Global Trade Preference Reform: Background Paper for Working Group[1]

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For more than 30 years, rich countries have provided preferential market access for developing countries, via lower than normal tariffs, as a mechanism for promoting development through export expansion and diversification. Trade preference programs have been strikingly successful in boosting exports in some cases, but the benefits are often concentrated in a relatively small number of countries and sectors and all too many poor countries remain dependent on primary commodity exports that continue to suffer from short-term volatility. Moreover, among rich countries today, tariffs on imports are generally in the low single digits and preferential access is less valuable than it was when trade preference programs were adopted in the 1970s.

Is there still scope, then, to use trade preferences as a tool for development, and, if so, what improvements are needed? There are three principal weaknesses in these programs identified in the literature: low average tariffs combined with restrictions or exclusions on "import-sensitive" products; high administrative costs, including rules of origin; and uncertainty surrounding the stability of the commitments under these programs, which deters investment. But the highest barriers in the tariff schedules of most countries typically apply to agricultural products, textiles and apparel, footwear, and other light manufactures—exactly the products that many developing countries, including some of the poorest, export. So the potential for improved preference programs to spur exports remains.

The current economic and political environment also makes preference reform more urgent. Efforts to bring the Doha Round of World Trade Organization negotiations to a conclusion in Geneva in Summer 2008 collapsed and are unlikely to be revived for many months. In the interim, negotiation of bilateral and regional trade agreements could accelerate, increasing discrimination against the smallest and poorest, countries that are often excluded from the most commercially significant agreements. Developing countries are also being hammered by an economic crisis that they had no role in creating.

Finally, rich countries are already committed in various fora to provide improved access for the poorest. The eighth Millennium Development Goal focuses on the role that the rich countries should play in helping developing countries to achieve the other goals to reduce poverty and improve health, education, and other outcomes for the poor. This goal extends to trade as well as

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aid and calls on rich countries to provide "duty-free, quota-free" access for the least-developed countries (LDCs) (as defined by the United Nations). The commitment to provide DFQF access for the LDCs was affirmed in 2005 at the WTO ministerial meeting Hong Kong, though U.S. negotiators insisted on limiting the access to 97 percent of tariff lines. The Hong Kong communiqué calls on rich countries, and emerging markets in a position to do so, to provide such access by 2008, or the end of the Doha Round at the latest.

Thus, extending DFQF market access to LDCs is a long-standing commitment and is *not* part of the Doha Round "single undertaking," which says that nothing is resolved until everything is resolved. Implementing this commitment as soon as possible, and in the context of a broader and globally coordinated reform, could boost the benefits for the poorest countries substantially.

The principal focus of the working group will be on the weaknesses in the design of many programs that make them more complicated and difficult to use than they need be. But the limited utility of these programs are also rooted in failures on the part of recipient countries to take full advantage of the opportunities offered. Where governments are committed to improving the climate for investment, better-targeted and coordinated aid for trade would also help to address other serious supply constraints. This paper begins by summarizing the preference programs that currently exist, focusing on provisions affecting LDCs. The next section discusses the limitations and potential benefits of these programs. The final two sections discuss the challenges that preferences pose for a multilateral trade system founded on nondiscrimination principles, and the supply-side constraints that can undermine the best-designed program. At the end is a list of questions that the Working Group may consider.

Summary of Existing Trade Preference Programs

Rich countries and, increasingly, many emerging markets have programs under the Generalized System of Preferences, which was promoted by the UN Committee for Trade and Development in the 1960s, adopted by most rich-country governments in the early 1970s, and approved by the General Agreement on Tariffs and Trade in 1979.[2] These programs provide better than normal market access for the exports of developing countries, and even more generous access for the least-developed among them, by either setting a lower tariff or eliminating duties entirely on designated products. Many countries also have programs that provide additional benefits to various countries or regions for political or historical reasons. And most of these programs have their own eligibility conditions for countries and products, different rules of origin, including for cumulation, and different provisions for program renewal. The brief discussion that follows focuses on the four largest programs, provided by the United States, European Union, Canada, and Japan.

The Japanese and Canadian programs are the simplest, while the United States and European Union have multiple programs with varying levels of preference and conditionality. Japan and

[2] See Hoekman and Ozden (2007) for the origin of these programs and analysis of key issues.

Canada each have a GSP program for all developing countries and a more generous program for LDCs that covers most products. Canada and the EU provide GSP access for more countries, more than 170 of the 180 countries listed by the World Bank as having per capita incomes below the high-income threshold. Japan and the United States provide GSP to only around 140 countries, in the U.S. case because of relatively stricter eligibility conditions and in Japan, apparently because many countries have not chosen to apply.

All but the United States extend GSP eligibility to China, though the EU, like the U.S. , has a formula for graduating specific products from specific countries when they reach a certain market share and the EU has excluded a number of Chinese (and other countries') exports. In addition to China, the U.S. excludes a number of countries for political reasons—because they are communist, or were during the Cold War, like Vietnam (though it is being considered for inclusion), are otherwise undemocratic or violate human rights, like Burma, have been judged to no longer need preferential access, like Korea and Malaysia, or have signed bilateral trade agreements with the United States, like Mexico and the countries of Central America.

Like the others, the United States has a broader list of eligible products for LDCs, but it still excludes what it considers "import-sensitive" products, including many that are important to developing countries. The U.S. government is more generous programs in its regional programs for the Caribbean, Andean countries, and sub-Saharan Africa, each of which has its own country and product eligibility conditions and rules of origin.

The European Union (EU) has a GSP-plus program for countries that meet certain standards with respect to worker rights, environmental protection, and governance, as well as the Everything But Arms program for LDCs, which will provide duty-free, quota-free access by the end of 2009. The EU is also now in the process of replacing preferences provided to former colonial territories under the Cotonou Agreement with "economic partnership agreements."

Table 1 summarizes key features of these programs as they apply to the LDCs. Anthony (2008) provides a more extensive summary of these programs, except for Japan's, while Sekkel (2009) provide more detail on these and several other programs, including those of Brazil, China, and India. Hoekman et al. (2009) also has papers describing all four programs and calculating the value of the preferences granted under each.

Limitations and Potential Benefits of Existing Preference Programs

Analytical critiques of unilateral trade preferences typically focus on the limited benefits due to low preference margins, product exclusions, costly administrative hurdles, and the uncertainty generated by frequent program renewals. The smaller the benefits, the less likely they are to exceed the political, economic, and negotiating costs of the discrimination involved. Thus, many trade economists have concluded that trade preferences no longer offer much utility as a development tool.[3]

But all four preference-granting countries have either adopted reforms or introduced new programs in recent years that addressed at least some of these problems and clear export gains can be observed in some of those cases. If those reforms could be extended across key countries, including delivering on the DFQF commitment, they could give an important boost to at least some poor economies. Recent research at the International Food Policy Research Institute also suggests that the adoption of effective programs by Brazil, China, and India could add significant benefits.

Programs in the Quad Countries

The European Union introduced the Everything But Arms program for LDCs in 2001, the same year that the United States implemented the African Growth and Opportunity Act. Canada substantially expanded the list of duty-free imports from LDCs and eased its rule of origin for apparel in 2003. Japan expanded its list of eligible duty-free imports from LDCs to 98 percent in 2007.

After these various reforms, only the EU is providing complete duty-free, quota-free access for LDCs (once restrictions on rice and sugar are phased out late in 2009), as pledged in the Millennium Development Goals. The chief problem with the EBA is the restrictive rules of origin, especially for apparel, but the EU is considering a reform of those rules for possible implementation next year, if approved. The Canadian and Japanese reforms bring them to, or are close to, the (U.S. -influenced) Hong Kong commitment of providing DFQF on at least 97 percent of tariff lines for LDCs. Canada excludes only supply-managed agricultural products (dairy, poultry, and eggs), and with far less restrictive rules of origin than the EU, at least for apparel. Japan's 2007 reform extended preferential access to LDCs on 98 percent of tariff lines, mainly excluding rice, sugar, and other agricultural products, and with more restrictive ROOs than Canada.

Except for its rules of origin in some cases, the United States is the clear laggard, providing duty-free, but not quota-free, access on 98% of tariff lines for 26 African LDCs (another six are potentially eligible if program conditions are met) on all but quota-controlled agriculture and a few other products. But duty-free access is provided on only 83 percent of tariff lines (73 percent of dutiable lines) for 15 Asian LDCs and textiles and apparel are excluded. There is a special program for Haiti that permits duty-free apparel exports under certain conditions.

The differing treatment of LDCs in the U.S. programs mean that some very poor countries, Bangladesh and Cambodia in particular (because of their export concentration in apparel), face high barriers in the U.S. market. As is frequently noted, exports from those two countries are

[3] Indeed, as discussed in Hoekman and Ozden (2007), many analysts predicted that trade preferences would be ineffective because they anticipated the limitations that politics would impose on the programs.

charged roughly the same level of duties as exports from the United Kingdom and France that are 15 times larger ($400 million to $500 million in U.S. duties collected for each). The differential treatment also creates a political economy problem for U.S. policymakers in reforming preference because some existing AGOA beneficiaries oppose extension of DFQF to the Asian LDCs because of fears of preference erosion.

There is evidence that programs that moved toward fewer exclusions and less restrictive ROOs have had tangible effects on exports. Figure 1 shows the share of European Union and Canadian imports originating in LDCs after their preference reforms in 2001and 2003, respectively. The LDC market share in the EU jumped in the late 1990s but then stagnated after the EBA went into effect, mainly because many of those eligible for the EBA already had good access to the EU market under the African, Caribbean, and Pacific (ACP) regional arrangement. EU imports from non-ACP LDCs did show some increase under the EBA, but by less than might have been the case without the restrictive rules of origin on apparel and continued quotas on sugar and certain other agricultural products. The LDC market share in Canada shows a sharper and immediate increase after the reform was introduced in 2003. More sophisticated empirical analyses also find limited effects of the EBA program and far stronger effects of the Canada program for LDCs. Finally, the U.S. African Growth and Opportunity Act contributed to increased apparel exports from eligible countries. The decline in exports since the end of the quota system under the Multi-Fiber Arrangement, however, underscores the limitations of preferences to sustainably boost exports if fundamental competitiveness is not also addressed. [4]

In addition to product coverage, rules of origin play an important role in whether preferences are utilized or not. Many studies have shown that countries often do not bother to claim benefits for exports where the preference margin is low because the administrative costs of doing so, including meeting the rule of origin, can be higher than the value of the preference. The impact of varying rules can be seen in the different patterns of trade in apparel between Africa and the United States and European Union. The two chapters in the tariff system that cover most apparel are 61, which includes knitted items, and 62, which covers woven garments. The former have an easier time meeting the EU rule, which requires apparel to undergo a “double transformation,” starting with yarn that is either spun or woven into fabric and then cut and assembled to make the final article, or “knit-to-shape” in one piece. The U.S. AGOA rule allows “lesser-developed beneficiary countries” (a broader category than LDCs) to perform a “single transformation,” assembling fabric that may be sourced anywhere (subject to a cap) to be assembled into clothing.

Another way to put it is that the U.S. rule for apparel under AGOA allows for “global cumulation,” meaning that inputs from anywhere in the world can be used and the final product still recognized as originating in the beneficiary as long as it is “substantially transformed” there. The combination of a high threshold for local content and only limited regional cumulation make

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[4] On the impact of the Canadian reform, see Anson et al.; on the limitations of EU preferences, Candau and Jean (forthcoming); on AGOA and the EBA, see Stevens and Kennan (2004).

the current EU rules on apparel quite restrictive. Canada requires that 40 percent of the value of the final product originate in the beneficiary, but then for some apparel products allows for cumulation of inputs across all developing country beneficiaries, including China, as well as Canada. Thus requirements for high levels of value-added can be offset by permitting cumulation across relatively broad groups of potential source countries.

Figure 3 illustrates the response of African apparel exporters to the different rules in the U.S. and EU. Sub-Saharan African countries increased exports to the U.S. of both knitted and woven apparel, while exports to the EU of woven apparel show no response to introduction of the EBA. The fact that only five African countries account for 90 percent of the AGOA apparel exports, however, again underscores the importance of local supply capacity in taking advantage of opportunities, even when market access is expanded. In addition, some argue that rules of origin that are too permissive prevent the development of backward linkages and lock countries into low-productivity assembly operations. But as Stevens and Kennan (2004, p. 7) note, the problem is that the impact of rules of origin is asymmetric: setting them too high can eliminate the benefits entirely while setting them too low may reduce the benefits but not eliminate them. They conclude:

> Since it will always be very difficult to set the rules so that they are 'just right', the implication is that preference-givers should always err on the side of cautious liberality. (ibid.)

Another facet of these programs that can undermine their development effectiveness is frequent renewals. Here again, the problem is primarily an American one. Japan and Canada authorize their programs for a decade at a time. The EU's regular GSP program is renewed every three years, but the EBA is permanent. The United States has different terms for different programs and, after lengthy terms early in its GSP history, the program has been renewed eight times since 1993, usually only for one to two years and in most cases it lapsed for from one to fourteen months at a time. The uncertainty created by frequent renewals undercuts incentives to invest to take advantage of the program and, among other things, could undermine export diversification goals.

Programs in Emerging Markets

Analysis by Antoine Bouët and colleagues (2008, pp. 6-7), using a computable general equilibrium model, suggests that DFQF access to the markets of Brazil, China, India, and South Korea, as part of a feasible Doha Round outcome, could substantially increase LDC benefits, *if* the access is on 100 percent of products, not 97 percent as proposed in Hong Kong. The programs thus far announced by the emerging markets fall well short of that.

India is offering access to all LDCs, China only those that recognize it instead of Taiwan diplomatically, while Brazil is planning to offer DFQF only to the 32 LDCs that are WTO members, and only as part of a Doha package. India and China have already begun implementing their programs. All the programs exclude a number of sensitive products and China offers DFQF only for products that LDCs currently export, impeding any prospect for export diversification.

Unfortunately, it is unlikely that the emerging markets will be willing to move to 100 percent access for the LDCs in the near term. But they should at least be encouraged to cooperate in constructing rules of origin and other administrative provisions that are needlessly costly, and in providing long-term commitments for access.

Preference erosion, distortions, and the political economy of preferences

Despite the name, "most-favored-nation" (MFN) treatment is the *normal* access provided to member countries under the General Agreements on Tariffs and Trade (GATT) and the World Trade Organization (WTO). Nondiscrimination generally, and MFN specifically, are core principle of the international trade system created after World War II, requiring that any tariff reduction negotiated between two or more trading partners must be extended to all other GATT (now WTO) members.

Thus, a waiver from the rules was required when GATT members agreed in the 1960s and 1970s to provide better-than-MFN access to developing countries. And, as the departures from the MFN principle proliferated over the years—with ever more numerous and complex preference programs and the burgeoning number of bilateral or regional trade agreements (RTAs)—trade system supporters have become increasingly concerned about the costs of the distortions created.

At the same time, the value of preferences for existing beneficiaries eroded steadily as preference-giving countries continued to negotiate multilateral MFN tariff reductions in the Tokyo and Uruguay Rounds, as well as expanding preferences for some but not all developing countries, and negotiating RTAs. If the Doha Round of multilateral negotiations is eventually completed, that will again lower the generally-applied MFN level of tariffs and further squeeze the overall value of preferences, whether reciprocal or unilaterally granted.

The prospect of preference erosion arising from multilateral liberalization has led some developing countries to call for less liberalization or for longer implementation periods for tariff cuts on products that would entail the greatest preference erosion. Since preferences are most valuable on products where MFN tariffs are highest, this dynamic creates incentives for a "Baptist-bootlegger" coalition, with preference-receiving countries joining with uncompetitive industries in preference-giving countries to avoid or delay liberalization for products where the overall global welfare gains would be highest.

Another potential negative effect of the diversity of preference programs is that it ends up pitting some developing countries against others. For example, additional preferences for LDCs come at the expense of other developing countries, such as India or Brazil. But LDCs are, by definition, small and vulnerable, as well as poor. Many of them are land-locked, especially in sub-Saharan Africa, others are islands. This means both that these countries can usually not benefit from economies of scale and transportation costs are often relatively higher. Mitigating those disadvantages is a legitimate aim of trade policies focused on development.

But the Baptist-bootlegger problem and LDC demands for "special treatment" for important preference products need to be addressed so as to avoid impediments to multilateral liberalization. Delaying liberalization for these products and phasing it in over very lengthy periods imposes additional costs on other developing countries for whom these exports are also important. Negotiators could consider a bargain whereby DFQF and other reforms, including by emerging markets, are implemented as soon as possible in exchange for a lowering of LDC demands on measures to avoid preference erosion in the Doha Round.

Addressing Supply-Side Constraints

Increased market access creates opportunities for expanded trade and investment in Africa and other LDCs, but research suggests several reasons that some countries have not taken advantage of the opportunities and that others have not been able to translate increased trade into sustainable growth and development. Among the key supply-side constraints identified are: 1) a lack of capacity to effectively ensure consistent quality and stable supplies of goods to buyers because of inadequate infrastructure, including roads, ports, storage facilities, low human capital, and unstable energy supplies; 2) international public and private health, safety, quality, and other technical standards that are difficult for developing country producers to meet, or where the costs of certifying compliance are too high; and; 3) weak institutions and domestic policies that result in a poor investment climate.[5] For smaller, and especially land-locked, developing countries, barriers to regional market integration and cooperation can also be a significant barrier.

Currently a number of organizations have programs that are specifically designed to assist in addressing these problems. Multilateral programs like the Enhanced Integrated Framework (EIF) and the Joint Integrated Technical Assistance Program (JITAP), as well as specific programs through the World Trade Organization (WTO), the World Bank, United Nations Conference on Trade and Development (UNCTAD), the United National Industrial Development Organization (UNIDO), and the International trade Centre (ITC), with substantial contributions from governments, are focusing intensely on issues related to both trade capacity and trade facilitation, including on standards and conformity assessment -- product testing, border inspections, and infrastructure – required to satisfy increasingly strict sanitary and phyto-sanitary (SPS) standards. In short, there exists a very strong recognition in the trade and development community that capacity building is essential if developing countries are going to establish attractive investment environments, expand production capacity, and take advantage of new opportunities.

While some trade preference programs in the developed countries are linked to capacity building assistance, significant problems remain in effectively coordinating these policies. Whether there

[5] For a recent examination of competitiveness problems in Africa, see Ramachandran et al. (2009).

is an effective and feasible proposal that could be incorporated in a reform of trade preference programs, and what the scope of such a proposal might be, are large questions.

Working Group Objective and Approach

The Center for Global Development's Global Trade Preference Reform Working Group seeks to motivate changes in the policies and practices of global actors that would expand market access for the poorest developing countries. While the primary focus will be on identifying priorities for reform of trade preference programs themselves, the Working Group will also consider the set of incentives, governance capabilities and actions, and financing mechanisms that could plausibly move the world in the right direction. Specifically, the Working Group will consider questions such as:

Can 100 percent DFQF (perhaps adjusted for quota-controlled agricultural products) for all LDCs be achieved in the U.S. , Japan, and other rich countries that have not yet done so?

Should the group receiving DFQF be expanded beyond just LDCs?

How should quota-controlled agricultural products be treated? Is quota-free preferred? If so, is it possible? What would a sensible safeguard look like?

Can/should rules of origin and cumulation be further improved and harmonized across major countries, including the emerging market programs?

How can concerns over preference erosion be prevented from impeding multilateral liberalization?

Is there a concrete proposal for aid for trade that makes sense in the context of a preferences reform proposal? Should it address compensation and adjustment assistance issues, supply-side capacity constraints, or both?

The main product of the Working Group will be a policy report identifying practical and feasible actions. The report will include recommendations for the major preference-providing countries, both developed and developing. The findings will be disseminated to decision-makers in key governments, development organizations, as well as key private sector interests, through targeted briefings, events, and outreach.

Table 1 Key Features of Major Preference Programs for LDCs			
Canada	**Japan**	**European Union**	**United States**
DFQF for LDCs, except supply-managed agricultural products (eggs, poultry, dairy)	DFQF on > 98% of tariff lines for LDCs; exclusions include rice, sugar, other ag. and a few other products	Everything But Arms provides 100% DFQF for LDCs (as of end-2009)	Provides duty-free treatment on ~98% of tariff lines for 26 LDCs, a few others in SSA ~88% for selected Caribbean, Andean countries ~83% for 15 Asian LDCs
ROO for LDCs requires 40 percent valued-added locally, with cumulation among all LDC beneficiaries (check) or Canada; for some apparel, inputs can be sourced from developing country GSP beneficiaries (incl. China), with 25% value-added in LDC	Change in tariff heading, cumulation with Japan only	Varies by product; considered relatively restrictive, especially for apparel, but changes proposed	General rule(35% value-added) with some regional cumulation; apparel, is considered relatively generous Apparel rules are complex and restrictive, except for "lesser-developed beneficiary countries" under AGOA that can use fabric from any country
Renewed for 10 years in 2004	Renewed for 10 years in 2001	Permanent Regular GSP renewed every three years	AGOA extended to 2015 (3rd-country fabric rule only til 2012) Other programs ad hoc, renewed frequently and occasionally with delays

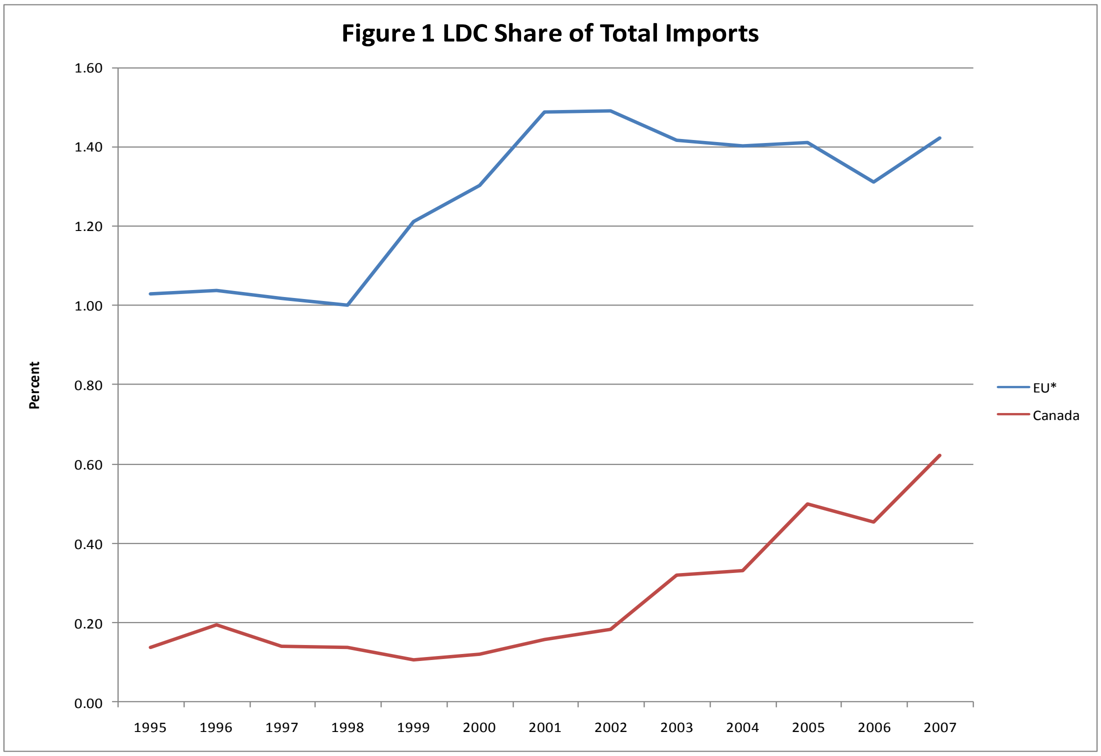
Figure 1 LDC Share of Total Imports
Percent
1.60
1.40
1.20
1.00
0.80
0.60
0.40
0.20
0.00
1995
1996
1997
1998
1999
2000
2001
2002
2003
2004
2005
2006
2007
EU*
Canada

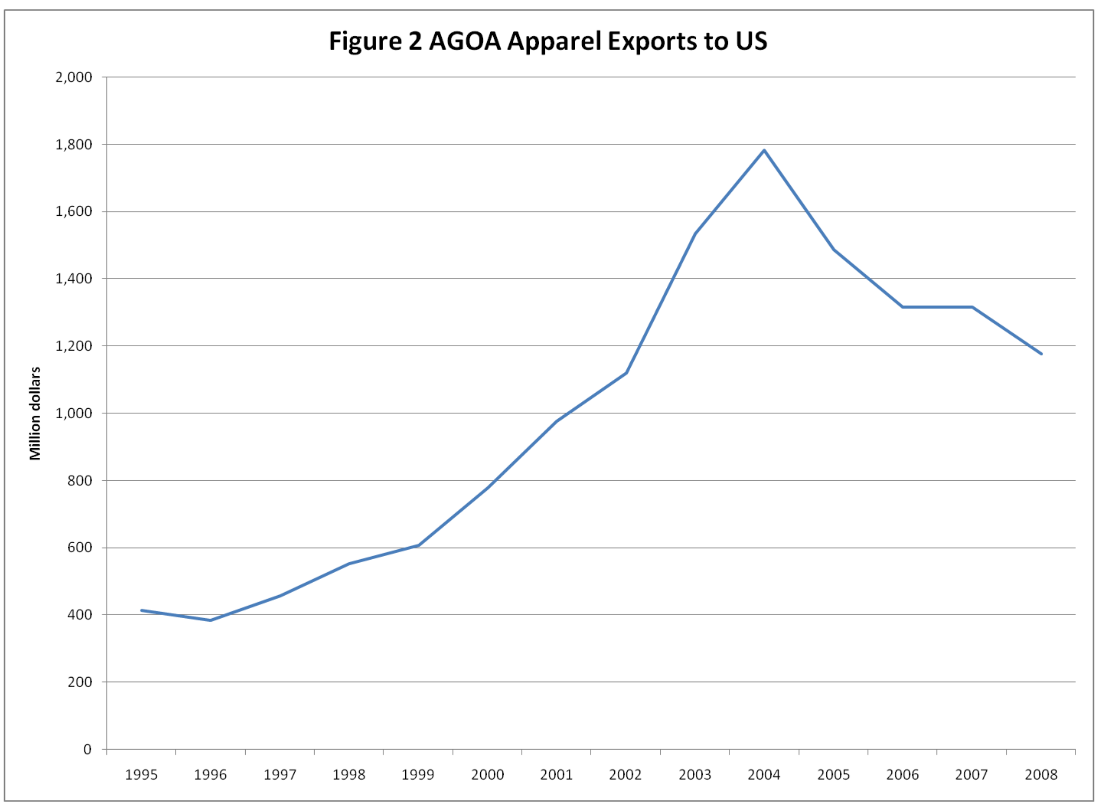
Figure 2 AGOA Apparel Exports to US
Million dollars
2,000
1,800
1,600
1,400
1,200
1,000
800
600
400
200
0
1995
1996
1997
1998
1999
2000
2001
2002
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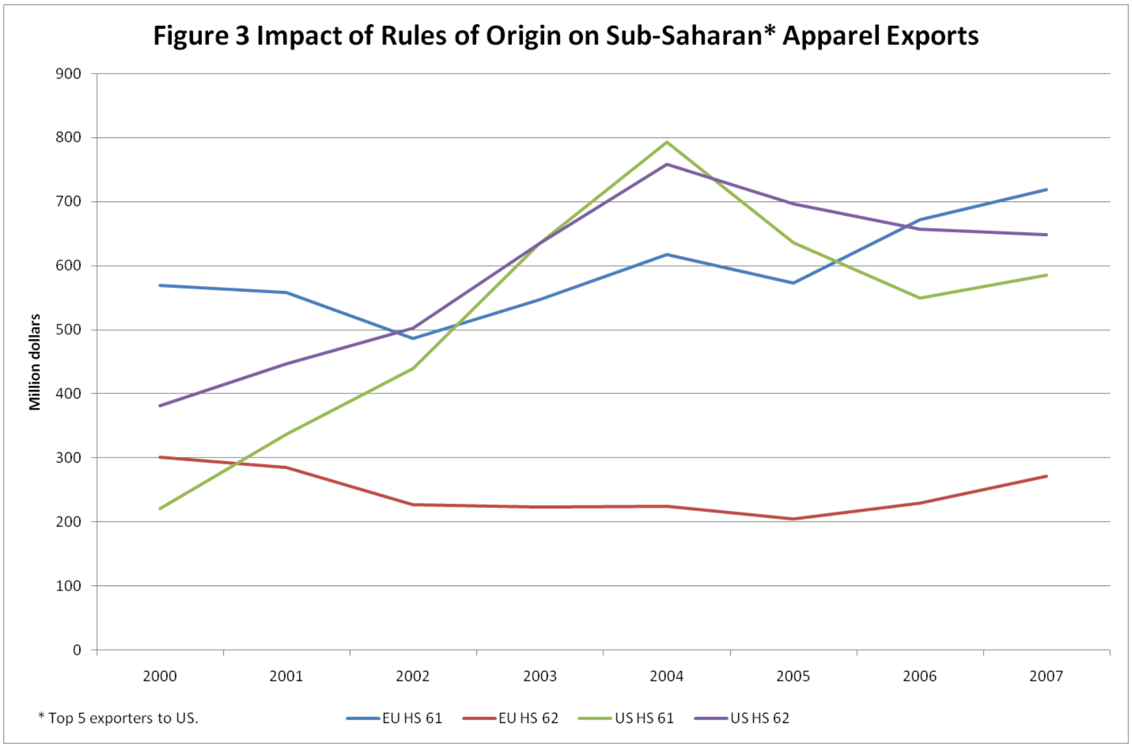
2004
2005
2006
2007
2008



Source for charts: UN Comtrade database.

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