Preference Erosion and the Future of Preferences

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Background

It is widely viewed that trade preferences have not yielded the benefits that were expected when preference schemes were introduced. It might be argued, therefore, that there should be little concern about the prospect of erosion of preference margins associated with preferential tariffs offered to developing countries by the industrial countries which will be induced by future multilateral trade reforms. While benefits have been limited in general, in terms of increasing exports and contributing to growth, this is as much due to deficiencies in schemes as inherent problems with preferences; preferential trade has been important for some developing countries and products, and very important for a restricted set of countries (because of the products that dominate their exports). For these countries that have been subject to recent preference erosion or are vulnerable to future preference erosion, the potential losses and adjustment costs are certainly important. Further, for all preference-receiving countries there is a remaining window of opportunity (at least until developed country tariffs are largely eliminated) to benefit more from preferences and to offset the effects of preference erosion through increasing the utilisation and effectiveness of remaining preferences. This issue of Trade Hot Topics reports on a recent Commonwealth study on the impact of recent and further preference erosion, and the policies and measures that are required to increase the effectiveness of preferences.

Nature and coverage of preferential schemes

The main trade preference providers, in terms of the value of trade covered, are the QUAD countries (European Union, USA, Japan and Canada) plus Australia, but preferences are offered by a range of other industrial and developing countries. The tariff preferences offered by these industrial countries are under a range of schemes that differ in terms of their product coverage, the margin of tariff preference, quantity restrictions on the volume of preferential trade allowed, the rules of origin (ROO) affecting this trade and the treatment of developing and least developed countries (LDCs). All QUAD countries (and Australia) offer preferences under the major schemes, GSP (generalised system of preferences) and LDCs, and have other specific schemes. The most important of the latter for preference-receiving countries are the African Growth and Opportunity Act (AGOA) for the USA – restricted to Africa – and 'Everything But Arms' (EBA) – restricted to LDCs – and special preferences for the ACP (African, Caribbean and Pacific group of countries) from the EU.

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The incidence of preferences can be measured in terms of the share of trade covered. The EU stands out as the most important export destination under preferences, accounting for 51 per cent of all preferential imports. The US absorbed 24 per cent, Japan 18 per cent, Canada 8 per cent and Australia 9 per cent. The GSP is by far the most important scheme, accounting for 87 per cent of total exports of developing and least developed countries. The EU absorbed the bulk of GSP exports followed by the US. The ACP scheme provided by the EU is the next most important, followed by the 'LDC' scheme provided by all QUAD countries plus Australia. Other schemes were important for particular regional groups of countries.

Given the restrictions on eligibility, other constraints and wide variability in peak tariffs across products and variations in export composition across countries, there are marked variations in the extent and value of preferential trade across recipient countries and products. These variations are driven also by the characteristics of the tariff regimes of the preference-giving countries. Many of their imports of raw materials are MFN (most favoured nation) duty free, and even in the case of some industrial goods the MFN tariff has been driven to zero or close to zero by previous Rounds of multilateral trade negotiations. In all except the USA, over half of all imports were subject to MFN duty free access and on which therefore no preference was possible (Table 1). Indeed only 24 per cent of US imports from developing countries had preferential access, all of which enjoyed duty free preferential treatment. Forty per cent of EU imports from developing countries were preferential, while the corresponding imports under duty-free preferences were 21 per cent.

Table 1: Imports from developing countries by terms of market access (%)

Terms of access	EU	USA	Japan	Canada	Australia
MFN duty-free	51	33	66	58	49
MFN dutiable	8	43	20	15	41
Preferential	40	24	13	26	9

Combined with safeguard provisions and other restrictions, the diversity of schemes and rules creates complexity about the opportunities and benefits of the schemes to potential exporters, and appears to deter exporters (actual and potential) from taking full advantage of the preferences available. Table 2 illustrates the underutilisation of preferences by actual exporters. Between 1994 and 2000 the proportion of imports by the QUAD countries eligible for GSP preferences for which preferential treatment was actually received (that is, the rate of utilisation of preferences) varied from 63.7 per cent to only 30.2 per cent. The table also demonstrates that restrictions on eligibility apply (typically either relating to local value-added or product exclusions and requirements); the share of eligible imports covered by GSP relative to dutiable imports from developing countries ranges from 40.1 per cent to 72.6 per cent over this same period. Indeed, many of the restrictions on eligibility for preferential treatment apply in product areas of particular interest to developing countries, that is, agricultural products, textiles and other labour-intensive manufactures.

Table 2: Utilisation by LDCs of QUAD preference schemes (1994-2000)

Year	**Total Imports (US$m)**	**Dutiable Imports (US$m)**	**Imports Eligible for GSP Preferences (US$m)**	**Imports Receiving GSP Preferences (US$m)**	**Imports Covered by GSP Scheme**	**Utilisation Rate of GSP Scheme**
	(a)	(b)	(c)	(d)	(c)/(b) (%)	(d)/(c) (%)
1994	5,347.0	3,917.3	2,071.0	999.0	52.9	48.2
1995	6,087.8	4,706.1	2,564.3	1,361.2	54.5	53.1
1996	9,956.3	7,451.1	2,985.0	1,517.9	40.1	50.9
1997	10,634.1	8,163.4	5,923.1	1,788.2	72.6	30.2
1998	9,795.7	7,915.1	5,564.2	2,704.5	70.3	48.6
1999	10,486.5	8,950.4	5,869.3	3,487.5	65.6	59.4
2000	13,359.2	11,715.5	7,836.0	4,990.2	66.9	63.7

Extent and benefits of preference margins

Measuring the value or margin of preferences is not simple. Although the difference between the preferential (often zero) tariff and the MFN tariff (the unadjusted margin) indicates the 'price benefit' relative to competitors that receive no preferences, this may overstate the true preference margin (and may of course not be wholly received by developing countries if captured in part at least by importers). Some competitors may also receive lower preferences (such as GSP) and, more important, restrictions on eligibility to preferences such as complying with rules of origin may impose costs that erode the true value of preferences. More generally, competitors may have a production cost advantage so the tariff differential overstates the true price advantage. Nevertheless, the tariff difference is an indicator of the extent of preferences.

Unadjusted preference margins 'received' by developing countries are already relatively small on average, ranging from 0.7 per cent (1.3 per cent) for developing countries to 6.4 per cent (2.5 per cent) for LDCs on non-agricultural (agricultural) products (Table 3), but they can be much larger for specific products. The significance of preference margins for beneficiary countries is affected also, however, by the level of preference utilisation and the degree of competition (from non-beneficiary countries). Indeed, some of the recipient countries recording the highest preference margins are among the countries with the lowest preference utilisation rates. This typically arises because they have a limited and/or non-competitive capacity to supply the products receiving preferences given the Note: Australia is not covered for agricultural exports.

Table 3: The value of preferences

	Shares (%) of Exports subject to:			
Exporters	**MFN-duty free**	**MFN duties**	**Preferential tariffs**	**Preference margin**
Agricultural exports				
Developing countries	46	29	23	1.3
LDCs	59	4	37	2.5
Non-agricultural exports				
Developing countries	52.1	31.8	15.9	0.7
LDCs	20.2	18.3	61.2	6.4

Note: Australia is not covered for agricultural exports.

The potential implicit rents generated by preferences (preference margins times the value of preference-receiving exports, a measure of the value to the exporting country) also vary enormously across developing and least developed countries; five LDCs and five non-LDCs, for instance, account for 75 per cent of the total preference rents going to LDCs and non-LDCs from the EU. Table 4 summarises the distribution of preference rents to Sub-Saharan African countries generated by the EU, US and Japanese schemes. From this table we can see how the rents are concentrated on a few beneficiary countries, and typically on a narrow range of export products.

Table 4: Size and distribution of preference rents for Sub-Saharan African countries

	Overall			LDCs			Non-LDCs		
	EU	US	Japan	EU	US	Japan	EU	US	Japan
Preference rents as % total exports Per cent by:	4.0	1.3	0.1	2.3	2.1	0.4	5.1	1.1	0.1
Top 5 beneficiary countries	59.9	73.9	88.9	73.8	98.8	95.8	76.9		98.7
Top 10 beneficiary countries	80.1	95.4	97.7	91.2	100.0	100.0	97.5		100.0
Top 1 sector (2 digit, HS)	31.3	31.9	41.0	37.1	51.5	70.9	34.5		31.9
Top 3 sectors (2 digit, HS)	56.5	79.6	63.6	68.5	91.3	92.2	65.2		56.8

Note: The figures correspond to 2002.

In general, targeted preference schemes have been more effective in increasing developing country (and LDC) exports; there is evidence of positive trade effects from Lomé, AGOA and EU-Mediterranean agreements. As in the case of AGOA, the benefits of EU trade preferences (in particular to ACP countries) have also tended to be concentrated on a few beneficiaries, notably in the EU case on those countries producing sugar and bananas. In the case of AGOA, the trade stimulus has been concentrated on countries such as South Africa, Lesotho, Madagascar, Mauritius and Kenya and products like coffee, tea, mate and spices, and knitted apparel. Overall, US AGOA imports more than doubled in the first six years of the scheme (up to 2007).

The benefits of preferences are susceptible to changes in the terms on which they are offered, in particular rules of origin and product standard requirements. These requirements limit utilisation and if made stricter could eliminate the benefits of preferences (this is especially true for apparel exports under AGOA). Complex (ill-defined and/or costly to comply with) ROO are one reason that preferences have not been fully utilised. This is especially true for the EU, where restrictive ROO have limited the growth of ACP exports to the EU, especially for garments. By contrast AGOA has generated benefits for African exporters to the US, in part because of relatively lax ROO (although these have also been tightened for apparel).

Prospects for and costs of preference erosion

Given the concentration of the current benefits of preferences, the actual erosion of preference margins due to national reforms (for example, reform of EU policies towards sugar and bananas) or prospective erosion associated with the multilateral tariff reductions proposed under the Doha Round of World Trade Organization (WTO) negotiations will be concentrated on a relatively small number of developing and least developed countries. The developing countries experiencing or facing high losses are typically island economies, mostly in the Caribbean and Pacific, especially those dependent on sugar or banana exports to the EU, or countries in North Africa (again with preferential access to the EU for apparel and agriculture products). The least developed countries facing the highest losses are mostly in Africa, those that benefited from the Lomé and Cotonou arrangements, or Asian exporters of apparel under preference. The most affected or vulnerable countries, therefore, are those with exports concentrated in a narrow range of products with high preference margins, primarily available from the EU. Although other countries face preference erosion, in general they have more diversified export structures and are more competitive producers.

Cuts in bound MFN tariffs in agricultural and non-agricultural goods, following a Doha Round Agreement and its implementation, will inevitably lead to some preference erosion. The costs associated with this erosion of preferences have been or are likely, however, to be restricted to a relatively small number of developing countries and LDCs; specific island economies benefiting from ACP provisions, specific African countries benefiting from both ACP and AGOA, and specific Asian countries with preference benefits concentrated on apparel. Table 5 shows the pre-reform preference margins in the most exposed middle-income, developing countries, and the breakdown of their overall margin. The importance of sugar, banana and textile reforms to this set of countries is clear. In Table 6, the predicted export losses from a Doha tariff cut for the most exposed LDCs are reported. For some, especially relatively competitive exporters among the preference-receiving countries, there are likely to be offsetting (even net beneficial) impacts arising from improved multilateral access. It would be possible, of course, to slow down the rate of preference erosion associated with MFN liberalisation by giving preference-giving countries some flexibility to shield specific products from the normal cut and phasing rules, but this would probably be an unpopular measure among non-preference-receiving developing countries.

Table 5: Developing countries most exposed to preference loss: Evidence on pre-reform preference margins

Most vulnerable	Trade preference margin[a]	Per cent of preference margin accounted for by			
		Sugar	Bananas	Textiles and clothing	Other products
Middle-income countries[b]	**4.9**	**42**	**19**	**12**	**27**
Largest beneficiaries[c]	**15.6**	**51**	**24**	**8**	**17**
Mauritius	39.9	84	0	13	3
St Lucia	32.9	0	94	2	4
Belize	29.3	47	23	0	30
St Kitts and Nevis	28.7	94	0	0	6
Guyana	24.2	95	0	1	4
Fiji Islands	24.1	96	0	1	2
Dominica	15.9	0	97	0	3
Seychelles	12.2	0	0	0	100
Jamaica	9.7	67	8	7	18
St Vincent and the Grenadines	9.4	0	89	0	11
Swaziland	8.2	97	0	1	2
Honduras	6.7	56	9	19	15
Tunisia	5.9	0	1	79	20
Côte d'Ivoire	5.7	8	51	2	38
Morocco	5.7	0	4	64	33
Dominican Republic	5.5	23	16	27	34

Notes: a. As a per cent of the trade-weighted average world market price of the country's exports. b. Average for 76 middle-income developing countries, weighted by margin. c. Eighteen countries with average preference margins greater than 5 per cent.

Table 6: LDCs most exposed to preference loss: Evidence on prospective export falls from preference erosion

Agricultural Products		Non-Agricultural	
Country	% loss	Country	% loss
Malawi	-8.4	Lesotho	-12.2
Mozambique	-6.2	Haiti	-11.3
Tanzania	-4.8	Cambodia	-11.0
Bangladesh	-4.3	Myanmar	-9.1
Congo, DR	-3.4	Bangladesh	-5.2
The Gambia	-2.8	Madagascar	-5.0
Senegal	-2.8	Senegal	-4.9
Angola	-2.6	Guinea-Bissau	-3.2
Zambia	-2.4	Maldives	-2.5
Mauritania	-1.6	Mozambique	-2.5
Cambodia	-1.2	Mauritania	-2.3
Uganda	-1.1	The Gambia	-1.8
Niger	-1.1	Solomon Islands	-1.2
Togo	-1.0	Uganda	-1.0

Making preference schemes more effective

For the major losers from EU reforms on sugar and bananas there have already been policy efforts and external financial support for adjustment and amelioration of adjustment costs. This will need to continue. This has in part been directed towards productivity enhancement in the directly affected sectors, but also towards the diversification of production and exports. Of course this diversification might in principle be into other goods sectors where there will be scope, for a period at least, of benefiting from remaining preferences. For many of these small, and often relatively remote, island economies the scope for diversification of agricultural and manufacturing goods production is limited. In which case the focus of the policy response has been and may well have to continue to be on encouraging diversification into services production where traditional preferences are irrelevant. Indeed, one of the motives of some ACP countries for negotiating Economic Partnership Agreements with the EU may well have been to gain improved and preferential access for labour and other services to the EU market, as well as retaining preferential access on better than GSP terms. The present focus is, however, on whether there are ways of increasing the effectiveness and value to all developing countries and LDCs of remaining tariff preferences in goods trade.

The impact of preference erosion can be ameliorated by actions by the preference-giving countries to improve the design of their preference schemes. The Commonwealth study by Milner, Morrissey and Zgovu (2009) proposes a number of measures:

a) the relaxing of ROO requirements so that value-addition requirements are set in line with technological realities (for example, rules based on change of tariff heading are generally less complex than those based on local value-added or technical tests) and development needs and with greater scope for cumulation of value-addition on regional basis

b) the reduction of tariff escalation (that is, higher tariffs on final goods than on raw material and intermediate inputs) in the tariff regime of the industrial countries so as to increase the opportunities for exporting of more processed or higher stage and final products

c) lowering non-tariff barriers to improve the market access and market opportunities of preference-receiving exports by developing countries and LDCs

d) the reduction of tariff peaks on products excluded from preference schemes

e) the extension of product coverage in those preference schemes where exclusions remain significant

f) improving incentives to utilise (and invest in the utilisation of) preferences by relaxing safeguard and graduation provisions and by deterring the capture of preference rents by other than the preference-receiving countries.

The preference-receiving countries need also to create more favourable business and investment environments, ones in which the capability to take advantage of preferences (and other trade opportunities) are enhanced. This includes regulatory reform and institutional strengthening to reduce transactions costs and encourage production and investment in these countries; to make it quicker and easier to establish a business or make new investments, to give improved access to finance and financial services and to make property rights more secure and enforcement of contracts more effective. These are measures that would also support trade development for non-preference-receiving products and in the longer term for all products when the window of opportunity for preferential trade is likely to have closed. Given limited resources and implementation capacity, efforts should initially focus on sectors that can benefit from preferences.

Trade policy options and negotiating strategies

Developing countries can negotiate as part of multilateral trade negotiations to increase the potential value of remaining preferences. The lowering of MFN tariffs by the preference-giving countries might, for instance, be smaller and/or more gradual in the case of products of particular importance to the preference-receiving countries (subject to the specific interests of non-preference-receiving, developing countries). The product coverage of preference schemes might also be targeted in bilateral trade negotiations. Reducing the number of products excluded from schemes provides opportunities for additional preferential trade for as long as MFN tariffs are positive. (Although not an issue relating to the effectiveness of existing schemes, it should be noted that developing countries may also negotiate schemes with the new and emerging economic powers such as China and India.)

The utilisation and effectiveness of preferential schemes can be improved by relaxing the 'terms of access' for preferential exporters. Negotiations should focus therefore on reducing the complexity and increasing the transparency and predictability of rules of origin. They should also focus on reducing unnecessary or very costly restrictions associated with product standards and other non-tariff barriers. Further, the utilisation and value of preferences can be increased by supporting export development in the preference-receiving countries. Investment in infrastructure and institutional development and reform (improved customs procedures, port management, export marketing support, etc.) are central to improving trade facilitation programmes in these countries. Improving transport and distribution facilities are particularly important for remote and landlocked economies, but reducing trade costs is necessary for all preference-receiving countries. This may well require greater co-ordination of trade facilitation programmes across groupings of countries, with the associated investment requirements being targeted and managed on a regional basis.

'Aid for Trade' (AFT) initiatives in recent years signal a recognition by bilateral donors and multilateral agencies of the need for comprehensive and co-ordinated support for adjustment to trade reform and for export development. These initiatives will need to accommodate both the need to take advantage of remaining preferences and to increase the capacity of countries to cope with reduced preferences. Preference-receiving countries threatened with the need to adjust in the face of preference erosion need to direct more support towards encouraging export diversification. This may require some aspects of AFT support that are available for a wider set of countries. Although the WTO is not a development agency, it could support the mainstreaming of trade development support into trade negotiations if it had an enhanced co-ordination and technical capacity in this area.

Conclusions and recommendations

Preference erosion has and will be an inevitable consequence of the lowering of MFN tariffs by the industrial countries. The effective tariff advantage of a given tariff preference has also been eroded in recent decades by the extension of regional and bilateral trade preferences among the industrial countries themselves. Irrespective of whether or not the preferential trading arrangements offered by the industrial countries to developing and least developed countries should have been viewed from the outset as necessarily desirable or appropriate policies (and the concept of preferences does have its critics), the schemes exist and it is legitimate to consider whether the effectiveness of the schemes can be enhanced in the period before MFN tariff lowering is complete.

Given that there are product exclusions from and quantity restrictions associated with some of the schemes and that there is underutilisation of the schemes for eligible products (because of complexities associated with restrictive ROO requirements and other non-tariff barriers), there is an opportunity to mitigate the effects of preference erosion by increasing the effectiveness of the schemes. Their effectiveness could be increased by extending their product coverage, and by encouraging greater utilisation through the relaxation of rules of origin, lowering of non-tariff barriers (NTBs) and easing of safeguard and graduation constraints.

The reform of the schemes themselves is, however, only part of the solution. Measures and accompanying funding support for export development (for example, 'aid for trade' initiatives) in the developing countries themselves are also required in order to increase the capacity of developing countries in general to take advantage of export market opportunities associated with preferences. This is particularly the case for the relatively small number of countries that are currently substantial beneficiaries from preferences, and who face the prospect of significant losses from further MFN liberalisation under the current arrangements for preference schemes. But it is a wider requirement. Trade development support measures should be seen both as a support in the shorter term for preferential trade, but also as part of the preparation for a world without preferences.

The assessment of the effects of preference schemes and vulnerability to preference erosion provides answers to questions of interest to policy-makers, especially in preference-receiving countries.

What has been the impact of non-reciprocal preferential trade arrangements? In general, for developing countries overall, the impact has been limited. The important exception is developing countries and LDCs that have been beneficiaries of targeted preferences, notably ACP countries from the EU and African countries from the USA under AGOA.

Which countries and products or sectors would be most affected by the erosion of preferences?

Essentially, it is those that benefited from targeted preferences that have already experienced or are vulnerable to further losses from preference erosion. These are mostly ACP countries (developing and LDCs, especially if dependent on exports of sugar or bananas), especially those in Sub-Saharan Africa (which also benefit from AGOA). Some Asian LDCs and North African countries are vulnerable because they have significant exports of apparel under preference schemes.

What are the key factors constraining a country's ability to benefit from trade preferences? Restrictive rules of origin are probably the single most important factor, as they impose high costs (in terms of the structure of production and acquiring information on the rules) and tend to be uncertain. Other product exclusions or restrictions (such as tariff peaks) and requirements for product standards, especially where these are uncertain and non-transparent, limit utilisation of preferences. Preference-receiving countries have often lacked the capacity or policy environment to encourage and support producers in availing of preferences.

What are the most important measures that could mitigate constraints on preference utilisation? Preference-receiving countries should implement regulatory and institutional reforms to support trade and export diversification. Preference-giving countries should provide more flexible and transparent terms of access, especially for rules of origin and product standards, with targeted and predictable preference terms. The bilateral and multilateral donors also need to continue to support adjustment in the most adversely affected and vulnerable countries, and to ensure that there is additional support in general for 'Aid for Trade'.

What policy measures are required to address the effects of preference erosion? In general, it is essential to recognise the features of vulnerable countries. Relatively few countries face potentially high losses and these are typically related to specific products, so measures should be targeted. There is a general need for financial and technical support to meet and mitigate adjustment costs and to enhance trade facilitation. This will require external funding and a co-ordination of effort. Beneficiary countries themselves should support producers and encourage export diversification.

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