

EU Preferential Trade Policies and Developing Countries

Arvind Panagariya¹

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¹ Professor of Economics and Co-director, center for International Economics, University of Maryland, College Park MD 20742. Email: panagari@econ.umd.edu. I am grateful to Mathew Tharakan for many helpful comments on an earlier draft and to Eric Reinhardt for providing a concise summary of his ongoing joint research on the Generalized System of Preferences. In addition to the references cited in the paper, this paper has benefited greatly from a number of websites that offer information on various EU preferential trade arrangements, especially those relating to developing countries.

1 Introduction

European Union, or the European Community (EC) as it continues to be called in the WTO parlance, has had the most extensive network of preferential trade areas (PTAs) of any WTO member. Prior to the current wave of PTAs, christened “New Regionalism” by Bhagwati (1993), EC was a participant to half of such arrangements. Thus, according to the WTO list current at the time of writing, a total of 32 PTAs had been notified to GATT/WTO prior to 1990 and were still in force. EC was a participant to 16 of these arrangements. The New Regionalism saw the PTAs form with vengeance with their number rising to a staggering 172 by early 2002. EC remained a major player in the game with membership in 33 additional arrangements.

To be sure the EC PTAs have not been confined to developed countries. EC has made a conscious effort to forge preferential trade arrangements with developing countries as well. Thus, it maintains special economic relations with its 12 developing Mediterranean neighbors, namely, Algeria, Cyprus, Egypt, Israel, Jordan, Lebanon, Malta, Morocco, Mauritania, Syria, Tunisia, Turkey and the Palestinian Authority. Recently, it has also forged FTAs with some far away trading partners, notably Chile and Mexico in Latin America and South Africa in Africa. EC also maintains a complex web of one-way trade preference to all developing countries under the Generalized System of Preferences (GSP) and to a large number of African, Caribbean and Pacific (ACP) group of countries under the so-called Lomé Convention, recently succeeded by the Cotonou Agreement.

In this paper, I offer an overview and qualitative assessment of the EC preferential trade arrangements with developing countries. My main conclusion is that beyond the obvious rent transfers accompanying such preferences, a definite positive impact of these

arrangements on developing countries is difficult to detect. To some degree, given the multi-layered European arrangements, it is not entirely clear what these preferences have meant. Indeed, preferences to one set of developing countries have probably come at the expense of another. The preferences may have also reduced pressures for trade liberalization within the preference-receiving countries thereby undermining the internal policy reform that could have promoted faster expansion of trade and possibly growth. Therefore, on balance, developing countries as a group will benefit more from a less discriminatory approach centered on the forthcoming Doha Round with the least developed countries assisted through direct aid.

The paper is organized as follows. In Section 2, I offer an overview of the EC arrangements, emphasizing its multi-layered nature. Here I build on the excellent work of Sapir (1998). In Section 3, I discuss briefly EC FTAs with developing countries and in Section 4, its non-reciprocal trade preferences including the recent “Everything but Arms” initiative. In Section 5, I conclude the paper.

2 The Multi-layered EC Arrangements

We can distinguish at least seven different layers of EC integration. While I will discuss in greater detail the layers relevant directly to developing countries in the following section, here I focus on providing an overview. The classification below proceeds from the deepest to shallowest integration.

1. European Union (EU): The 15 EU members are characterized by the deepest integration with a common external tariff, common agricultural policy, common competition policy and common basic rules governing four basic freedoms: movement of goods, services, capital and persons. Citizens of all 15

members have the right to move freely throughout the EU—to live, work, set up business, invest or buy real estate. The majority of the EU members now also use a single currency, Euro.

2. European Economic Area (EEA): The Agreement on European Economic Area extends the Single Market of the EU to three out of the four European Free Trade Area (EFTA) members, namely Norway, Iceland and Liechtenstein.¹ There are two main differences between EU and EEA. EU is a customs union with a common external tariff whereas EEA is a free trade area with each member maintaining its own separate tariff (EU enters EEA as a single entity). In addition, the EU common agricultural policy does not extend to EEA. Altogether EEA constituted a market of approximately 380 million consumers and accounted for almost 18 % of world imports and 20 % of world exports (excluding intra-EEA trade) in 2000.
3. Customs Unions: EU has agreements in place for the formation of customs unions, albeit in industrial products only, with Andorra, Cyprus, Malta and Turkey. These are currently at various stages of integration. From the available details, only the agreement with Turkey is in the final stages of implementation. The agreement with Andorra came into force in 1991 though it was notified to WTO only recently in 1998. The first generation association agreements with Malta and Cyprus, which included provisions for the establishment of customs unions and were concluded in the early 1970s, were

¹ Switzerland, though a member of EFTA, voted against membership in EEA in December 1992. It maintains its relationship with the EU through bilateral Agreements.

notified to GATT in 1971 and 1973, respectively. But these do not seem to have resulted in the establishment of customs unions to-date. A new agreement with Cyprus is in the works and is expected to be signed by the end of 2002.

4. Free Trade Areas: EU has a very large number of FTA arrangements, which are at various stages of implementation. These include the Europe Agreements with the eastern and central European countries of Bulgaria, Czech Republic, Slovak Republic, Poland, Hungary, Romania, Slovenia, Estonia, Latvia and Lithuania, Euro-Mediterranean Association Agreements with Tunisia, Israel, Morocco and Jordan and free trade areas with Switzerland, Denmark, Iceland, Mexico and Chile.²
5. Mediterranean Partnerships: EU has a special relationship with its 12 Mediterranean partners located in the Southern and Eastern Mediterranean. Among these are the three Maghreb partners, Morocco, Algeria and Tunisia; six Mashreq partners, Egypt, Israel, Jordan, the Palestinian Authority, Lebanon and Syria; and Turkey, Cyprus and Malta. The so-called Barcelona Process, launched in 1995, governs the current EU-Mediterranean relations. A key goal of this process is the establishment of a WTO consistent Euro-Mediterranean free-trade area by 2010. This is to be achieved through a series of bilateral agreements involving EU and the 12 Mediterranean partners. So far, EU has concluded Association Agreements with Tunisia, Israel, Morocco, Jordan and Egypt. An interim agreement has also been signed with the Palestinian

² Both Europe Agreements and Euro-Mediterranean Association Agreements are wider in scope and include FTAs as one of their provisions.

Authority while negotiations are still under way with Lebanon, Algeria and Syria. Reference to customs unions with Turkey, Malta and Cyprus has already been made.

6. ACP Preferences: EU maintains one-way trade preferences for seventy-one countries spread over Africa, Caribbean and Pacific (ACP) regions. Because these preferences are neither available to all developing countries nor restricted to just least developed countries, they violate WTO rules and granted under waivers by other WTO members.
7. GSP Preferences: Additionally, EU offers trade preferences under the Generalized System of Preferences (GSP) of the Enabling Clause of WTO. As a part of its GSP program, it also undertook the recent “Everything but Arms” initiative aimed at the least developed countries. Broadly speaking, for countries that are not least developed countries, GSP preference margin and commodity coverage are narrower than those offered under ACP. As such, for ACP countries, GSP offers little extra benefit.

As Sapir (1998) reminded us, an implication of these layers of arrangements is that the EU Most Favored Nation (MFN) tariffs apply uniformly to only six countries today: Australia, Canada, Japan, New Zealand, Taiwan and the United States. Though zero MFN duties in EU on more than one fifth of the items has an ameliorating effect on the resulting trade diversion, in products of potential comparative advantage of developing countries, the impact may still be large. Given the EU integration with many richer countries is deeper, developing countries may suffer a loss of market access despite the presence of preferences

in their favor. Finally, some developing countries face discrimination on account of deeper preferences to others.

3 EU Preferences Involving Developing Countries

In the previous section, I have identified three sets of EU arrangements targeted specifically to developing countries: arrangements pertaining to the Mediterranean partners; ACP preferences under the Lomé Convention; and GSP that are applicable to all developing countries.³ In the following, I consider each of these in greater detail.

3.1 Relations with Mediterranean Partners

Bilateral agreements between EC and its Mediterranean partners have existed since the 1960s. But the 1973 war between Israel and its Arab neighbors followed by the oil embargo led to renewed efforts for improved cooperation. EC signed cooperation agreements with three Maghreb countries (Algeria, Morocco and Tunisia) in 1976 and with four Mashreq countries (Egypt, Jordan, Lebanon and Syria) in 1977. There were two key provisions in the agreements: trade preference and direct aid. The agreements more or less governed the relations between EC and the Mediterranean partners until 1996.

The resurgence of regionalism during 1990s and political developments including the end of the East-West conflict led EC to make renewed efforts for strengthening its ties with the Mediterranean states. The outcome was the Euro-Mediterranean Partnership launched at the 1995 Barcelona Conference. The Conference drew a comprehensive agenda aimed at

³ I should also include the FTAs with Mexico and Chile, which probably foreshadow the impending expansion of EU into Latin America. But since Marcel Vaillant and Alvaro Ons discuss these arrangements in detail in their contribution to this volume, I will hold the temptation.

promoting partnership between EU and the 12 Mediterranean states in three areas: political and security area, economic and financial area; and social, cultural and human area. Within the economic and financial partnership, two key objectives were identified: (i) creation of an EU-Mediterranean free trade area by the year 2010 and (ii) expansion of the EU financial assistance to €4.685 billion over the period 1995-99.

The EU-Mediterranean free trade area is to be created by 2010 through bilateral free trade areas between EU and its Mediterranean partners on the one hand and similar arrangements among the latter. So far EU has signed the Association Agreements that include free trade area as one of the provisions with Tunisia, Israel, Morocco, Jordan, Egypt and Algeria. Agreements with the last two of these countries have not been ratified so far, however. There also appears to be little progress towards free trade areas between the Mediterranean states themselves.

3.2 ACP Preferences

Seventy-one countries, spread over Africa, Caribbean and Pacific regions, receive one-way trade preferences from EC under the Lomé Convention. The beneficiaries include forty-seven countries from south of the Sahara in Africa, sixteen island nations of the Caribbean, and eight islands from the Pacific. Thirty-nine of the ACP countries are classified as the least developed countries by the United Nations.

The origins of the EU-ACP cooperation can be traced back to the Treaty Of Rome signed in 1957, which expressed commitment to contribute to the prosperity of the colonies and overseas countries with historical ties with the EC member states and proposed the creation of the European Development Fund (EDF) for this purpose. Subsequently, this provision culminated in the Yaounde I (1963-69) and Yaounde II (1969-75) agreements

between EC and ACP countries under which bulk of the EDF funds were pledged to French-speaking Africa to build infrastructure.

Accession of the United Kingdom to EC in 1973 led to the signing of a more far reaching agreement, Lomé I (1975-80), between 46 ACP and the EC member states. The agreement introduced trade preferences for most ACP exports to EC markets. Additionally, the UK desire to bring its special trade preferences for bananas and sugar under the EC umbrella resulted in separate trading 'protocols' on sugar, bananas, and beef and veal. The trade preferences and the protocols became integral parts of the successive Lomé Conventions, Lomé II (1980-85), Lomé III (1985-90) and Lomé IV (1990-2000).

The banana protocol gives duty-free entry for specific quotas of bananas into the EU market. Several small island Caribbean states have been among the main beneficiaries of the quotas. Under the sugar protocol, EC annually buys a fixed quantity of sugar from ACP producers at its internal sugar price. Among the major beneficiaries of this arrangement are Mauritius, Fiji, Guyana and Barbados. Under the beef and veal protocol, EC refunds 90 per cent of tax normally paid on beef imports from several ACP countries. This has been especially beneficial to Southern African exporters.

Trade preferences in the Lomé Convention cover 99 percent of the industrial products of ACP countries without quantitative limits. This is superior to the preferences under GSP described below. In the case of 39 least developed countries, the recent "Everything but Arms" initiative (see below) supersedes the ACP preferences, however. The agreement also consists of a major aid component through the EDB, which allocates funds amounting to €4 to 6 billion every five-year period.

The scope of the Lomé Convention is a far wider than trade preferences and aid. Lomé IV especially widened the agenda of the agreement, introducing even human rights as an ‘essential element’ of cooperation, meaning that any violations could lead to a partial or total suspension of aid by EU. It also introduced environmental considerations through a ‘protocol’ that allowed the tapping of the eighth EDF budget (1995-2000) for the preservation of rainforests in the ACP member countries.

With Lomé IV having expired, the Cotonou Agreement has recently replaced it. This is a 20-year agreement, resting on five pillars: a comprehensive political dimension, participatory approaches, a strengthened focus on poverty reduction, a new framework for economic and trade cooperation and a reform of financial cooperation. Some of the detailed provisions illustrate further the wide reach of the agreement: respect for human rights and democratic principles; a new specific procedure to be launched in serious cases of corruption; consultation of civil society on the economic, social and institutional reforms and policies to be supported by EC; an integrated approach to poverty reduction centered on economic development, social and human development and regional cooperation and integration; a process to establish new trading arrangements that will pursue trade liberalization between the parties; cooperation in trade related areas such as competition policy, intellectual property, trade and environment and trade and labor; and the channeling of EDF funds through two instruments—one envelope for providing grants and one for providing risk capital and loans to the private sector.

Under the agreement, trade relations between EU and ACP partners are to undergo a major overhaul. During 2000-07, which is regarded as the preparatory period, the current regime with its preferences and the protocols on sugar, banana, and beef and veal are to be

maintained in some modified form. In parallel, countries other than the least developed countries are to negotiate economic cooperation agreements including a GATT Article XXIV compatible bilateral free trade area with EU. This means that the current one-way trade preferences by EU will be replaced by reciprocal preferences more or less as in the case of the Mediterranean partners. The new arrangements are to enter into force latest by January 1, 2008 with transition to a full FTA spread over at least 12 years.

3.3 Generalized System of Preferences

The first United Nations Conference on Trade and Development (UNCTAD), held in 1964, considered possible ways to promote preferential treatment to goods exported by developing countries. In 1968, it recommended the creation of the “Generalized System of Tariff Preferences” under which developed countries will grant autonomous tariff preferences to developing countries. Because such preferences would be in violation of the Most Favored Nation principle of the GATT Article I, they required a waiver. This was granted by the GATT Contracting Parties through the “Enabling Clause” adopted in 1971 for a ten-year period and renewed in 1979 for an indefinite period.

Under the Enabling Clause, trade preferences have to be non-discriminatory, non-reciprocal and autonomous. No discrimination across developing countries is permitted except in favor of the least developed countries. Preferences must also be one-way meaning that they must not require beneficiary countries to grant reciprocal preferences. Finally, the preferences cannot be a part of a contractual agreement with the recipient countries. Thus, GSP preferences are distinct from the ACP preferences, which are contractual and require a GATT waiver distinct from the one available under the Enabling Clause.

EC was the first to implement a GSP scheme in 1971. Back then, the preferences were characterized by quotas and ceiling for individual products and countries. But since 1995, EU has done away with quotas and replaced them with tariff preferences that vary according to the sensitivity of products. Currently, EU maintains five different GSP arrangements: general arrangements, special incentives arrangements for the protection of labor rights, special incentives arrangements for the protection of the environment, special arrangements for the least developed countries, and special arrangements to combat drug production and trafficking. These are described below in detail.

3.3.1 General Arrangements

The preferences under general arrangements are available to all developing countries including China, which has chosen not to join the Group of 77, as also the transition economies. Of the total of 10,300 products, 2,100 products face zero duties in EU. Of the remaining 8,200 products, approximately 7,000 are subject to preferences under general arrangements.⁴ Of these, 3,300 are classified as non-sensitive and 3,700 as sensitive. Under the general arrangements, EU grants duty free access on non-sensitive products and partial tariff preferences on sensitive products. Sensitive products are defined as those requiring higher border protection. This definition automatically rules out duty free access in products with high tariff duties. Given that high duties typically apply to products such as textiles and apparel and footwear in which developing countries have a comparative advantage, this rule introduces a negative correlation between the margin of preferences and the ability of developing countries to export.

⁴ Typically, agricultural products are left out of the list of products subject to tariff preferences.

As a rule, a flat preference of 3.5 percentage points is provided on sensitive products. For a product with 14 percent duty, this amounts to a 25 percent preference margin. A major exception to the rule is textiles and clothing for which the flat-preference rule is replaced by a 20 percent preference margin. On a product with 14 percent duty, this makes the preference 2.8 percentage points, which is often insufficient for exporters to make it attractive for exporters to put together the paper work.

Based on certain criteria, a country may be excluded from GSP altogether or graduated from specific products. Two criteria are applied for complete exclusion. First, the World Bank classifies the country as a high-income country for three consecutive years. Second, a development index, which measures a country's industrial development and participation in international trade relative to EU, attains a pre-specified value. Both criteria must be satisfied.

Sometimes, even if a country is not excluded from GSP entirely, it can be graduated from GSP privileges in specific sectors. The graduation is based on achieving a certain degree of competitiveness in the sector. Graduation may take place under one of the two mechanisms: a lion's share clause and a graduation mechanism. The former applies if the EU imports of a product from a beneficiary country reach 25 percent of the combined imports from all beneficiary countries. The graduation mechanism, on the other hand, is based on the degree of specialization of the beneficiary country. A sector graduates if it reaches a certain threshold. In turn, the threshold is higher the lower the level of development.

3.3.2 *Special Arrangements under Environmental and Social Clauses*

These arrangements necessarily apply to sensitive products only since the other products already come duty free under the general arrangements. In the case of textiles and clothing, an additional 20 percent preference is available under the arrangements. For products receiving the flat preference of 3.5 percentage points under general arrangements, the extra preference under special arrangements is 5 percentage points.

The special incentive arrangements under the social clause are available to countries complying with the so-called “core labor standards.” These standards are laid down in the ILO Conventions No 29 and No 105 on the elimination of forced or compulsory labour, No 87 and No 98 on the freedom of association and the effective recognition of the right to collective bargaining, No 100 and No 111 on the elimination of discrimination in employment and occupation, and No 138 and No 182 on the abolition of child labour. The request for preferences under these arrangements by a country must be accompanied by a description of laws incorporating the substance of the eight ILO conventions and the measures taken to implement these laws. Ratification of the conventions is not required as a pre-condition for qualification, however.

The special incentive arrangements under the environmental clause are available to countries complying with international standards on forest management, specifically, the standards of the International Tropical Timber Convention. Preferences under the arrangements apply to products of the tropical forest included as sensitive products in the general arrangements.

3.3.3 Special Arrangements for the Least Developed Countries: EBA Initiative

Countries classified by the United Nations as the Least Developed Countries have always enjoyed more extensive preferences than other developing countries. Currently, there are 49 such countries. Following the adoption of the “Everything but Arms” (EBA) initiative in February 2001, with three important exceptions (plus arms and ammunition) all products from these countries can now enter duty free into the European Union. The initiative essentially added the approximately 10 percent of the tariff lines representing agricultural products that were not included previously. The three excluded products are bananas, rice and sugar. They are to be given unlimited duty free access starting January 2006, July 2009 and September 2009, respectively. Currently, two of the products, rice and sugar, are subject to limited tariff-free quotas, which are to be increased annually.

3.3.4 Special Arrangements Aimed at Combating Drug Production and Trafficking

As an incentive to fight drug production and trafficking, EC introduced duty free access to certain products originating in the Andean Community. Subsequently, the arrangement has been extended to Venezuela, the Central American Common Market (Costa Rica, Guatemala, Honduras, Nicaragua and El Salvador), Panama, and most recently Pakistan.

Though the preferences under this arrangement are naturally available to countries with drug production and trafficking only, monitoring is not limited to the beneficiary country's efforts in combating drug production and trafficking. Instead, the latter are also evaluated for their respect and promotion of core labour standards, as well as their environmental policy, particularly with respect to the management of tropical forests.

4 Evaluation of the EU Web of Preferences

The EU integration can be viewed as consisting of three broad layers: the core EU with its common external tariff and the single market initiative, free trade area involving reciprocal trade preferences and one-way trade preferences applying to developing countries. Of these, the first one is non-controversial. EU is an effort to create something akin to the United States of America and has been a positive force for generating economic prosperity for its member states.

The remaining two layers are more controversial, however, and require somewhat closer scrutiny.

4.1 Free Trade Areas

The subject of free trade areas remains controversial even among pro-free-trade economists. While some argue that these arrangements are essentially a move towards free trade, others note that being discriminatory, they need not bring the efficiency benefits usually associated with freer trade and may also undermine the multilateral freeing of trade. The controversy on the “static” efficiency effects revolves around the Vinerian concepts of “trade creation” and “trade diversion” while that on regional versus multilateral free trade is cast in terms of Bhagwati’s “dynamic” time-path question of whether PTAs are building blocks or stumbling blocks of global free trade.

While a detailed review of this debate is beyond the scope of the present paper, four important concerns of the advocates of the multilateral approach, among whom I count

myself, may be noted.⁵ First, trade diversion remains a serious concern of those advocating the multilateral approach. Trade diversion refers to the fact that tariff preference to a trading partner makes the partner's supply more competitive relative to that coming from a more efficient outside supplier. This diverts imports from the latter to the former.⁶ The change is not only globally inefficient but also leads to adverse welfare effects on those outside the union. Even when trade creation effects are present and dominate so that the union as a whole improves its welfare, outside countries are hurt due to whatever trade diversion does take place. Thus, even a PTA in which trade creation effects dominate is not benign.⁷

Second, PTAs can lead to increased protection against outside countries and, thus, turn into stumbling blocks of multilateral liberalization. Bhagwati (1993) first noted this possibility arguing that even when a PTA is initially trade creating, pressures to protect the domestic industry may lead to increased protection against the outside countries and eventually turn trade creation into trade diversion. As the partner begins to undermine the inefficient domestic firms following the tariff preference, the latter may seek protection through increased barriers against outside partners. The increase in such barriers may take the form of higher tariffs when outside tariffs are not WTO bound and of anti-dumping when tariffs are bound. Some evidence supporting this phenomenon has been documented in Panagariya (1999).

⁵ For detailed reviews, see Bhagwati and Panagariya (1996), Bhagwati, Greenaway and Panagariya (1998) and Panagariya (1999, 2000).

⁶ In contrast, trade creation takes place when the preference makes the partner's goods more attractive relative to the previously protected, less efficient domestic goods. In this case, imports from the partner eliminate the less efficient domestic production.

⁷ That trade diversion effects do accompany PTAs has been documented in a variety of studies. Some of these studies are described in Panagariya (1999).

Third, as a corollary of the previous point, the expectations to forge PTAs have led to a slowdown of unilateral, nondiscriminatory liberalization. Much of this liberalization in recent years has taken place in Asia, which has more or less stayed away from the preferential trade arrangements. In contrast, Latin America, which has chosen to go the PTA route during 1990s, has essentially lost the momentum for nondiscriminatory, unilateral liberalization it had acquired during 1980s. The essential point here is that if countries want to form PTAs, they can do so only if they have tariff preference to offer. For instance, if Mexico were to eliminate its outside tariff, it will be in no position to conclude PTAs with its trading partners.

Finally, for a considerable time to come, crisscrossing FTAs have given rise to what Bhagwati calls the spaghetti bowl of tariffs. There are two sources of the spaghetti-bowl effect. First, each FTA has a different transition timetable. Therefore, until each FTA is fully implemented, tariff depends on the union partner from which the product is imported. Second, each FTA has its own rules of origin to determine whether the product was actually manufactured within the union before giving it the duty-free status. Therefore, even after the FTAs have been fully implemented, discrimination based on the rules of origin will remain.

EU, which has signed by far the maximum number of FTAs and has plans to sign many more, has contributed most significantly to this spaghetti-bowl effect. Indeed, the problem has been compounded by its multi-layered one-way trade preferences under GSP, ACP and other arrangements. As mentioned earlier, Sapir (1998) has made the dramatic point that the EU MFN tariff applies to only six countries today. Additionally, EU FTAs have often

excluded agriculture where the scope for trade creation through the elimination of inefficient suppliers is perhaps the largest!

4.2 *One-way Preferences*

For approximately four decades, developing countries have asked for and received considerable preferential access to developed country markets. EU has clearly contributed its share towards such market access. Yet, the preferences can hardly claim to have generated significant successes. For example, a ‘green paper’ published in 1997 by the European Commission as a preparatory step towards the 1998 talks aimed at a new agreement that would succeed Lomé IV offered a grim assessment. Thus, the share of ACP countries in the EU market had declined from 6.7 percent in 1976 to 3 percent in 1998. Merely 10 products accounted for 60 percent of the total ACP exports to EU. Per-capita GDP in Sub-Saharan Africa grew by only 0.4 percent per-annum compared with 2.3 percent for all developing countries from 1962 to 1992. At most, a handful of nations—Ivory Coast, Mauritius, Zimbabwe and Jamaica—have benefited perceptibly from the preferences.

The empirical literature supports the broad conclusion that trade preferences have had little beneficial impact beyond the obvious rent transfer accompanying duty-free entry of goods.⁸ For example, Whalley (1990, p. 1319) concludes thus in his assessment of the impact of the special and differential treatment to developing countries under GATT:

“The paper suggests that available empirical studies, limited as they are, seem to point to the conclusion that special and differential treatment has had only a marginal effect

⁸ See Baldwin and Murray (1977), Grossman (1982), Sapir and Lundberg (1984), Brown (1989), MacPhee and Oguledo (1991) and Mattoo, Roy and Subramanian (2002).

on country economic performance, especially through GSP. And in the more rapidly growing economies, such as Korea, Taiwan, Turkey and others, there is little evidence that special and differential treatment has played much of a role in their strong performance.

There are many reasons why trade preferences may have had a limited impact on the exports of the beneficiary countries. Among them, the following are especially important.

Adverse Impact on the Beneficiary-Country Liberalization

The preferences discourage liberalization within the beneficiary countries themselves. Hudec (1987) noted this many years ago when he wrote, “the non-reciprocity doctrine tends to remove the major incentive that [developing country] export industries have...for opposing protectionist trade policies at home.” Once exporters have achieved free access to the markets of major trading partners, their incentive for using internal liberalization as an instrument of encouraging the partner to open its market disappears. Alternatively, if exporters fear losing GSP status if exports cross a certain threshold, they may be more accommodating of protectionist policies at home.

Recent econometric research by Ozden and Reinhardt (2002) supports this hypothesis. These authors analyze a panel dataset of annual observations on each of the 154 developing countries ever eligible for the United States GSP program, starting in the year of first eligibility (mostly 1976) and continuing through 2000. Comparing those countries remaining on GSP to those dropped, they find that the countries dropped from the program open their markets substantially.

Specifically, according to their quantitative estimates, the removal from GSP program has the effect of boosting a developing country's imports by 8 percent of its GDP,

cutting its average nominal tariff by 4 percentage points, and reducing the duties it collects by about 1.6 percent of the value of its trade. These findings control for a wide variety of confounds (like geography, income, GDP size, and global liberalization trends), and the response rises slightly after correction for the endogeneity of GSP.

Ozden and Reinhardt offer the example of Chile, whose trade liberalization had come to a standstill by the late 1980s. In 1988, it was dropped from the US GSP program in 1988 (for human and worker rights violations). Its finance minister immediately announced a reduction in Chile's average nominal tariff from 20 to 15 percent; his explicitly stated rationale being to compensate for its exporters' loss of competitiveness in the US market by defraying their input costs.

Product Selectivity, Discrimination Across Beneficiary Countries and Side Conditions

Under the original conception, GSP preferences were to cover all products (“generalized”), be non-discriminatory across developing countries except if the discrimination was in favor of the Least Developed Countries, and preclude reciprocal concessions from developing countries. But given the “permissive” rather than “mandatory” nature of the Enabling Clause, developed countries have often been able to violate this conception along all three dimensions without risk of a challenge in the WTO Dispute Settlement Body. Thus, they frequently exclude precisely those products in which developing countries have comparative advantage, “graduate” a country out of the preference for a product just as it begins to achieve significant success as an exporter, and attach side conditions that amount to reciprocal concessions from developing countries. Let me elaborate on each of these violations.

Often the scope of GSP has been limited in precisely those products in which developing countries have a comparative advantage. It was noted above that EU gives very limited preference on textiles and clothing. More importantly, it has maintained strict import quotas on the imports of these products from all significant suppliers under the Multi-fiber Arrangement (MFA). Indeed, it was not until developing countries opted for reciprocal bargains in the Uruguay Round that EU and other developed countries agreed to dismantle the MFA regime.⁹

This point applies even more forcefully to agricultural exports. Until recently, agricultural products have remained virtually entirely out of the EU GSP schemes. Only recently, the EBA initiative, aimed exclusively at the Least Developed Countries, attempted to bring them into the GSP net. But even this attempt seems to have more symbolic than real value. Thus, three major items of potential interest, rice, banana and sugar, have been left out of the EBA net. What is surprising is that the publicity surrounding the EBA initiative notwithstanding, the potential for agricultural exports from the least developed countries is minimal. This is evident from the magnitudes of agricultural exports of the Least Developed Countries shown in Table 1. For example, given the paltry 2,000 tons of annual rice exports to EU, it is difficult to understand the rationale against granting immediate quota-free entry of that product to the Least Developed Countries. A similar point also applies to sugar.

⁹ Even as the MFA and other quantitative restrictions are dismantled, threats of anti-dumping and other contingent protection measures loom large. Irrespective of whether or not such threats are carried out and when carried out whether or not they succeed, their mere presence may have a lasting effect on the exporters. Thus, for example, though the recent EU attempts to impose AD duties on unbleached cotton imports from five emerging markets failed, the attempt itself led to considerable disruption of markets for the developing country-exporters who were so targeted.

Discrimination across developing countries other than that favoring the Least Developed Countries has also become a feature of the current preference regime. Within the GSP, this is accomplished by graduating countries from products in which they achieve success as also by invoking side conditions (see below). Outside the GSP, FTAs are another way to discriminate. Finally, the EU ACP preferences and the U.S. Caribbean Basin Initiative and recent Africa Growth and Opportunity Act all introduce discrimination across developing countries that goes beyond the Least Developed Countries.

Finally, despite the original conception of GSP as unilateral, autonomous preferences, they have been effectively turned into reciprocal, contractual preferences through side conditions. Thus, with all the special agendas relating to labor, environment and drug production and trafficking attached to the grant of any significant preferences under GSP, it is difficult to see regard these preferences as non-reciprocal or even non-contractual.

Moreover, these side conditions introduce a certain element of uncertainty for exporters: the benefit may be withdrawn any time on the pretext that a specific standard is not being fulfilled. In particular, in the United States, domestic lobbies have made free use of these conditions to pursue their favorite goals. As an example, in April 1992, the U.S. terminated India's GSP privileges on \$60 million worth of exports of pharmaceuticals and chemicals on the pretext that the country did not have adequate intellectual property protection.

Rules of Origin

To take advantage of a tariff preference, an exporting country must satisfy certain "rules of origin" to substantiate the claim that it indeed produced the good rather than import

it from another one excluded from GSP privileges. The commonest such rule makes the preference contingent on a minimum valued addition to the product within the exporting country. This requirement can be a major deterrent since many small and poor countries are able to perform only simple assembly operations. And even if the requirement is not prohibitive initially, developed countries have been known to raise it after a country successfully penetrates their markets.

Thus, drawing on Bovard (1991), Hoekman and Kostecki (2001, p. 391) offer the following interesting example. In 1983, under the Caribbean Basin Initiative, initially the U.S. granted tariff preferences on ethanol to the beneficiary countries provided it had a 35 percent local value content. Investments by companies in Jamaica and Costa Rica to convert surplus European wine into ethanol allowed them to reach the 35 percent local value content. Two years later, with production and exports doing well, the U.S. raised the local value content requirement to 70 percent. This was an impossible standard for the Caribbean producers to meet.

In one important respect, the rules of origin introduce an element of discrimination between small and poor developing countries and their richer and larger counterparts. Many small, poor economies are able to perform only simple assembly operations so that they may not be able to satisfy the rules of origin. In contrast, richer, larger developing countries may succeed in satisfying these rules and better able to take advantage of the preference.

Adverse Impact on the Developed Country Liberalization

Trade preferences have also ended up turning into a defense against genuine, multilateral liberalization by developed countries in products of potential comparative advantage of developing countries. By offering special side deals to specific groups of

countries through the preferences, they have effectively succeeded in maintaining the MFA for several decades as well as retain high tariffs on textiles and apparel, footwear and fisheries.

The negotiating power conferred by this instrument on developed countries was demonstrated most recently at Doha with these countries successfully breaking up the united front offered by a group of developing countries against the inclusion of the Singapore issues into the Doha agenda. The U.S. decision to go along with the waiver in favor of the Cotonou Agreement, sought by the African countries to preserve the ACP preferences, substantially muted the African opposition to the Singapore issues. In this vein, there remains the danger that developed countries may succeed in using the preferences to resist pressures for genuine liberalization of sectors subject to peak tariffs in the Doha Round of negotiations.

5 Concluding remarks

This paper has provided a unified discussion of the EC/EU trade relations with developing countries. The focus has been on preferential trade intended to promote closer ties with these countries. In the process, I have noted that the EC integration schemes have been multi-layered such that developing countries may have suffered discrimination despite the special schemes in their favor because the special schemes offered others are sweeter. As EU forges closer and closer ties with its European partners, developing countries are bound to suffer from trade diversion. Some developing countries, particularly the Mediterranean and ACP countries, may be compensated through preferences for themselves but that will then necessarily come at the expense of other developing countries in, say, Asia.

I have also argued that one-way preferences such as those under GSP have failed to fulfill the objectives for which they had been intended. Because these preferential schemes are offered as privileges not subject to genuine WTO discipline, they can be withdrawn any time on one of the many pretexts that have been built into them. This deters potential entrepreneurs from making the necessary investments. The point is well illustrated in the following excerpt from a letter to the *Financial Times* (June 6, 2002) by Amar Hamoudi of the Center for Global Development regarding the Africa Growth and Opportunity (AGOA) Act.

“Take the recent case where a consortium of US fruit producers asked the Bush administration to suspend South Africa's Agoa benefits on canned pears, arguing that the expansion of the industry in South Africa threatened to put a handful of Americans out of work. Fruit producers in South Africa protested that Agoa did not induce them to expand production, since the necessary investments were too risky given that the benefits granted by Agoa can be revoked at any time. Producers in Africa can expect that any time they succeed in taking true advantage of Agoa, some special interest group in the US will demand that the benefits be rescinded.”

The shortcoming of preferential trade practices, discussed principally in the context of the EU schemes, are of course applicable to all such schemes and therefore pose greater threat to the interests of developing countries than might seem from the focus on EU alone. Therefore, it is more important than ever to successfully complete the Doha round of negotiations, bringing trade barriers down in developed and developing countries on a nondiscriminatory basis. Such liberalization will not only promote genuine free trade but also remove the uncertainty associated with one-way trade preferences, reduce the existing

discrimination across countries and help clean up the spaghetti-bowl phenomenon that now characterizes the trading system. In this regard, mention may be made of the call Jagdish Bhagwati and I have made (Bhagwati and Panagariya 2001) for a Jubilee 2010 movement aimed at the removal of the remaining restrictions on industrial products in developed countries.

Table 1: Least Developed Country Exports
(Average for 1996-98 in 000 tons)

| | World | ASEAN/SAARC | EU15 |
|------------------------------------|-------|-------------|-------|
| Cereals | 275 | 151 | 28 |
| Rice | 68 | 70 | 2 |
| Oilseeds | 827 | 76 | 467 |
| Livestock and Meat | 1.815 | 200 | 2 |
| Dairy Produce | 3 | 1 | 0 |
| Fruit & Vegetables | 586 | 561 | 77 |
| Sugar | 423 | 25 | 216** |
| Tropical (coffee/cocoa/bananas...) | 942 | 166 | 517 |
| Bananas | 21 | 0 | 18 |
| Wine & Vermouth | 0 | 0 | 0 |
| Food Preparations | 27 | 3 | 1 |
| Alcoholic Drinks | 6 | 0 | 4 |
| Soft Drinks/Fruits Juices | 3 | 2 | 0 |

**Including 134,000 tons of molasses

Source: European Commission (undated)

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