

Chapter 6

Is erosion of tariff preferences a serious concern?

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Preferential trade arrangements (PTAs) have become a key device of the world trading system, with their number rising dramatically since the early 1990s. More than 200 have been notified to the WTO. Their objectives have also widened in scope. In particular, trade preferences are being used increasingly as a substitute for more ambitious development policies, especially since the Singapore WTO Ministerial conference in 1996. Granting developing countries non-reciprocal preferential access to markets is not new. However, the long-standing importance to developing countries of schemes such as European Union's Cotonou Agreement (formerly Lomé Convention) or the United States' Caribbean Basin Initiative (CBI), as well as the use of new schemes targeted on least developed countries (LDCs) or on sub-Saharan Africa (SSA), have changed the nature of this issue. Preferences in general, and non-reciprocal preferences in particular, are among the important issues to be addressed during the Doha Round. A major concern of the G-90 member countries, in particular those in SSA, is that multilateral trade liberalization will erode these preferences. This contributed to its inclusion as an issue in the July 2004 Framework Agreement (WTO 2004).

This chapter aims to clarify the specific issues raised by trade preferences, in particular non-reciprocal ones, as they pertain to the Doha round. How important are trade preferences

for developing countries, and for which developing countries are such preferences of special importance? What are the issues raised from the perspective of multilateral liberalization for preference-receiving countries? In particular, is the erosion of preferences a legitimate concern? For which countries? And what are the possible policy implications?

The importance of preferences for numerous developing countries is well recognized, and has been widely documented and discussed. Preferences have not interfered much with multilateral trade liberalization in the past, however, for at least two reasons. One is because the impact of preferences was most substantial in agriculture and textiles/clothing where previous GATT rounds failed to expand market access, at least until the recent MFA phase out. The other is that, until recently, the quantitative economic analysis of multilateral liberalization failed to deal satisfactorily with trade preferences.

No comprehensive global database describing the levels of protection while taking into account preferences was available until 2004. Since the Uruguay Round, most worldwide empirical studies of multilateral liberalization have been based on computable general equilibrium (CGE) models that drew on the GTAP database. But until GTAP version 6, released in late 2004, this database did not take into account PTAs, except five among the most important reciprocal agreements: the EU, EU-EFTA, NAFTA, ANZCERTA and SACU. This means that virtually all global quantitative assessments of the impact of multilateral liberalization have been unable to address the issue of non-reciprocal trade preferences.

The MAcMap database, jointly developed by CEPII (in Paris) and ITC (UNCTAD-WTO's joint agency in Geneva), has now filled that lacuna. It has done so by putting together a consistent and quasi-exhaustive set of *ad valorem* protection rates across the world for 2001, taking account of all preferential agreements enforced at that date (see Bouët et al. 2004b).

In this chapter we take advantage of this new protection database, as well as of a series of studies recently carried out by CEPII (Bouët et al. 2004a, Bchir et al. 2004, Candau et al. 2004), to address the above-mentioned issue. The scenarios considered are a subset of those described in Jean, Martin and Laborde (2005), but the information is used directly at the HS6 level of product disaggregation.

The "mechanics" of the erosion of preferences are simple. Following multilateral trade negotiation (MTN) at the GATT/WTO, cuts are applied to bound import duties, not directly to applied tariffs. A most-favored-nation (MFN) applied duty is reduced only if the liberalized bound duty for this product is lower than the initial applied duty, and then only to the extent of that difference. In turn, preferential rates (which are applied duties that had been set lower than the MFN rate) typically are cut by proportionately less than the MFN applied rates. This means preferential margins are eroded when tariffs are cut, other things equal. Also important is the fact that preferential tariff rate quotas (TRQs) are fairly common among agricultural products. Many of them give rise to substantial rents for some developing countries, and those rents are reduced following a cut in the out-of-quota tariff rate (OQTR) as a result of a MTN.

In addressing the question of the extent to which preference erosion is a serious problem, and for which countries, the chapter is structured as follows. It begins by reviewing the historical context of preferences, and by exploring their market access implications for developing country exporters. It then assesses how multilateral liberalization following the Doha round could erode preferences. This is done by clarifying the "mechanics" of preference erosion and assessing the corresponding implications for preference margins. CGE simulations are then carried out to gauge the impact on trade, output and welfare. Policy implications are discussed in the final section.

An overview of preferences

The current situation is the result of a gradual piling up of numerous individual preference schemes. It is particularly complicated for farm products, not only because of the nature of the instruments used (specific tariffs, TRQs) but also because these instruments are managed in a non-transparent manner and are often aimed at introducing exceptions at the time of conceding more general access.

Where do we start from?

Members of the GATT/WTO are generally constrained to offer non-discriminatory MFN access to their markets for all other GATT/WTO members. As a core rule of the multilateral trade system, a Member should neither discriminate between its trading partners nor discriminate between its domestic products and import. The very basis for this non-discrimination is the MFN clause, which requires MFN tariffs to be applied equally to all WTO members. Accordingly, Article I (paragraph 1) of the GATT states that “any advantage, favour, privilege or immunity granted by any contracting party to any product originating in or destined for any other country shall be accorded immediately and unconditionally to the like product originating in or destined for the territories of all other contracting parties”. Despite this very clear statement, a significant amount of goods shipped around the world finally do not face a MFN tariff when entering the destination market.¹ The reason for this is

¹ According to World Bank (2004), RTAs cover more than 20 percent of world trade when zero-MFN imports are excluded.

the existence of preferences, introduced in Paragraph 2 of that same Article I of the GATT: “The provisions of paragraph 1 of this Article shall not require the elimination of any preferences”.

Generally speaking, two kinds of preferential schemes operate: symmetric schemes, under which two countries mutually offer preferential access to their market, and asymmetric ones in which one country unilaterally concedes preferential access to a well-defined (but not necessarily stable) list of exporting countries. The former system includes the treatment of regional agreements by the GATT, while the latter is associated with the Generalized System of Preferences (GSP) and its extensions (e.g., the EU’s recent ‘Everything But Arms’ (EBA) initiative that offers duty- and quota-free market access for LDCs, and the United States’ African Growth and Opportunity Act (AGOA), plus development-targeted agreements introduced earlier (e.g., Cotonou, Caribbean Basin Initiative).

Regarding regionalism, Article XXIV of the GATT (“the provisions of this Agreement shall not prevent, as between the territories of contracting parties, the formation of a customs union or of a free-trade area”) has translated into a myriad of preferential agreements. Often these are regional (eg the Common Market in the late 1950s, NAFTA, MERCOSUR,), but plenty of bilateral ones involve non-contiguous countries (USA-Morocco or Mexico-Israel, for instance). According to notifications to the WTO, the number of such agreements in force by the end of 2005 might approach 300. Many of the 148 WTO members are participating in various trade agreements. Accordingly, their tariff schedules involve many different levels of concessions, often defined at the product level, and frequently embodying numerous exceptions. The official and optimistic view that regionalism is a building block of multilateralism leaves unexplained the desire by WTO members to devote such efforts to escape from Article 1 of the GATT.

For non-reciprocal trade agreements, the picture is even more complicated. The Millennium Development Goals aim, *inter alia*, at developing a global partnership for development through more aid, better market access, and debt sustainability. This target is an extension of the decision taken in 1968 under the auspices of UNCTAD to grant developing countries non-reciprocal preferential access to developed-country markets under the GSP scheme.² Under the latter scheme, rich countries offer non-reciprocal preferential access to products originating in a tailor-made list of developing countries, with preference-giving countries unilaterally choosing countries and products to be included in their GSP schemes. The lists are revised on a regular basis, leading to “entries” and “exits”. In addition, the preferences conceded can be subject to quotas, or designed according to the degree of political “sensitivity” of products.

Not surprisingly, preferences conceded generally aim at preserving the vested interests of domestic producers. For instance, until 1994, the EU’s GSP scheme applied quantitative limitation of GSP imports.³ This system has been replaced by “tariff modulation” in which reduced rates of duty are classified into four categories: very sensitive products (preferential margin equal to 15 percent of the MFN tariff), sensitive products (30 percent), semi-sensitive

² Resolution 21(ii) taken at the UNCTAD II conference in New Delhi in 1968 states that “the objectives of the generalised, non-reciprocal, non-discriminatory system of preferences in favour of the developing countries, including special measures in favour of the least advanced among the developing countries, should be: to increase their export earnings; to promote their industrialisation; and to accelerate their rates of economic growth”. It is a follow up to the proposal made in 1964 by Raúl Prebisch.

³ See UNCTAD (2003a) for an overview.

(65 percent), non-sensitive products (duty-free). There are also special incentive schemes, offering an additional tariff preference according to specific development purposes (e.g., special incentive arrangements for the protection of labor rights, or special arrangements to combat drug production and trafficking).

The general goal of such asymmetric or non-reciprocal preferences is to make it possible for countries with limited export potential to more-easily reap the benefits of globalization. The multilateral trading system also guarantees “special and differential treatment” (SDT) to developing countries according to the so-called “enabling clause”.⁴ Besides longer implementation periods or smoother commitments, SDT offers asymmetric market access. A recent extension of such agreements involves the specific concessions granted to LDCs by the EU, the US, Japan, or Norway. The European initiative is the previously mentioned “Everything But Arms” (EBA) deal which offers duty-free and quota-free access to all products originating in LDCs, with the exception of arms and three agricultural products for which liberalization has been delayed (sugar, banana and rice).

⁴ This is the translation into GATT law of the GSP scheme, formally undertaken in 1979, and states that “Notwithstanding the provisions of Article I of the General Agreement, contracting parties may accord differential and more favourable treatment to developing countries, without according such treatment to other contracting parties.” For more on SDT as it relates to Doha, see Josling (2005).

The EU and US preferential schemes at a glance

Figure 6.1 illustrates the European Union's trade policy in 2004. It highlights its degree of intricacy.⁵ Several free trade agreements have been negotiated on a regional basis (EFTA/EEA) or on a bilateral basis (with Chile, Mexico, ...) or, as with Mediterranean countries, within a framework such as the Euromed initiative. The structure of European preferences has reached great complexity. Since 1995, the European GSP has been divided into five regimes: the standard GSP, the GSP granted to countries fighting against drug production and trafficking, the one granted to countries enforcing labor rights, the scheme for environment protection (which has not been granted so far), and the EBA initiative for LDCs.

As a result of historical links with African, Caribbean and Pacific (ACP) developing countries, an ACP preferential regime has long been established. This scheme, which is not WTO-compatible but has survived under a GATT waiver, will need to be replaced by 1 January 2008. The Cotonou Agreement, signed in 2000, renewed the non-reciprocal ACP preferential arrangements formerly offered under the Lomé Convention, but it also foreshadowed the negotiation of Economic Partnerships Agreements (EPAs) with six groups of countries, later defined as countries from Central Africa, from Eastern and Southern Africa, from the Southern African Development Community, from the Pacific, from the Caribbean Islands and from Western Africa. The EPAs are currently scheduled to come into force by the end of 2007, but that may change if the GATT waiver is extended again.

⁵ Complexity also concerns exporting countries: for example, products shipped by 28 countries, such as Burundi, Malawi, Sierra Leone, Angola, Solomon Islands or Chad, might be taxed under any of four alternative tariff regimes and administrative rules. This represents a sizeable information cost for small exporters.

These myriad trade preference regimes mean that European trade policy is less multilateral and highly fragmented. Today for Europe as an importing zone, the WTO multilateral regime applies to only 11 countries amongst the 208 potential exporting countries. This fragmentation particularly concerns trade policy *vis-à-vis* developing countries. Under the GSP scheme as it was originally negotiated in 1971, tariff preferences had to be non-discriminatory, with deeper preferences applying only to the LDCs. Figure 6.1 reveals how much this scheme is departing from that initial principle. This results in part from the fact that trade policy for a long time has been the only foreign policy instrument of European Community competence.

Even if its degree of intricacy is lower, US trade policy is also fragmented (see Figure 6.2). Recently it has been pursuing a bilateral path as free trade agreements have been negotiated with single trade partners including Panama, Jordan, Singapore, Morocco, Bahrain, and Australia. As compared to the EU's, US trade policy is more multilateral as the WTO regime still applies to 25 partners. Trade preferences granted to developing countries are also less fragmented, with just four preferential regimes being defined (the GSP, CBI, Andean Trade Pact Agreement, and AGOA). Another noteworthy difference is that, unlike the EU, the US has a set of sensitive products that are excluded from all preferential schemes (although the United States' GSP scheme generally offers duty free access to all products that benefit).

Implications for protection faced

What are the implications of these intricate trade policies for protection faced by developed and developing countries on their exports? The MAcMap_HS6 database allows for an aggregation of applied duties across all products and all reporters (importers), for each

partner (exporter), to obtain the average duty faced by each country on its exports to the rest of the world. The 1st and 5th columns in Table 6.1 report this average for agricultural and for industrial products, using the MAcMap's reference-group based weighting scheme (see Bouët et al. 2004).

In agriculture, the average duty faced on exports ranges from 0.6 percent (Equatorial Guinea) to 87 percent (Guyana). For OECD countries, the average duty faced is regularly below 20 percent (except for Australia and New Zealand), whereas products originating from numerous small developing countries are highly taxed (Guyana, Barbados, Belize, Botswana, Gabon, Mauritius, ...). These huge differences are the result of the combination of two different effects: a *composition effect* and a "*true*" *preferential margin*. The first is the result of the composition of exports varying across countries due to different product specialisations and due to various geographic destinations.⁶ The "true" preferential margin captures the fact that each country is benefiting from an average preferential margin, thanks to the trade regimes it has been conceded. Compared to the world average preferential margin (the worldwide average difference between MFN and applied duties), a country might benefit from a higher or lower average preferential margin. We call this difference with respect to the world average the "true" preferential margin.

In order to tackle these different components, we derive the following equation. Let $t_{s,r}^h$ be the applied ad valorem equivalent (AVE) duty imposed by country s on product h exported by

⁶ The unit value used in computing the AVE of specific tariffs also varies across reference groups.

country r , let $w_{s,r}^h$ be the weight of this flow, $MFN_{s,r}^h$ the MFN AVE duty imposed by country s on product h .⁷

Let us define the apparent margin faced by country i AM_i as:

$$AM_i = \frac{\sum_r \sum_s \sum_h w_{s,r}^h t_{s,r}^h}{\sum_r \sum_s \sum_h w_{s,r}^h} - \frac{\sum_s \sum_h w_{s,i}^h t_{s,i}^h}{\sum_s \sum_h w_{s,i}^h} \quad (1)$$

The first term on the right-hand side of (1) is the applied duty faced by the world, the second one is the applied duty faced by country i . From (1), we derive:

$$\begin{aligned} AM_i = & \left[\frac{\sum_r \sum_s \sum_h w_{s,r}^h t_{s,r}^h}{\sum_r \sum_s \sum_h w_{s,r}^h} - \frac{\sum_r \sum_s \sum_h w_{s,r}^h MFN_{s,r}^h}{\sum_r \sum_s \sum_h w_{s,r}^h} \right] \\ & + \left[\frac{\sum_r \sum_s \sum_h w_{s,r}^h MFN_{s,r}^h}{\sum_r \sum_s \sum_h w_{s,r}^h} - \frac{\sum_s \sum_h w_{s,i}^h MFN_{s,r}^h}{\sum_s \sum_h w_{s,i}^h} \right] \\ & + \left[\frac{\sum_s \sum_h w_{s,i}^h MFN_{s,r}^h}{\sum_s \sum_h w_{s,i}^h} - \frac{\sum_s \sum_h w_{s,i}^h t_{s,i}^h}{\sum_s \sum_h w_{s,i}^h} \right] \end{aligned} \quad (2)$$

The "apparent" preferential margin obtained by country i on its exports is thus defined by the sum of three components. The first term is the worldwide difference between the average applied and MFN duty. It is the opposite of the world average preferential margin. The second term is the difference between the MFN duty faced by the world and the one faced by country i . It measures a composition effect of country i 's exports. The third term is the difference

⁷ The MFN AVE duty is defined as a three-dimensional variable (reporter, product and partner) due to the calculation of the ad valorem equivalent based on a bilateral unit value.

between the average MFN duty and the average applied duty faced by country i ; it is country i 's preferential margin. We call the "true" preference margin the sum of the first and the third terms, that is, the difference between the country's and the world's average preferential margin, defined as the weighted average across products of the difference between the MFN and the applied rate. This "true" preferential margin is featured on Figure 6.3, where both reciprocal and non-reciprocal preferences are taken into account. This world map illustrates how the impact of preferences varies within regions (Africa, Latin America) or groups of countries (LDCs).

Based on equations (1) and (2), the average applied duty faced by country i on its exports can thus be defined as the applied duty faced by the world, minus the composition effect (the second difference term in equation 2), minus the "true" preferential margin effect. A positive composition effect means that country i is specialized in products (or in geographical destinations) that are less protected all around the world. A positive "true" preferential margin means that, on average across its export markets, a larger preference is reaped by country i on its exports as compared to the world. The corresponding decomposition is reported in Table 6.1. For the sake of clarity, since world average levels are taken as references in this calculations, they are reported in Table 6.: in agriculture, the average AVE applied duty faced by the world is 19 percent, while the MFN AVE duty faced by the world is 27 percent.

Table 6.1 should read as follows. The first row shows that Lesotho's agricultural exports face an average applied AVE tariff duty of 18.4%, 0.8 percentage points less than the world average. But this tiny "apparent" preference margin results from the combination of strongly negative composition effect (-24.1 percentage points), revealing specialization in highly taxed products, and of strongly positive "true" average preferential margin (24.9

percentage points), due to the preferential agreements from which Lesotho benefits.

In agriculture, the composition effect appears to vary strongly across countries. It is strongly negative for several countries (Guyana: -76 percent; Mauritius:⁸ -36 percent; St Kitts and Nevis: -35 percent; Barbados: -25 percent; Belize: -27 percent), as a result of their specialization in products still highly protected in most large markets. These large, negative composition effects are likely to be largely endogenous: although preferential agreements frequently exclude highly sensitive products, preferential margins by construction can only be large in highly protected products. As a matter of fact, preference-receiving countries thus face incentives to specialize in highly protected products, since this is where their preferential margin is higher. This is not a systematic rule, though, and some other developing countries tend to specialization in largely liberalized products, as reflected in a positive composition effect (Equatorial Guinea: 26 percent; Chad: 20 percent). Orders of magnitude are far lower in non-agricultural products, but it is even more striking that most countries with significant "true" preferential margin exhibit a large, negative composition effect.

Although the "true" average preferential margin does not reach extreme values comparable to the composition effect, its value in agriculture is as high as almost 25 percentage points for Lesotho and Aruba, and it is higher than 6 points for Gambia, Saint Vincent, Uruguay, Yugoslavia, Saint Lucia, Guyana, Suriname, Turkmenistan, Virgin Islands,