PREFERENCE EROSION:
THE TERMS OF THE DEBATE

Bernard Hoekman, William J. Martin and Carlos A. Primo Braga

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I. Introduction

The multilateral trade system has as its cornerstone the principle of non-discrimination. The most-favored-nation (MFN) clause embodied in Article I of the GATT was the defining principle for a system that emerged in the post-World War II era to a large extent as a reaction to the folly of protectionism and preferential trading arrangements that had contributed to the global economic depression of the 1930s. From its origins, however, the GATT allowed for exemptions to the MFN rule in the context of reciprocal preferential agreements and with respect to unilateral preferences granted to developing countries.

Unilateral preferences granted by OECD countries introduced an inevitable tension between “more preferred” developing countries – typically beneficiaries from pre-existing colonial regimes – and other developing countries with respect to the effects of MFN liberalization by preference-granting countries. Concerns about preference erosion have become one of the key points of debate in the negotiations around the Doha Development Agenda (DDA). These concerns, however, are not new. In the 1970s, for example, the impact of Tokyo Round-related liberalization on the benefits derived by developing countries from the Generalized System of Preferences (GSP) was extensively debated. In the last few years the scope and coverage of unilateral preferential regimes

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1 This note serves as the Introduction to a set of papers that were presented at the International Symposium on “Preference Erosion: Impacts and Policy Responses” in Geneva, June 13-14, 2005, organized by The World Bank with support from the Canadian International Development Agency and the UK Department for International Development. We are grateful to all the authors for having subsequently revised their papers, and to C. Tully for helpful comments and assistance. The views expressed are personal and should not be attributed to the World Bank Group, its Executive Directors, or the countries they represent.

has increased significantly, especially for the least developed countries (LDCs). It is argued both by donor countries and some beneficiary countries that, as a consequence, the value of these preferences has significantly increased. Hence, it is not surprising that preference erosion has been receiving a great deal of attention in the current round of multilateral negotiations.

The papers included in this volume review the current “value” of preferences for beneficiary countries, assess the implications of preference erosion under different global liberalization scenarios, and discuss potential policy responses. In this Introduction, our intention is not to summarize each of the papers. Instead, we briefly describe the main features of unilateral preferential regimes, introduce the basic terms of the debate around the topic of preference erosion and discuss the variables that affect the magnitude and incidence of erosion. So as to provide context for the findings reported in the various papers, we also summarize the results of other recent research on preference erosion. We conclude with a discussion of possible policy responses by preference granting countries and the international community to erosion losses.

II. Unilateral, Non-Reciprocal Trade Preference Regimes

The rationale for granting preferential market access to developing countries by industrialized nations emerged in the context of the arguments in favor of special and differential treatment (SDT) for developing countries. The underlying justification for this reflected development thinking in the late 1950s and early 1960s – most notably work by Raúl Prebisch and Hans Singer. This was premised on the argument that developing countries needed to foster industrial capacity both to reduce import dependence and to diversify away from traditional commodities that were subject to long-term declining terms of trade (and often also affected by short-term price volatility). This gave rise to the policy prescription of high trade barriers in order to protect infant industries—i.e., import-substitution industrialization.

At the same time it was recognized that exports were important as a source of foreign exchange and that the local market might be too small for local industry to be

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3 This is a group of the poorest countries that is defined by the United Nations, with inclusion based on specific criteria. At the time of writing, 50 countries were classified as LDCs by the UN.

4 This section draws on Hoekman and Ozden (2005).
able to capture economies of scale. The second plank of the SDT agenda therefore revolved around calls for preferential access—a general system of preferences that would give developing countries better than most-favored-nation (MFN) treatment in the major markets of the world—the industrialized countries. The GSP, the framework for providing such preferences, was established under the auspices of the United Nations Conference on Trade and Development (UNCTAD) in 1968.\(^5\)

Early evaluations of the shortcomings of preferential regimes questioned whether preferences were an efficient way to help developing countries, noting that producers in beneficiary countries need to compete with domestic producers in the donor country as well as other exporters.\(^6\) It was debated to what extent a 5-7 percent preference margin would make a significant difference (the GSP involved preferences, not duty- and quota-free access of the type that is now accorded to the LDCs by many OECD countries). Furthermore, it was pointed out that even in sectors where preferences would make a difference, they might lead to specialization in sectors where the beneficiary country did not have inherent comparative advantage, resulting in socially wasteful investment. Other concerns expressed included potential political friction between beneficiary and excluded countries; administrative costs such as rules of origin; the danger that preferences might reduce the incentives for multilateral MFN liberalization as beneficiaries became concerned about erosion of their preference margins; and, more generally, the politicization of trade policy insofar as donor countries used preferences “to reward and punish the recipients for their behavior and performance” in other non-economic areas (Johnson 1967, p. 199).

The GSP conflicted with basic GATT rules. In recognition of this, GATT members approved special waivers for the GSP, temporarily in 1971 and permanently in 1979 through the “Enabling Clause” (part of the Tokyo Round set of Agreements). This followed on the creation of a Committee on Trade and Development and the addition of several articles to the GATT that addressed development issues in the mid 1960s – Part

\(^5\) UNCTAD was founded in 1964, with Raúl Prebisch as the first Secretary-General. UNCTAD (1964), a report written under Prebisch’s direction, outlines the arguments in favor of trade preferences. The primary role of unilateral preferences was to support infant-industry policies, with expansion of exports of manufactured goods being a part of the overall industrialization process.

\(^6\) See, for example, Patterson (1965) and Johnson (1967).
Part IV encompassed the new principle that reciprocity in multilateral negotiating rounds should be limited to whatever was consistent with the development needs of developing countries (Article XXXVI). The 1979 Enabling Clause (formally Differential and More Favorable Treatment, Reciprocity and Fuller Participation of Developing Countries), which gave permanent legal cover for the GSP, included language on “graduation” – indicating that SDT policies were to be phased out as the recipient countries reached a certain level of economic development. However, criteria for this were not defined, as was the case for eligibility of SDT. A recurring concern expressed by developing countries has been that SDT provisions, including the GSP, are “best endeavors” commitments – they are not enforceable through WTO dispute settlement. Eligibility and graduation criteria, as well as product coverage and the type of preferences are left to donor countries to determine unilaterally.8

One result of the Enabling Clause and the GSP was that developing countries played a limited role in the subsequent development of the multilateral trading system. Until the Uruguay Round negotiations of 1986-94, their participation was à la carte, and many did not make trade-liberalizing commitments in GATT negotiations (although they did over time implement unilateral trade liberalization, especially in the 1980s). With the entry into force of the WTO in 1995, the terms of their participation changed. Because of the concept of the single undertaking, developing countries became subject to most of the disciplines of the many agreements reached in the Uruguay Round negotiations, which they had not joined at the time. The primary type of SDT that was offered in the Uruguay Round was longer transition periods.

Unilateral preferential regimes: the rules of the game

The European Union and the United States passed legislation establishing their General System of Preferences (GSP) regimes in 1971 and 1974, respectively. Although Japan,

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7 See GATT (1994) for the texts on Part IV of the GATT and the Enabling Clause.
8 Such conditions may comprise trade and non-trade conditionality, either de jure or de facto. The Enabling Clause only exempts non-reciprocal preference programs that apply to all developing countries or the LDCs. No other country discrimination in the application of preferences is formally permitted. Until the early 1990s this requirement was not enforced. This changed with the report of a GATT panel dealing with the EU banana import policy, which found the EU regime for banana imports from ACP members violated the GATT MFN rule. As a result the EU was obliged to request waivers for the Lomé Convention in 1994, and its successor, the Cotonou Convention in 2000. The latter was an issue at the 2001 Doha ministerial.
Canada, Australia and several other countries implemented their own GSP regimes, the EU and the U.S. have been and continue to be the most important markets for the developing countries over recent decades.9

The GSP program of the United States divides eligible countries into two groups based on their income levels -- all developing countries and a subset of the least developed. All eligible countries pay zero tariffs on around 4,650 tariff lines; LDCs have duty-free market access for an additional 1,750 lines. Certain articles are prohibited from receiving GSP treatment. These include most textiles, watches, footwear, handbags, luggage and certain apparel. One of the key features of the US GSP program is that a specific country may lose eligibility for a specific product if its exports exceed a certain "competitive need limit," currently $110 million per tariff line. If the country in question has a market share larger than 50% of total U.S. imports in that category, it may also lose the GSP eligibility. GSP eligibility can be removed at the country, product, or country-product level. The President has discretion over when and how to apply these criteria. In practice, an Assistant U.S. Trade Representative chairs an inter-agency committee which makes eligibility and graduation decisions after reviewing petitions from interested parties (the country in question, import-competing domestic firms, labor unions, other firms, human rights/environmental NGOs, etc.). Since the program first entered into force in 1976, 36 of the 154 eligible countries have “graduated” from the GSP program (including Singapore, Hong Kong, Taiwan, Korea, Malaysia, Mexico, and Botswana). Major developing countries remaining eligible include Brazil, India, Russia, Indonesia, Turkey, South Africa, and Thailand.

The U.S. offers additional non-reciprocal trade preferences via the Caribbean Basin Initiative (CBI; launched in 1983 and expanded in 2000 through the U.S.-Caribbean Basin Trade Partnership Act), the Andean Trade Preference Act (enacted in 1991 to help combat drug production and trafficking in the Andean countries and expanded in 2002, becoming the Andean Trade Promotion and Drug Eradication Act),

9 See Onguglo (1999) for a review of schemes in operation as of the end of the 1990s. The non-reciprocal trade preferential initiatives of Australia, Canada and Japan are described in the papers by Lippoldt (2005); Kowalski (2005) and Komuro (2006), respectively. Other OECD countries (e.g., Switzerland, Norway) also provide preferential access to their markets under non-reciprocal trade initiatives. Details about their programs can be found in WTO (2004a, 2004b, 2004c).

The European Union GSP scheme, first implemented in 1971, is more complex than the U.S. regime, but has the same basic principles.\textsuperscript{10} Whereas the United States program grants duty-free market access to all eligible products, the initial EU arrangement classified products into four groups that enjoyed different preference margins: (i) non-sensitive products were granted duty-free market access; (ii) semi-sensitive products had a tariff rate that is 35 per cent of the Common Customs Tariff (CCT); (iii) sensitive products had a tariff rate of 70 per cent of CCT and (iv) very sensitive products faced a tariff rate of 85 per cent of CCT. In 2001, this system was simplified to span only two categories -- sensitive and non-sensitive. The latter group enjoys duty-free market access, and accounts for around 32 per cent of all tariff lines. Most sensitive products receive a flat 3.5 percentage point reduction from the applicable MFN rate. These products comprise around 36 per cent of tariff lines.\textsuperscript{11} As sensitive products are generally the ones with high MFN rates, the proportionate impact of the preference can be rather small.

Country eligibility for the EU GSP program is determined on the basis of a more codified approach than in the U.S., with graduation determined by “indices” that combine the development and specialization level of the country. South Korea, Singapore and Hong Kong, among others, were removed completely from the GSP program on the basis of these criteria. Other countries, including Brazil, India, China, and Argentina, have lost eligibility for a wide range of product categories. In 2001, the EU adopted new graduation criteria. All countries designated as high-income by the World Bank lose eligibility for all products automatically.

As mentioned, in addition to the GSP, the EU has other preference programs, most notably preferences accorded to ACP) countries under what is now the Cotonou

\textsuperscript{10} See Grilli (1997) for additional discussion of EU programs.
\textsuperscript{11} See EC Council Regulation No.2820/98, 21 December 1998 and EC Council Regulation No.2501/01, 10 December 2001 for details of the EU programs.
Convention.\textsuperscript{12} These countries are granted preferences that often exceed those available under the GSP. Most industrial products have duty and quota free market access whereas the preferences are less comprehensive for agricultural products. In 2000 duties were still applied to 856 tariff lines (837 of which were agricultural products). Of these, 116 lines were excluded from the Cotonou agreement. An additional 301 tariff lines were eligible for reduced duties, subject to specific quantitative limits (tariff quotas) set for the ACP countries as a group. The remaining 439 products were eligible for reduced duties without quantitative limits. Another important EU program is the Everything But Arms (EBA) initiative, introduced in March 2001. This program grants duty-free access to imports of all products from the LDCs except for three major products where liberalization is delayed: fresh bananas, rice, and sugar. Tariffs on these items will be reduced gradually to zero by the end of 2006 for bananas and by 2009 for rice and sugar, with tariff quotas for rice and sugar increased annually during the transition. A key feature of the EBA is that, in contrast to the GSP, preferences are granted for an unlimited period and are not subject to periodic review. Candau and Jean (2006) provide additional details on the current EU preferential programs.

In sum, one can characterize OECD preference programs as (1) explicitly differentiating between developing countries (by region, level of development, export potential) and (2) adopting significant “conditionality” in the determination of eligibility, including non-trade considerations. It is also worth noting that there has been a recent trend toward emphasizing “deeper” preferences for a subset of vulnerable countries via special initiatives (e.g., AGOA, EBA) rather than expanding “shallow” preferences under the GSP across the board.

III. Preference Erosion

Empirical analysis of the effects of preferences is confounded by the difficulty of identifying the specific impact of preferences as opposed to other factors. The observed growth rate of exports from recipients to the countries granting trade preferences, for

\textsuperscript{12} This is an international treaty that provides a framework for cooperation between the EU and former colonies of EU member states. The associated commitments are binding and cannot be unilaterally modified by a signatory. Thus, ACP preferences are more secure than the GSP. The Cotonou Convention supercedes earlier treaties, the Yaoundé (1963-75) and Lomé (1975-99) conventions.
example, is not informative without controlling for other factors. Common approaches have been to use simulation methods to estimate trade creation/diversion (which are sensitive to assumptions regarding elasticities) and gravity regressions where preference status is captured by a dummy variable. To the extent that exceptions in preferential regime are often defined at a very disaggregated product level, the absence of (recent) elasticity estimates at this level of disaggregation, plus the difficulty of finding the right controls to include in regressions, contributes to make available studies controversial.

These data and methodological problems help explain why the policy-oriented literature has tended to rely heavily on descriptive indicators. Four indicators are particularly common: (i) calculation of preference margins – the difference between MFN and preferential tariffs for products; (ii) potential coverage – the ratio between products covered by a scheme and the dutiable imports originating in beneficiary countries; (iii) utilization – the ratio between imports that actually receive preferential treatment and those that are in principle covered, a measure of how effectively beneficiaries are able to use preferences; and (iv) utility – the ratio of the value of imports that get preferences to all dutiable imports from that exporter. The lower this ratio is, the less generous the preference scheme.\footnote{For further discussion, see UNCTAD (2003) and Brenton and Ozden (2006).}

To focus on these variables, however, provides at best a partial perspective of the economic value of a preferential regime. In order to get a more precise estimate of the value of preferences one has to take into account: (i) the costs of compliance in terms of documentation (e.g., in proving conformity with rules of origin); (ii) the economic costs of sourcing inputs from more expensive sources in order to comply with origin requirements; (iii) the various limitations and constraints embodied in preferential schemes; and (iv) the distribution of related rents.

Before assessing the cost of preference erosion, it is necessary to have a basic understanding of the value of the transfers being generated by the preferential regime. The simplest measure of these transfers is based on the difference between the applied tariffs facing a country and the MFN tariffs that would apply on its exports in the absence of a preferential agreement. As Bouet, Fontagné and Jean (2005) and Low, Piermartini and Richtering (2005) have emphasized, this measure is an upper bound on the transfers
to the extent that many countries receive preferences, implying that the true preference margins should be adjusted for the preference margins being received by other countries – something that is undertaken in the Low et al. (2005, 2006) papers. It is also necessary to consider the administrative costs. In what follows we ignore these factors and focus on the simpler, traditional, margin of preference as an indication of the overall, upper bound per unit value of preferences.

Table 1. Nonreciprocal preference margins for developing country exports, percentage points

<table>
<thead>
<tr>
<th>Granting countries</th>
<th>EU % points</th>
<th>EU % points</th>
<th>US % points</th>
<th>US % points</th>
<th>Japan % points</th>
<th>Japan % points</th>
<th>Canada % points</th>
<th>Aust % points</th>
<th>Quad + Aust % points</th>
</tr>
</thead>
<tbody>
<tr>
<td>LDCs</td>
<td>6.6&lt;sup&gt;a&lt;/sup&gt;</td>
<td>4.1&lt;sup&gt;d&lt;/sup&gt;</td>
<td>3.2&lt;sup&gt;a&lt;/sup&gt;</td>
<td>2.6&lt;sup&gt;d&lt;/sup&gt;</td>
<td>2.6&lt;sup&gt;a&lt;/sup&gt;</td>
<td>10.9&lt;sup&gt;d&lt;/sup&gt;</td>
<td>4.2&lt;sup&gt;d&lt;/sup&gt;</td>
<td>3.6&lt;sup&gt;d&lt;/sup&gt;</td>
<td>4.6&lt;sup&gt;d&lt;/sup&gt;</td>
</tr>
<tr>
<td>Sub-Saharan Africa</td>
<td>4.0&lt;sup&gt;b&lt;/sup&gt;</td>
<td>1.3&lt;sup&gt;b&lt;/sup&gt;</td>
<td>2.1&lt;sup&gt;b&lt;/sup&gt;</td>
<td>0.1&lt;sup&gt;b&lt;/sup&gt;</td>
<td>0.1&lt;sup&gt;b&lt;/sup&gt;</td>
<td>0.4&lt;sup&gt;b&lt;/sup&gt;</td>
<td>0.4&lt;sup&gt;b&lt;/sup&gt;</td>
<td>0.4&lt;sup&gt;b&lt;/sup&gt;</td>
<td>0.4&lt;sup&gt;b&lt;/sup&gt;</td>
</tr>
<tr>
<td>African LDCs</td>
<td>2.3&lt;sup&gt;b&lt;/sup&gt;</td>
<td>2.1&lt;sup&gt;b&lt;/sup&gt;</td>
<td>0.5&lt;sup&gt;c&lt;/sup&gt;</td>
<td>0.5&lt;sup&gt;c&lt;/sup&gt;</td>
<td>0.5&lt;sup&gt;c&lt;/sup&gt;</td>
<td>0.5&lt;sup&gt;c&lt;/sup&gt;</td>
<td>0.5&lt;sup&gt;c&lt;/sup&gt;</td>
<td>0.5&lt;sup&gt;c&lt;/sup&gt;</td>
<td>0.5&lt;sup&gt;c&lt;/sup&gt;</td>
</tr>
<tr>
<td>LIX</td>
<td>3.8&lt;sup&gt;c&lt;/sup&gt;</td>
<td>3.4&lt;sup&gt;d&lt;/sup&gt;</td>
<td>2.6&lt;sup&gt;a&lt;/sup&gt;</td>
<td>2.6&lt;sup&gt;d&lt;/sup&gt;</td>
<td>2.0&lt;sup&gt;a&lt;/sup&gt;</td>
<td>3.4&lt;sup&gt;d&lt;/sup&gt;</td>
<td>3.4&lt;sup&gt;d&lt;/sup&gt;</td>
<td>1.6&lt;sup&gt;d&lt;/sup&gt;</td>
<td>1.5&lt;sup&gt;d&lt;/sup&gt;</td>
</tr>
<tr>
<td>All</td>
<td>3.8&lt;sup&gt;a&lt;/sup&gt;</td>
<td>3.4&lt;sup&gt;d&lt;/sup&gt;</td>
<td>2.6&lt;sup&gt;a&lt;/sup&gt;</td>
<td>2.6&lt;sup&gt;d&lt;/sup&gt;</td>
<td>2.0&lt;sup&gt;a&lt;/sup&gt;</td>
<td>3.4&lt;sup&gt;d&lt;/sup&gt;</td>
<td>3.4&lt;sup&gt;d&lt;/sup&gt;</td>
<td>1.6&lt;sup&gt;d&lt;/sup&gt;</td>
<td>1.5&lt;sup&gt;d&lt;/sup&gt;</td>
</tr>
</tbody>
</table>

Notes: LDCs refer to the UN list of Least Developed Countries. LIX refers to World Bank Low Income Countries excl. India.

There are some important conceptual differences between the measures presented in Table 1. Those presented by Brenton and Ikezuki (2005) give the margin relative to the overall value of exports from the country to the granting market. By contrast, the results based on the Low, Piermartini and Richtering dataset refer to the margin only on those products for which there are exports, there is a non-zero duty, and a positive apparent preference. The broad picture provided by Table 1, however, is a reassuring one in terms of general consistency between the alternative measures. The average margins generally tend to be higher in Europe relative to the other markets. In most studies, average preference measures seem to be lower in Japan than in the EU or the USA, except in the Low et al. measures, which are affected by very high preferences on imports of manufactures from Cambodia (over 150%), as well as margins of preference of around 50 percent on imports from Bangladesh and Mauritius.
Given the importance attached to assisting the LDCs in the design of preference schemes, there are surprisingly small gaps between the preference margins granted to LDCs and to developing countries as a whole under the preference schemes of the EU, the US and Japan. By contrast, Canada and Australia appear to give substantially higher margins of preference to the LDCs, with the margin more than twice as high for LDCs as for developing countries as a whole. The gap between the two measures may reflect different coverage of products, with narrower coverage of products from non-LDCs, a difference that will be reflected in the measures of the overall value of preferences.

While the average rates of assistance to developing country exports suggested by Table 1 are relatively small, the studies presented in this volume highlight the very considerable variation in the preference margins between countries. Candau and Jean (2006) show that EU preference margins were more than 10 percent of the value of exports in two countries—Seychelles and Dominica—even after allowing for less than complete utilization of preferences. For two other countries—St Lucia and Senegal—they accounted for more than 5 percent. Dean and Wainio (2006) show an even more divergent pattern in US preferences. Even though the average value of US preferences is only 0.5 percent of the value of exports, two small countries—Lesotho and Swaziland—had preference margins above 15 percent in 2003, primarily because of apparel preferences.

A measure of the overall value of preferences corresponding with the preference margin numbers in Table 1 can be obtained by multiplying these preference margins by the value of imports to which they apply. The relationship between the resulting numbers and the benefits to the exporter are shown in Figure 1, where the original demand curve for the country’s exports shifts up vertically by an amount $ad$ because of elimination of the tariff on its imports. The area $abcd$ corresponds to this measure of the potential value of preferences. In the case depicted this overstates the income gain to the preference-receiving country, which is given by the area $fecd$. If, however, either the supply or the demand curve for the products being considered were perfectly elastic, then the gain to the exporting country would be much nearer to the area $abcd$, because the increase in price would equal $ad$. If so, there would be a second-order loss associated with distorting either production or consumption decisions. This case seems quite appropriate for
situations where small countries are supplying relatively homogenous products to much larger economies – as in the case of LDCs supplying raw agricultural products to the US or the EU. The basic insight of this diagram is that a crude measure of the value of preferences like \( abcd \) should provide an upper limit on the potential losses from preference erosion.\(^{14}\)

**Figure 1. The estimated “value” of preferences, $m**

In Table 2, we present estimates of the value of preferences, calculated on the basis of measures such as \( abcd \) in Figure 1. These numbers are based on the Low, Piermartini and Richtering dataset, which has precise and up-to-date estimates of the imports subject to preferential treatment. Recall again, however, that these are “upper bound” estimates as they ignore compliance costs and assume full utilization of preferential programs. The results reported in Table 2 reveal that of a total of $587 million estimated potential value of preferences to LDCs, $287 million, or almost half, is provided by the EU. The US is the next largest provider, at $131 million per year. Japanese preferences amount to some

\(^{14}\) While this is true in a simple partial equilibrium framework, second-best considerations may change the result in a general equilibrium analysis. Fukase and Martin (2002) note that improved market access may generate second-round welfare gains by allowing the country to increase the volume of imports it passes over an unchanging tariff barrier.
$50 million per year, while Canada and Australia are much smaller at $14 million and $0.4 million per year, respectively. The comparison of the preferences received by LDCs and other developing countries shows that the vast majority of preferences go to non-LDCs. Only one-twentieth of the value of total preferences appears to go to the LDCs, despite the importance of the EU EBA and the US AGOA programs in offering benefits to these countries.\(^5\)

For preferences overall, the EU is again the largest contributor by a wide margin, contributing over 40 percent of the total.

Table 2. Estimates of the value of preferences to developing countries (US$ million)

<table>
<thead>
<tr>
<th></th>
<th>EU</th>
<th>US</th>
<th>Japan</th>
<th>Can</th>
<th>Aust</th>
<th>Quad+</th>
</tr>
</thead>
<tbody>
<tr>
<td>LDCs</td>
<td>287</td>
<td>131</td>
<td>49</td>
<td>14</td>
<td>0.4</td>
<td>587</td>
</tr>
<tr>
<td>All</td>
<td>4,945</td>
<td>3,953</td>
<td>743</td>
<td>215</td>
<td>46</td>
<td>11,565</td>
</tr>
</tbody>
</table>

Note: Quad = U.S., EU, Japan and Canada; Quad + = Quad + Australia
Source: Compiled by the authors based on data from Low, Piermartini and Richtering (2005).

**Estimating the magnitude of preference erosion**

Until recently the question of erosion was not a particularly strong constraint on MFN-based reforms in the GATT/WTO because GSP programs typically gave a preference and not duty or quota-free access. Thus, even if MFN rates were lowered, it was possible to maintain a given preference margin by lowering the preferential tariff and/or expanding the coverage of the scheme. But new programs such as EBA or AGOA feature duty and quota-free access for (virtually) all products and therefore any reductions in MFN tariffs lower the preference margin.

A recent paper by Subramanian (2003) uses a partial equilibrium framework to examine the overall impact on the exports of LDCs of preference erosion arising from trade liberalization by the Quad (Canada, EU, Japan, and the US).\(^6\) Assuming a 40 percent cut in protection by the Quad and that LDCs have free access to these markets, it concludes that the potential loss at the aggregate level amounts to 1.7 percent of total

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\(^5\) These numbers do not imply that preferences have not been a factor in stimulating diversification into manufactures for certain developing countries. The case of apparel illustrates that preferences can have this effect, as AGOA has led to substantial increases in imports from a number of Sub-Saharan Africa countries. However, the scope for preferences to facilitate diversification into the apparel sector is limited by the lack of consistency across the different preference schemes. As pointed out by Brenton and Ozden (2006), an apparel product from Africa that can enter under one countries preference scheme often will not be able enter under another due to differences in the rules of origin.

LDC exports. Individual LDCs, however, may suffer a more significant loss from preference erosion due to the concentration of their exports in products that enjoy deep preferences. Of these, Malawi, Mauritania, Haiti, Cape Verde, and São Tomé and Príncipe are found to be the most vulnerable to preference erosion. Malawi was predicted to experience a loss of 11.5 percent of total exports, the next four countries between 5 and 10 percent, and another 10 countries between 3 to 5 percent. The total (aggregate) value of lost export revenue would be around $530 million (of which two-fifths would be accounted for by Bangladesh). While these are small numbers from a global perspective – less than one percent of annual ODA flows – they are significant for some of the countries concerned and may translate into substantial adjustment requirements for these nations.

Alexandraki and Lankes (2004) complement this analysis by focusing on middle-income economies. They include sugar, textiles and banana programs in their evaluation. Their analysis suggests that the potential erosion problem is heavily concentrated in small-island economies that are dependent on quota-type preferences and the associated rents in these sectors.\(^{17}\) The problem is therefore also commodity-specific – concentrated in areas where OECD protection and preference margins are the highest. As stressed by Tangermann (2002), insofar as preferences have had the result of “sucking” investment and production into the wrong direction (i.e., areas where countries do not have a comparative advantage), the effect has been to make the beneficiaries dependent on preferential exports. As the sugar and banana regimes are reformed in the EU, such countries will have to adjust.

Grynberg and Silva (2004) estimate that the losses in income transfers for sugar, beef, bananas, textiles and clothing producers in trade-preference-dependent economies would add up to $1.72 billion per year. These estimates are heavily influenced by the weight of disappearing quota rents associated with the phase-out of the Agreement on Textiles and Clothing (which account for $1.1 billion of the loss estimate).

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\(^{17}\) Preference-dependent or sensitive countries include Mauritius, Malawi, Mauritania, Cambodia, Maldives, Haiti, Cape Verde, Sao Tome, Tanzania and the Comoros (Stevens and Kennan, 2004). The only large country expected to suffer from preference erosion is Bangladesh, which has benefited significantly from the quota restrictions on textiles and clothing imposed on other large competitive developing countries such as China. The potential impact of the removal of quotas on non-quota controlled textile and clothing exporters has been on the agenda since the negotiation to end the MFA in the Uruguay Round.
Computable general-equilibrium (CGE) estimates of the value of preference erosion can provide additional insights. These models allow terms-of-trade effects, improved market-access opportunities in non-preference-granting countries, and the asymmetrical impacts of preference erosion in different markets to be considered. The latter arises because of the different hierarchy of preferences in OECD markets, which span not only non-reciprocal programs, but also reciprocal preferences as a result of free trade agreements (FTAs). One implication of FTAs is that they lower the actual value of non-reciprocal preferences, and thus estimates of the preference-erosion effect. Francois, Hoekman and Manchin (2006), for example, estimate that full EU liberalization on an MFN basis would translate into real income losses of $460 million for African LDCs. This figure, however, drops to $110 million when the experiment is extended to an OECD-wide liberalization.

There are different ways of calculating the value of nonreciprocal preferential programs to beneficiaries. The most straightforward and arguably appropriate from a policy perspective is to simply determine what the impact would be of MFN liberalization by OECD countries, taken as given the existing structure of trade policies affecting all countries, both preferential and non-preferential. Estimates of the potential impacts will be more accurate if account is also taken of the administrative costs that may result in under-utilization and lower the net value of the programs. Francois, Hoekman and Manchin (2006) estimate that the ad valorem equivalent of administration costs is about 4% on average. Ozden and Sharma (2006) estimate that Caribbean exporters capture only two-thirds of preference margin in the US market, the remainder being taken by importers. Focusing on Africa, Olarreaga and Ozden (2005) conclude that the share of rents captured by exporters under AGOA may be even lower. Losses are lowered further if account is taken of the potential gains from reforms in markets that do not offer preferences, including other developing countries.
Table 3. Recent estimates of losses from tariff preference erosion

<table>
<thead>
<tr>
<th>Authors</th>
<th>Affected Countries</th>
<th>Granting Countries</th>
<th>Simulated Liberalization</th>
<th>Change in:</th>
<th>How measured?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hoekman, Ng and Olarreaga (2002)</td>
<td>Developing countries</td>
<td>N.A.</td>
<td>Tariff peak elimination</td>
<td>-71</td>
<td>Partial Eqm</td>
</tr>
<tr>
<td>Subramanian (2003)</td>
<td>LDCs</td>
<td>Quad</td>
<td>40% cut in MFN tariffs</td>
<td>-530</td>
<td>-265(^a)</td>
</tr>
<tr>
<td>&quot;</td>
<td>African LDCs</td>
<td>OECD</td>
<td>Full MFN Liberalization</td>
<td>-110</td>
<td>General Eqm</td>
</tr>
<tr>
<td>&quot;</td>
<td>African + Asian LDCs</td>
<td>OECD</td>
<td>Full MFN Liberalization</td>
<td>-198</td>
<td>General Eqm</td>
</tr>
</tbody>
</table>

\(^a\) Because the elasticity of supply of exports is 1.0, the real income effect is exactly half the change in the value of exports.
A summary of key results from previous studies of preference erosion is given in Table 3. The results associated with the non-reciprocal schemes alone generally produce results that are less than the full potential value of preference estimates presented in Table 2. These estimates are not strictly comparable not only because of the different methodologies (partial-equilibrium versus CGEs) and focus (welfare effects versus trade effects), but also because they tend to operate with distinct liberalization scenarios to estimate the potential for preference erosion (only removal of peaks, Doha-related forecasts, full liberalization, etc.). It is also important to underscore that these figures tend to overestimate the value of existing preferential regimes because they typically do not take into account the costs of compliance with preferential regimes.

Notwithstanding these qualifications, the studies included in this volume come to similar overall conclusions. They add value by providing more detailed analyses on a country-product basis for the major markets – the EU and the US – as well as a number of other OECD markets, including Australia, Canada and Japan. The papers on the EU and US confirm earlier findings that the value of preferences – measured by the product of the volume of dutiable exports and the preference margin – is significant for a number of countries. Thus, US preferences are equal to 5 percent or more of dutiable exports for some 27 countries (Dean and Wainio, 2006), while in the case of the EU the value of non-reciprocal preferences exceed 6 percent of dutiable exports for 16 recipient countries (Candau and Jean, 2006). Specific products such as apparel and some agricultural products – especially sugar and bananas in the EU – tend to account for the largest share of the value of preferences. While trade losses for some countries are large relative to their total dutiable exports to the markets concerned, the overall, aggregate value of the preferences – and thus potential losses – continues to be found to be relatively small, and in the case of the EU will diminish when reforms in sugar and bananas take place. Similar findings are reported in Low, Piermartini and Richtering (2005, 2006) for the Quad counties as a group.

Lippoldt and Kowalski (2005) provides further insights on the impact of preference erosion across the globe by adopting a 50 per cent cut on all merchandise tariffs in separate experiments: first, unilateral liberalization by each of the five major preference-granting countries/regions (EU, U.S., Japan, Canada and Australia); second, plurilateral simultaneous liberalization in these regions; and third, multilateral liberalization. For most countries, potential negative effects are dampened as the liberalization experiment is widened.
Among the included papers, Van der Mensbrugghe (2006) generates the highest estimates for the value of preferences. The way he approaches the issue is to ask what would be the loss to preference-receiving countries if their imports were taxed at current MFN rates. This is a counterfactual simulation that assumes away all reciprocal preferences as well, and assumes that the value of preferences is the difference between what would occur under this simulated MFN world and the one currently observed for all GSP beneficiaries. For the LDCs/sub-Saharan African countries his results are similar to those found in other recent studies using the most recent GTAP database with preferences. However, he also finds nontrivial benefits for other developing countries.\footnote{In part this reflects the trade response and supply elasticities used. The former averaged 4.3 percent for exports to the EU and 5.0 for exports to the US; the latter are close to infinite for non-agricultural commodities.}

While the preference programs reduce the benefits to be attained from further MFN liberalization for the affected countries, they do not change the “sign” of such a movement. Indeed, full liberalization generates substantial gains for each region.


Although the thrust of the conclusions emerging from the research on the magnitude of erosion is similar – it is small relative to the total potential gains from deep, global MFN liberalization, but likely to be significant for a limited number of preference dependent countries – the precise absolute potential magnitude of erosion remains open to debate. Much will depend on what is negotiated in the Doha Round on MFN liberalization in non-agricultural market access (NAMA) and agriculture, as well as the spread of FTAs over time. Much also depends on the sectoral composition of the potential impacts, as this is a key factor in determining the incidence and distribution of adjustment costs within countries.

What could be done to address potential losses? There are two broad options – seek a solution within the trading system (i.e., tied to trade and trade policy) or alternatively, to use non-trade instruments.\footnote{Trade-based solutions are reviewed in greater detail in Low, Piermartini and Ritchering (2005). Aid-based solutions are analyzed in Hoekman and Prowse (2005).} The most obvious trade-based “solution” is not to liberalize the products that are the most important source of preference rents. This
would imply a significant opportunity cost in terms of MFN liberalization forgone and is therefore not desirable from a global perspective. A much more desirable alternative is to frame multilateral trade concessions to address the negotiating priorities of preference-dependent countries in other areas on an MFN basis, either in terms of market access and/or rules – a solution that has been advocated by many observers in the past (e.g., Hudec, 1987).

Trade-based options also include enhancement of existing preferential programs; improvements in the rules-of-the-game for access to preferential regimes (e.g., adoption of harmonized liberal rules of origin and diminution of compliance costs) and/or through the extension of coverage of preferential regimes, leveraging utilization rates and increasing the effectiveness of preferences. Such enhancements could partially counterbalance the economic impact of preference erosion. Finally, consideration could be given to implementation of new preferential trade regimes by non-OECD importers – as was called for at the Hong Kong Ministerial meeting.

Initiatives of the latter type will not do much to help those countries that are not competitive in world markets because of supply constraints and high cost operating environments. Hoekman and Prowse (2005) argue in favor of “aid for trade” to assist countries to deal with both the adjustment costs associated with global trade reforms and to improve their capacity to exploit trade opportunities and diversify their economies. They note that preferences have not done much to assist the poorest countries use trade as a development tool, and are unlikely to do so absent actions in these countries to improve the investment climate and business environment. Aid for trade can help do so.

“Aid for trade” should be seen as a complement, not a substitute for global trade liberalization (Prowse, 2006). One reason for this is that the overall potential positive net effects of global trade reform are significant and will more than offset preference erosion losses (van der Mensbrugghe, 2006). That is, losses to preference recipients from OECD liberalization can be offset by gains in other markets – those of other developing countries and those of OECD members that do not already provide full duty-free and quota-free access to markets.

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21 Low, Piermartini and Richtering (2005) show that there is limited scope to expand preferential schemes to additional product lines in major OECD markets.
The limited number and small size of most of the economies concerned with preference erosion suggest that measures to help mitigate the problem should be closely targeted at the countries at risk. Existing instruments such as the mechanism for adjustment financing put in place by the IMF – the Trade Integration Mechanism (TIM)\textsuperscript{22} – could be complemented with bilateral donor funds. A number of proposals have been made for the establishment of new stand-alone, grant-based compensation funds.\textsuperscript{23} Whether or not such proposals will find support among the development agencies remains to be seen. Whatever the institutional mechanisms that are used to address trade policy and related financing needs – a subject that is being discussed by the WTO taskforce on aid for trade established in February 2006 – it is important that these commitments are (and are seen to be) credible; that the associated aid is additional to existing flows; and that it be used to address effectively the adjustment burden in recipient economies and addresses needs that have been defined by them to be priorities.

V. Concluding Remarks

The debate about how best to address preference erosion in the context of multilateral negotiations is an important component of the negotiations on the development dimension of the Doha round. Although one could argue that the jury is still out in terms of the developmental impacts of trade-preferences, there is growing support for the idea of de-linking development assistance from trade policy, shifting from “trade as aid” to “aid for trade” as discussed in Hoekman and Prowse (2005) and IMF and World Bank (2005a,b). This growing consensus, however, is challenged by parallel efforts to deepen existing preferential regimes and/or introduce new preferential initiatives. Multilateral trade negotiations provide additional ferment to the debate to the extent that they foster alliances between protectionist interests in OECD countries and preference-dependent industries in developing economies.

Recent preferential initiatives have deepened the scope of preferences offered and simplified administrative procedures with significant impact on some countries. Although the EU (reflecting the magnitude of barriers and thus preference margins offered as well

\textsuperscript{22} See IMF (2004).
\textsuperscript{23} See, for example, Page and Kleen (2004), Grynberg and Silva (2004), and Page (2005).
as its importance as a destination market for many preference-dependent countries) stands out as the main market where preference erosion can ensue in the case of MFN liberalization, with the deepening of preferences for the LDCs by other OECD countries the potential for erosion is increasing on the margin. While preferences have been instrumental in promoting developing countries’ export diversification into textiles and clothing, the track record of unilateral preferential systems as mechanisms to promote integration of developing economies into the world economy has been mixed at best. In part this is because rules-of-origin and other forms of “conditionality” remain a major constraint for further expansion in some regimes. But more fundamentally it reflects supply capacity constraints in many of the beneficiary countries.

It is difficult to come up with consensual estimates about the dimensions of preference erosion, since these estimates are a function not only of the methodology adopted, but also of liberalization scenarios considered. Moreover, the reference-point for compensation (e.g., whether to focus on reductions in the potential de jure transfer or on the de facto economic value of transfer, taking into account compliance costs and eventual offsetting measures) is an area open to debate. The limited scope to expand preferential schemes to additional product lines in major OECD markets as a trade-related solution to preferences, and the supply constraints just mentioned, suggests that aid-related solutions to preference erosion are preferable to “trade solutions” that involve continued or additional preferential access to markets.

Summing up, preferences are clearly important for some countries in some sectors, insignificant for most, and injurious for others. Preferences are being eroded by liberalization at all levels (national, regional and multilateral), but the Doha Round is unlikely to lead to significant preference erosion unless the negotiations become a lot more ambitious. Independently of the debate on the magnitude and impact of preference-erosion, it is clear that a re-orientation of trade policies away from procedures that tend to hollow out the multilateral trade system would be welfare enhancing at global level. The “aid for trade” agenda provides a potential framework to address preference-erosion concerns and its implementation could help steer the Doha negotiations in this direction.
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