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Revisiting Special Preferences for Developing Countries

I. Introduction

The inherent tension between trade preferences and the Most-Favoured Nation (MFN) principle has been mainly examined in the context of regional free trade agreements and customs unions. Much less attention has been given to non-reciprocal special trade preferences given by developed countries to developing countries. WTO rules on these special preferences are less explicit than WTO rules governing free trade agreements and customs unions.

The Doha Round of the WTO negotiations should not neglect this aspect of trade relations between developed and developing countries. Tariff preferences by developed countries in favour of developing countries are welcome, because they further trade and growth in developing countries. They may be even more welcome if they are given without reciprocity. But these tariff preferences can cre-

ate trade distortions among developing countries, thus defeating the basic objective of promoting trade for developing countries.

There are four categories of these special preferences.

- 1) **Preferences for certain regions**, mostly as a result of a historical close relationship between developed and less advanced developing countries;
- 2) **Special preferences applied by all developed countries in favour of developing countries**, such as the Generalised System of Preferences (GSP);
- 3) **Special preferences applied to least developed countries**; and
- 4) **Special preferences given by developed countries to developing countries to pursue non-economic objectives**, such as fighting the narcotics trade.

About the IPC

The International Food & Agricultural Trade Policy Council (IPC) convenes high-ranking government officials, farm leaders, agribusiness executives and agricultural trade experts from around the world and throughout the food chain to build consensus on practical solutions to food and agricultural trade problems.

An independent group of leaders in food and agriculture from industrialized, developing and least developed countries, the IPC's thirty-eight members are chosen to ensure the Council's credible and impartial approach. Members are influential leaders with extensive experience in farming, agribusiness, government and academia.



Special Preferences for Certain Regions

The Lomé Convention is a well-known example of special preferences for a geographic region. The Lomé Convention has provided the framework for trade and development between the European Union and the associated countries of Africa, the Caribbean and the Pacific (ACP countries). The Lomé Convention IV expired in February 2000, but its trade provisions will continue to apply under the new EU-ACP Partnership Convention, signed in Cotonou in June 2000 (Cotonou Convention). The trade provisions give wide-ranging, non-reciprocal preferential access to the EU market, although the preferential access is more selective in textiles and agriculture. Under the new Cotonou Convention, after 2008, these unilateral preferences will be replaced by free trade agreements between the ACP countries and the European Union.

In the past, the European Union has given similar preferences to the Southern Mediterranean countries. But these unilateral preferences are being replaced by free trade agreements. So far free trade agreements have been concluded between the European Union and the majority of the Mediterranean countries. The European Union has a similar system in place, on an autonomous basis, in favour of the countries of former Yugoslavia and Albania. Preferences for these countries extend to all products, including agriculture. This system is to be replaced by so-called Stabilisation and Association Agreements, which will be based on free trade agreements. The first such Agreements have already been concluded with Croatia and the former Yugoslav Republic of Macedonia.

Non-reciprocal preferences are not confined to the European Union. The United States gives unilateral tariff preferences to Caribbean countries under the Caribbean Basin Initiative (CBI), revised by the Caribbean Basin Economic Recovery Expansion Act. Recently, the African Growth and Opportunity Act (AGOA) extended similar preferences to sub-Saharan African countries, but eligibility is subject to certain requirements.

Caribbean countries are expected to undertake their obligations under the WTO, to provide protection for intellectual property rights, internationally recognised labour rights, non-discriminatory procedures in government procurement and to fight drug trafficking. Sub-Saharan African countries are subject to similar requirements, such as protecting internationally recognised worker rights and not engaging in gross violations of internationally recognised human rights. The African Growth and Opportunity Act views tariff preferences for sub-Saharan African countries as a first step towards free trade agreements with

these countries. The trade preferences for Caribbean countries should be superseded by the Free Trade Agreement of the Americas (FTAA) in 2005. Canada, too, has a preferential scheme for the Caribbean countries in place (CARIBCAN) that goes beyond the Generalised System of Preferences. These tariff preference programs granted by the European Union, the United States and Canada are all based on a special relationship that has its roots in geography and history.

All these non-reciprocal regional preferences are incompatible with WTO rules, in particular with the Most Favoured Nation principle, unless granted a waiver.

This was the conclusion of the panel in the US dispute with the European Union on bananas in 1993. Subsequently the European Union sought and obtained a waiver for the non-reciprocal preferences agreed under the Lomé Convention. This waiver expired in February 2000. It was extended at the launch of the Doha Round of WTO negotiations in November 2001 to cover the transition period until the unilateral preferences are replaced by free trade agreements under the new Cotonou Convention. The European Union has not sought a waiver on its other non-reciprocal preferences. Since it is now European Union policy to replace these preferences by free trade agreements it may feel less need to do so. The United States has obtained a waiver on preferences for CBI countries and is expected to seek one on preferences for sub-Saharan African countries.

The Generalised System of Preferences

The Generalised System of Preferences (GSP) dates back to the early 1970s. It resulted from a growing recognition in the 1960s that developing countries did not benefit from international trade because of structural weaknesses and trade barriers in developed countries. Special and differential treatment (S&D) was seen as a way to improve the competitive position of developing countries. The need for S&D was pushed by the United Nations Conference on Trade and Development (UNCTAD), but the WTO's predecessor, the General Agreement on Tariffs and Trade (GATT), only reluctantly embraced it and the concept was only slowly introduced into the GATT articles.

The GATT chapter on developing countries, which was included in 1967, stated in Article XXXVI that

developed countries do not expect reciprocity from developing countries in trade negotiations but it did not yet use the term “special and differential treatment.”

In 1971, GATT Contracting Parties decided to allow developed countries to provide tariff preferences to developing countries on a non-reciprocal, non-discriminatory basis. This preference scheme came to be known as the Generalized System of Preferences. The decision was to expire after ten years. In the Tokyo Round of GATT negotiations, the role of developing countries in international trade was again on the agenda. In 1979, the “Enabling Clause” was introduced. This Clause incorporated the 1971 decision and extended the scope of special and differential treatment to non-tariff measures. The 1979 language also emphasised special treatment of least developed countries.

According to the “Enabling Clause” any differential and more favourable treatment of developing countries shall

- **Facilitate and promote the trade of developing countries;**
- **Not impede the reduction or elimination of tariffs and other restrictions to trade on a most-favoured-nation basis; and**
- **Respond to the development, financial and trade needs of developing countries.**

The “Enabling Clause” does not commit WTO members to give preferences to developing countries nor does it limit the scope of those preferences. The selection of products and the depth of the tariff cuts have been left to the discretion of the donor countries. The trade preference may be given within a tariff rate quota or without a quantitative limit. WTO members, however, are not allowed to discriminate among developing countries when giving preferences. Therefore, access to tariff rate quotas must be open to all developing countries.

Since the GATT gave its blessing in 1971, the Generalised System of Preferences has been widely used to facilitate exports from developing to developed countries. All developed countries participate in this scheme. But its implementation varies from country to country. The United States, for example, provides duty-free access, whereas the European Union applies four different preference margins. Unlike the European Union, the United States determines eligi-

bility for GSP on the basis of criteria that go beyond economic development to include reasonable and equitable market access, protection of intellectual property rights and internationally recognised labour rights.

In general, donors exclude countries after they reach a certain level of economic development from all or some of the benefits of the system (“graduation”). Although this may be justified by the development objectives of the scheme, it makes the GSP less predictable and excludes competitive exporters from its benefits.

Under US legislation, a country loses eligibility if it exceeds the middle-income level as defined by the World Bank. If exports of a product exceed certain limits, eligibility for that article ceases to exist. The European Union applies a formula that combines industrial development and export performance criteria to withdraw benefits for certain products. For example, Thailand lost preferential access into the EU market for a number of agricultural and fishery products, while other neighbouring, economically advanced countries kept them.

To promote labour rights, the European Union offers additional preferential margins to countries that comply with certain International Labour Organisation (ILO) standards. The European Union applies similar benefits to imports of tropical forest products if the exporting countries comply with the standards of the International Tropical Timber Organisation. Furthermore, the European Union reserves the right to withdraw preferences in case of exports of goods made by slavery, forced labour or prison labour. In the United States, failure to meet eligibility criteria at a later stage can lead to the loss of preferential tariff access.

In its negotiating proposal for the agricultural negotiations in the WTO, the European Union has proposed to examine ways to ensure that GSP preferences become more stable and predictable.

Special Preferences in Favour of Least-Developed Countries

Forty-eight countries have been recognised as least developed because of their low per capita income and specific structural weaknesses. Despite the attention given by the United Nations, the World Bank and UNCTAD to these countries, their situation has not improved much in the last decade and they

are still at the margins of the world economy. At the first WTO Ministerial Conference in Singapore, a Plan of Action for the Least-Developed Countries was adopted with few practical effects. Only in the run-up to the Seattle Ministerial Conference did the idea of giving special preferences to least developed countries gain momentum.

All developed countries provide special treatment to least developed countries. In the United States, least developed countries have duty-free access for a long list of products. Canada, too, has a system in place, which provides duty-free access for most agricultural products from these countries. Recently, the European Union has extended duty free market access for least developed countries to “everything but arms,” including agricultural products, although with transition periods for bananas, rice and sugar. Duty-free access for products from least developed countries has received another boost in the Doha Round negotiations.

Special Preferences for Non-Economic Reasons

In the fight against drug trafficking, attention has turned to the question of reducing supply in addition to reducing demand. As farmers in producing countries have few alternatives but to grow plants which produce narcotics, governments are trying to encourage the cultivation of alternative crops. One technique has been to provide special preferences for selected products. The European Union and the United States are applying such a scheme to the Andean Pact countries. The European Union has extended this treatment to countries of the Central American Common Market. Since these preferences are limited to Andean and Central American countries, the “Enabling Clause” does not cover them. The United States has obtained a waiver for its preferential treatment. The European Union is granting the preferences within its GSP without having sought a waiver.

II. Economic Impacts

Impact on Participants

Preferences have clear short- and medium-term benefits for the recipients. They offer better prices when selling into the protected markets, as the reduced or zero tariffs increase the re-

turns to the exporter. Also, they secure access for particular quantities of exports, allowing production and shipping to be geared to established markets.

These preferences also have several shortcomings. They lock in patterns of trade, which inhibits adjustment to profitable new markets; they are subject to the political decisions of the preference-granting country, which inhibits investment; and they confer benefits to marketers, with no guarantee that higher prices reach developing country producers.

The real economic impact of different preference schemes varies. Comprehensive studies are lacking. Preferential schemes, which are built on traditional relationships with less developed countries, such as under the Lomé Convention or the CBI, probably have the strongest economic impact since they preserve traditional economic links. The Sugar and the Bananas Protocols of the Lomé Convention provide good examples for important market access opportunities into the European Union.

The economic benefits of the GSP are more widely spread. But in the agricultural sector, tariff rate quotas sometimes limit access to developed country markets. The exclusion of developing countries that exceed economic development or performance criteria can disrupt trade and limit the benefits of the GSP. Despite these shortcomings, the economic benefits of the GSP for developing countries are significant. It has become a factor in their development that should not be underestimated.

Impact on Non-Participants

The impact of a preferential arrangement on non-participants has been discussed mainly in the context of regional trade agreements. Countries excluded from a regional free trade area will face stiffer competition in those markets (trade diversion) even though imports may expand as a result of better access within the area (trade creation). In the case of preferential trade, countries not enjoying preferences have relatively poorer access to importers' markets while the preferred trading partner can expand exports. Trade diversion can occur as easily in preferential systems as in free trade agreements. Trade creation in both cases is the objective, but it comes at a cost to those excluded. In the case of non-reciprocal tariff preferences, the excluded countries are often other developing countries.

There is, however, a difference between free trade agreements and special non-reciprocal preferences. This is what may be called the “development factor.” Under the GSP, trade diversion occurs mainly to the detriment of competing developed countries. The differences in economic efficiency between developed and developing countries justify this effect. More problematic is the effect on more advanced developing countries, if they are excluded from the preference system once they have reached a certain level of per capita GDP. Again, this exclusion could be justified by their stronger capacity to compete. This sort of trade diversion is more strongly felt if quotas limit access. If there is unlimited access at no or reduced tariffs, then the chances for a weaker exporter to capture some of the market are much better.

Trade diverting effects are probably stronger if only developing countries benefit from the preferences. But here, too, the “development factor” has to be considered. Most of the ACP and the CBI countries are very poor, and many of the ACP countries are least-developed countries. This could justify the trade diverting effects of these preferences as long as the beneficiaries do not make significant progress in their economic development.

Trade diversion can be particularly negative if a more advanced developing country loses its trade preferences because it meets certain economic development and performance criteria while other similar developing countries keep them. To prevent this from occurring, economic criteria for exclusion should be established so developing countries in similar situations are treated equally.

The justification for trade diversion weakens further when special preferences are granted to some developing countries for non-economic reasons, such as preferences to fight narcotics production.

Special Preferences as Part of a Comprehensive Development Framework

It is widely recognised that trade is an essential element of economic growth in developing countries, and developing countries are demanding more open markets in developed countries for agricultural products. Special preferences are one way to achieve this goal. However, market opening alone does not provide the expected or needed benefits. There are two sorts of obstacles that prevent countries from reaping

the full benefits of trade. These obstacles apply to special preferences as well as to market opening measures in general. Some originate in developing countries and others in developed countries.

First, agricultural producers in developing countries need a favourable business environment. But this is not enough. Given the sophistication of modern international trade, developing countries may find it difficult to expand existing markets and to enter new markets for their products. The need to provide a steady supply of products in sufficient quantities can pose major problems for some countries. The ability to comply with sanitary and phytosanitary regulations or to meet quality criteria in export markets is often lacking.

Capacity building and a modern infrastructure can help agricultural producers competitively market their products domestically and internationally. In many cases, this requires external assistance. In the past, some developed countries have coupled development assistance with special preferences. The European Union provides development assistance to the ACP countries under the Lomé Convention and to the Mediterranean countries. The United States gives assistance to the Caribbean countries under the CBI. But, this approach falls short of what is required.

International financial institutions, like the World Bank and the international donor community should invest more in capacity building and trade infrastructure in developing countries, enabling them to take full benefit of the GSP and trade overall.

But developed countries should not simply provide capital and technical assistance, they also have to provide an environment that will make market-opening work. All too often, non-tariff barriers and domestic support jeopardise the beneficial effects of lower import duties. Special preferences and lower import tariffs will only provide full benefits if developed countries check their quality and labelling requirements against their development policy objectives and provide domestic support which meets the criteria of the “Green Box.”

Conclusions

As tariffs have been falling, the value of special preferences, as well as preferences within free trade areas, is eroding. This process will continue as the agricultural negotiations in the Doha Round lead to further reductions in MFN tariffs. Special preferences can be seen as a way to encourage imports from developing countries before generally freer market ac-

cess. Developing countries have early access to developed country markets (a concrete manifestation of special and differential treatment) that allows them to ramp up production and establish marketing channels. The market advantage will erode over time, but these countries can improve productivity and maintain their market position in the meantime.

The erosion of preferential tariffs is not the main reason free trade areas are replacing special regional preferences. Rather, there is a growing perception that these preferences are locking the beneficiaries into producing a few products and are delaying adaptation to the world trading system instead of promoting it. Free trade areas, however, are a valuable alternative only if they provide comprehensive coverage.

In general, economic development is best served when the principle of non-discrimination is applied to developing countries, too. Therefore, special preferences should only be provided within the GSP. The World Bank distinguishes between low-income, lower-middle and upper-middle income countries, depending on GDP per capita. Eligibility should be limited to these three categories of developing countries. Further differentiation could fragment international trade. It would also obscure the fact that world trade is best

served when there is no discrimination. Hence, different treatment should only be allowed when there is a clear, generally recognised case for such a treatment. Least developed countries are such a case. Small island developing countries may be such a case, but this fact has not yet been universally recognised.

Since the GSP is a trade policy instrument for developing countries, eligibility should not be made dependent on additional requirements (e.g., compliance with environmental or labour standards).

The main shortcoming of the GSP is that preferences are at the discretion of developed countries. This creates uncertainties and contradicts the development objectives of the system. Therefore, tariff preferences under the GSP should be granted for a period long enough to justify additional investment (for example, ten years). During this period, tariff preferences within the scheme could not be reduced. Any unforeseen developments could be met by applying a safeguard clause.

There may be exceptional cases that justify special preferences for certain regions for a limited period of time. In such cases, countries should seek a waiver under Article VI of the WTO Agreement. The waiver should commit donor and recipient countries not to increase applied tariffs (if they are lower than bound tariffs) for products covered by the preferential scheme. This would be analogous to the requirements for free trade agreements under Article XXIV of the 1994 GATT Agreement.

Recommendations

Recognizing the political and economic challenges facing preferential agreements as regional and international trade liberalization progresses, the IPC believes that over time, special non-reciprocal preferences for developing countries should comply with the following guidelines:

- 1) The GSP should be the only place where special preferences are given by developed countries to developing countries.
- 2) Preferences should apply to all developing countries as foreseen by the "Enabling Clause." This would reduce, if not eliminate, the trade diverting effect of these preferences on developing countries that do not currently benefit from the preferences.
- 3) More advanced developing countries should not lose preferences as long as they remain low- or middle-income countries according to the World Bank's definition.
- 4) Eligibility for preferences should not be contingent on other criteria beyond compliance with WTO commitments.
- 5) GSP tariff preferences should cover substantially all trade to avoid the distortions that occur in commodity markets when preferences dominate trade flows. As many of the commodity-specific preferences limit access in sensitive import sectors, the move to generalise such preferences will expand trade opportunities.
- 6) Preferential access should not be quota-restricted. Tariff rate quotas favour the more efficient producer and penalise the less efficient, which contradicts the principle of special and differential treatment for developing countries. Furthermore, tariff rate quotas distort trade in other ways as well. As quotas need to be allocated, they confer financial benefits on quota holders.
- 7) Tariff preferences should provide duty-free access, rather than reduced tariffs. This would increase the value to the beneficiaries, reduce "tariff escalation" - where tariffs rise as goods are processed - and facilitate the eventual transition to free trade areas.
- 8) Tariff preferences under the GSP should be granted for a sufficiently long time to provide a reliable basis for trade and investment (for example, ten years). During this period, tariff preferences should not be reduced, except in cases which justify safeguard action by the donor country.
- 9) Where tariff preferences do not provide duty-free access, least developed countries should be exempted from the principle of non-discrimination and be provided with a zero-duty. This would be consistent with the provisions of the "Enabling Clause." Preferences should cover all least developed countries for a given product. Careful consideration should be given to extending this exception to small developing island countries.
- 10) WTO members should be allowed to request a waiver for exceptional cases. If such a waiver is granted on special preferences for certain regions, the donor and the beneficiary country should not be allowed to increase applied tariffs for products subject to the preferential treatment, in accordance with the rules of Article XXIV/5 on free trade areas.

All existing non-reciprocal preferences should conform to these guidelines or be converted into free trade areas within an agreed time frame. For many developing countries the sudden removal of these preferences would have major repercussions. Not only are their trade patterns heavily influenced by the preferences, but also their ability to compete in these markets has become dependent on the continuation of preferential access. This implies the need for a sufficiently long transition period.



Revisiting Special Preferences for Developing Countries

The issue of special preferences is one of the most challenging and controversial political issues confronting trade negotiators in the Doha Development Round. Special preferences, which provide access to developing countries into developed country markets, usually at high domestic prices, benefit both developing country farmers who grow the crops under preferential schemes, but also developed country farmers, whose crops are also protected by limited access into their markets. Developing countries which produce commodities benefiting from preferences, and developed country farmers who are also protected by preferences are deeply worried about the potential loss of preferential arrangements.

Yet, even developing countries that receive special preferences understand that the time is coming to begin to dismantle them. The economic arguments, coupled with trends in agricultural policy in the United States and Europe are building a strong case for finding alternatives to special preferences.

Special preferences conflict with a key goal of trade negotiations—expanding overall market access. In addition, they can disadvantage developing countries that do not have special access, consumers who pay higher prices for food, and developing countries whose agricultural economies have become inexorably tied to preferences.

The IPC's first Issue Brief examines four types of preferences, assesses their economic costs and benefits, and the consequences for the international trade system. The Issue Brief also places preferences into the larger context of economic development. The paper concludes by recommending that special preferences evolve over time into a general system of preferences.

In the coming months, as the WTO negotiators continue to consider modalities for the agricultural trade negotiations, the IPC plans to bring forward more detailed recommendations on how this transition might be accomplished, and how the transition costs for developed and developing country farmers might be eased.

This Issue Brief was discussed and approved by IPC members. As with all IPC documents, individual IPC members do not necessarily agree with every statement in the Brief. The IPC would like to thank Rolf Moehler, who drafted and revised the text.

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