹ “U.S.-Central America Free Trade Agreement National Action Plan for Trade Capacity Building: Honduras.” Government of the Republic of Honduras. November 1, 2002. Page 20.

² See Annex 1: Recommendations for USAID/Honduras SO2, IR 2.1.

³ ERP 2nd Progress Report, 2003. Page 4.

⁴ Human Development Report 2004. U.N. Development Programme.

⁵ Government of the Republic of Honduras. December 2003. Honduras Poverty Reduction Strategy First Progress Report. Tegucigalpa, Honduras. page iii, paragraph 15.

⁶ “National Action Plan,” page 26.

⁷ See forthcoming USAID Women in Development strategy paper on economic opportunity and trade.

⁸ See Annex 2: The Effects of CAFTA on Poverty in Honduras: A Literature Review.

⁹ This section draws substantially from Winters, L. Alan; Neil McCulloch, and Andrew McKay. “Trade Liberalization and Poverty: the Evidence So Far,” *Journal of Economic Literature*: XLII. March 2004. Pp. 72–115.

¹⁰ Pro-poor growth is defined here as “growth that rapidly raises the absolute income of the poor by increasing the growth rate of the economy and the extent to which that growth benefits the poor.” *Pro-Poor Growth: A Guide to Policies and Programs*. USAID/EGAT/PR/PASSN. January 2004. Page xxi.

¹¹ Reference years are respectively 2001 for Honduras and 2000 for the United States. From “Indicadores de sensibilidad de productos agroalimentarios de Honduras.” Documento referencial. Secretaría de Industria y Comercio (SIC), Government of the Republic of Honduras (study partially supported by USAID). June 2003. page ii.

¹² Stiglitz, Joseph E. “Whither reform? Towards a new agenda for Latin America.” *CEPAL Review*, 80. August 2003.

¹³ World Bank. “Doing Business in 2005: Removing Obstacles to Growth.” September 2005. Washington, DC.

¹⁴ See also USAID/EGAT/EG assessment of Honduran law and regulatory regimes (forthcoming).

¹⁵ Tariff-free access by the United States for white maize is not included in CAFTA.

¹⁶ Nadal, Alejandro. *The Environmental and Social Impacts of Economic Liberalization on Corn Production in Mexico*. Oxfam GB and WWF International.

¹⁷ Hoekman, Bernard; Constantine Michalopoulos, Maurice Schiff, and David Tarr. *Poverty Reduction Strategy Paper Sourcebook*. Chapter 13: Trade Policy. World Bank. September 2000. Washington, DC.

http://poverty.worldbank.org/files/13876_chap13.pdf.

¹⁸ World Bank. 2004 (draft). *Drivers for Rural Growth*, Annex F: “CAFTA and Its Implications for Honduras.”

¹⁹ SIC, June 2003.

²⁰ Honduras Poverty Reduction Strategy Pape Progress Report. Government of the Republic of Honduras. December 2003. Page 8, paragraph 46.

²¹ See USAID’s Agriculture Strategy: http://inside.usaid.gov/EGAT/off-ag/ag_strategy_9_04_508.pdf. See also empirical studies on the effects of supermarkets in Central American countries at www.regoverningmarkets.org.

²² Todd, Jessica; Paul Winters, and Diego Arias. “CAFTA and the Rural Economies of Central America: a Conceptual Framework for Policy and Program Recommendations.” Paper for the Inter-American Development Bank. Page 10. October 22, 2004.

²³ Annex F of *Drivers of Growth* (draft), pp. 9–10.

²⁴ The authors warn that the model cannot easily capture the complexities related to rules of origin and the end of the Multi-Fiber Agreement. They also caution that such models cannot anticipate new types of exports so typically underestimate the supply response to free-trade agreements.

²⁵ Cited in Todd, Winters, and Arias, 2004. Page 30.

²⁶ U.N. Conference on Trade and Development. *The Least Developed Countries Report 2004: Linking International Trade with Poverty Reduction*. May 2004.

²⁷ *Ibid.*

²⁸ Lederman, Daniel; William F. Maloney, and Luis Servén, eds. *Lessons from NAFTA for Latin America and the Caribbean Countries: A Summary of Research Findings*. World Bank. December 2003. Washington, DC.

²⁹ Todd, Winters, and Arias, 2004. Page 52.