BRIEFING PAPER

CUTS International

TDP 2/2006

Trade Preferences: Furthering Development or Political Interests?

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Introduction

The issue of trade preferences for developing and least developed countries (LDCs) gained high visibility at the World Trade Organisation (WTO) Hong Kong Ministerial 2005 through, for example, the discussion on duty free and quota free market access for LDCs. The granting of trade preferences itself is generally viewed as an achievement by developing countries, and provides benefactor countries with a 'good reputation' in the international arena. The debate that ensued as a consequence of the latest promises by developed countries to cut their tariffs in favour of the more vulnerable economies shows the extent of media attention that this issue has attained, on the premises that it is a crucial factor for speedy economic development in developing countries and LDCs. Still, more often than not the grant of preferential treatment does not come as a 'free gift': this aspect has long been highlighted by stakeholders and development actors, and is further proved by the use of preferences as a bargain card during the last round of WTO negotiations in order to accrue concessions from developing countries on the liberalisation of their markets.

This briefing paper discusses the evolution of the political motives behind granting trade preferences from the post-World War II (WWII) period to the creation of the WTO. It undertakes a concise analysis of trade preferences as a source of aid with a view to answer the *cui bono* (who benefits?) question. Moreover, it asserts that trade preferences, although helpful to an extent, might not be the 'magic recipe' for development. Finally, it draws attention to the need for supply-side and institutional capacity building in developing countries and LDCs, if sustainable, long-lasting development is to be achieved.

The Politics Behind The Economics

Trade preferences existed long before the idea of a rules-based multilateral trading system (MTS) came about. During the colonial era trade preferences were called 'imperial preferences', i.e. a commercial arrangement in which preferential rates (below the general level of an established tariff) were granted to the constituent units of an empire. Imperial preference could also include other sorts of preferences, such as favourable consideration in the allocation of public contracts, indirect subsidies to shipping, etc. Already at this stage preferences were subject to 'competitiveness limitations' that could be modified by the grantor at the grantor's will (Shaffer & Apea, 2006).

With the signing of the General Agreement on Tariffs and Trade (GATT) in 1947, the international trading system seemed to have been set on a path that would lead to the progressive elimination of all tariffs; this partly stemmed from the hope that greater economic interconnectedness would avoid another devastating war like the one the world had just experienced (WWII). However, the newly independent states that arose from the ashes of the war – mostly former colonies of the pre-war European empires – found themselves in a disadvantaged economic position *vis-à-vis* the 'metropole' (a term used in some International Relations literature to indicate the European colonial powers in respect to their colonies), which the GATT free trade approach seemed set to exacerbate.

In order to further the economic prospects of developing countries, the 'Group of 77' was founded in June 1964. Almost simultaneously, the United Nations Conference on Trade and Development (UNCTAD) held its first session to address the concerns relating to the position of developing countries in the international trading system (UNCTAD website). One of the first achievements of UNCTAD was the creation of a 'Generalised System of Preferences' (GSP) in 1970 that was negotiated by an UNCTAD Special Committee on Preferences with the Organisation for Economic Cooperation and Development (OECD) Trade Committee (Shaffer & Apea, 2006). This development was viewed as a victory by developing countries, since it seemed to signal a shift of power from the developed to the developing world. What had previously been 'imperial favours' granted by the empire to its subjects now became a symbol of the newly-found strength of the former colonies.

However, the proposition contained in the GSP was clearly in contrast with the most-favoured nation (MFN) concept enshrined in Article I of GATT. This hitch was smoothed in 1971, when GATT members agreed to a ten-year waiver, which was consolidated in 1979, with the GATT Decision on Differential and More Favourable

* *This paper is written by Francesca Arcovito of and for CUTS International, as part of the Linkages between Trade, Development & Poverty Reduction (TDP) project. The views are personal.*

With the support of

MINBUZA Ministry of Foreign Affairs, The Netherlands & DFID Department for International Development, UK

Treatment, Reciprocity and Fuller Participation of Developing Countries (the 'Enabling Clause') that has since become an integral part of the Agreement (Shaffer & Apea).

The preferences granted under the GSP were not without qualifications, i.e. when beneficiaries were deemed to have reached a certain threshold of competitiveness (defined by the benefactor) they would 'graduate' from the scheme and lose their preference margin. And 'vulnerable' products (e.g. sugar for the EU) would still be protected (usually through a lower preference margin) regardless of the comparative advantage in production that developing countries might hold. This shows how economic solutions are, more often than not, trapped into political intricacies and defined by them. In fact, the US GSP scheme, which was initiated in 1976, is rife with additional clauses that have very little to do with the economic condition of the country. For example, countries that harbour international terrorists, nationalise American property without compensation, are members of a commodity export cartel causing 'serious disruption to the world economy', or are communists are not eligible for preferential treatment; moreover, the President has discretion over the granting and withdrawal of preferences (Ozden & Reinhardt, 2002). Thus, in principle, the GSP needs to be applied without discrimination to all developing countries – in accordance with WTO rules – whereas in practice, countries can be excluded from preferential schemes for political reasons. In this scenario, trade preferences, instead of enhancing developing countries' power in the international trading system, can turn into yet another bargaining advantage for the developed countries.

Among the most well-known *ex*-WTO preferences are the Caribbean Basin Initiative (CBI that later became Caribbean Basin Economic Recovery Expansion Act) by the US and the Lomé Conventions by the EU, now transformed into the Cotonou Agreement. The CBI expects its members to undertake their obligations under the WTO, to provide adequate intellectual property protection, labour rights, and fight drug-trafficking, among others.

The Lomé Conventions were less demanding, at least in their inception. By the time the IV Lomé Convention was negotiated (1994-1995) with the African, Caribbean and Pacific (ACP) countries, respect for human rights, democratic principles and the rule of law became the fundamental criteria to be met in order to benefit from the agreement. Although these additions represent partly a change in sensitivity over time and are certainly worthy commitments to make, the question remains about the extent to which these noble goals could be manipulated for political reasons. Even more so, one needs to question the rationale behind granting preferential treatment to developing countries in recognition of their lesser economic status, while asking them to fulfil standards that match those of countries with an advanced level of economic development.

Moreover, a decision by a WTO panel regarding the US-EU case on bananas stated that this type of non-reciprocal regional preferences is incompatible with WTO rules, in particular with the MFN principle, unless granted a waiver. This ruling applied directly to the Lomé Conventions, preferential trade agreements (PTAs) of the EU with the ACP countries based on the discrimination between ACP and other banana producers (among which were many Latin American developing economies). This type of arrangement disproves the rationale on which Raúl Prebisch, an Argentinean economist, proposed the preference system at UNCTAD in the 1960s, (UNCTAD website): '…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:

(a) to increase their export earnings;
(b) to promote their industrialisation; and
(c) to accelerate their rates of economic growth (emphasis added).'

In fact, the EU treaty with the ACP countries goes counter to the principle of non-discrimination between developing countries enshrined in the UNCTAD principles (although the same allows for different treatment of developing countries and LDCs).

Box 1: Going Bananas: The Politics Behind the EU-US Dispute

During the 1980s, Latin American countries accounted for 75 percent of the world's banana production, while ACP countries and EU overseas territories produced about 15 percent. However, the representatives of the latter countries argued that the elimination of 'banana preferences' would lead them to economic ruin. Hence, any kind of action against this proposition would have meant political ruin of the then European leaders, who were obviously not keen on this outcome. The main actors behind the dispute were the big banana traders (Geest and Fyffes in Europe, and Chiquita, Del Monte and others in the US), who managed to influence trade policy to the extent that the mutually agreed solution under the WTO dispute settlement system was less 'trade-liberalising' than it could have been. In the words of Chiquita's main competitor, Dole, 'the settlement that was finally reached by US and EU gives one company, Chiquita … a dominant, fixed share of the EU's closed, quota market and continues to allocate licences to protectionist EU traders'.

Source: Cadot, O. and Webber, D. (2001), "Banana Splits: Policy process, particularistic interests, political capture and money in trans-Atlantic trade politics".

Preferential Treatment, But With Strings Attached

Not only did the GSP discussed in the GATT fail to indicate a common framework for national schemes, but the GATT/WTO also tolerated this haphazard set of national GSP arrangements for many years. It was only recently that the issue of compatibility with trade liberalisation beckoned greater attention, albeit it seemed to be moved primarily by political motives (see Box 1). Notwithstanding the WTO's 'awakening' to the issue of reconciling trade preferences with the effort to create an MFN-based MTS, such schemes have been periodically

revamped by developed countries. The penchant of the developed countries for these sorts of 'aid' as opposed to specific aid programmes aimed at enhancing the supply-side of developing economies might derive from the alleged greater political viability of the latter. In fact, revenue forgone when trade preferences are granted (less tax revenue for the benefactor country) does not appear in the public budget and is thus less prone to the uncertainties of political debate than developmental aid (Tangermann, 2002).

Among the most recent additions to the 'spaghetti bowl' of PTAs are the EU's Everything But Arms (EBA) and GSP+ and the US's African Growth and Opportunity Act (AGOA). Put in place in 2005, the GSP+ is a programme that grants 'extra-preferences' to those countries that can prove to have ratified and implemented key international conventions on subjects such as good governance, the right to strike, discrimination of women, child labour, etc. (EU press release, 2005). The AGOA sets among its eligibility criteria elimination of barriers to US trade and investment, property rights protection, political pluralism, poverty reduction and policies.

The criteria listed above are prone to liberty of interpretation, which in turn implies that the granting or removal of preferences can fall into hands of the lobby of the moment or be based on nationalistic or protectionist considerations. Further, in-built volatility can make preferences 'investor-unfriendly', as the risk of sudden changes in the economic environment increases.

Box 2: EBA and Rules of Origin

In February 2001, the European Council adopted Regulation (EC) 416/2001, the so-called 'EBA Regulation' granting duty-free access to imports of all products from LDCs, except arms and munitions, without any quantitative restrictions (with the exception of bananas, sugar and rice for a limited period). The only restriction faced by LDCs under this programme relates to the 'Rules of Origin' (RoO).This sounds harmless and even reasonable, since it avoids 'free riding' by other nations that do not meet the requirements to be eligible for EBA. However, the certification requirements that accompany the 'reasonable' prerequisites are often so burdensome that they can discourage LDCs to apply for the programme, as has happened in the case of many ACP LDCs that have stuck to the Cotonou Agreement. Again, the point of helping developing countries to improve their economic situation clashes with the imposition of requirements they meet with difficulty.

Source: http://ec.europa.eu/comm/trade/issues/global/gsp/eba/index_en.htm

For example, Cote d'Ivoire was deemed eligible for AGOA in 2002, but removed from the scheme in 2005. This might have been motivated by the political unrest that hit the country in September 2002; however, if trade preferences were to be used as an effective deterrence against internal unrests, then the removal from a certain scheme should be speedier than in the above example. Also, if there is consensus on the creation of an MTS whereby power is more equitably distributed and rules are in place to counter the negative effects of power concentration, then trade preferences should not contain eligibility criteria that can be exploited as a tool by developed countries for 'policy-making abroad'.

The one positive thing about AGOA is the flexibility of its RoO, which differentiates it from its allegedly more generous European counterpart, EBA. The RoO have the power to 'make or break' a preference regime if they are too strict or require great technical detail. Besides, they might impose great costs on the 'beneficiary' that would in effect nullify the positive effect of the preference.

Are Trade Preferences Really Worth It?

The risk of political manipulation could be at least justified if it were incontestable that trade preferences significantly help a country's economy. Unfortunately, the case is not so clear-cut. Generally, promoters of free trade tend to depict trade preferences as economically non-viable, while supporters of 'the development view' highlight the benefits that some countries have accrued from preferential trade tariffs. In principle, trade preferences can have a positive effect if they do not create trade distortions (i.e. over-investment in the preference area that is not consistent with the country's comparative advantage and leads to lack of diversification in the economy) or trade diversion (i.e. when the product imported on a preferential basis substitutes for imports from other countries that were previously trading in that product with the beneficiary). This has been the case with Madagascar and Lesotho, which have managed to reap benefits through AGOA by increasing their textile production. However, benefits tend to erode over time, due to the phenomenon of 'preference erosion', which is a result of the direction taken in the MTS towards further liberalisation.

The case of banana production in the Windward Islands illustrates well how trade preferences have gone too far. The Windward Islands are very small, with a population of less than 450,000. Due to the weather and soil conditions, as well as the preferential treatment they have been receiving for many years, their production structure rests on the cultivation of bananas (Oxfam UK, 1998). Banana cultivation is almost the only economic resource of the inhabitants of the Islands, who thus found themselves very much at risk when the WTO ruled that the type of preferences given by the EU to Caribbean states were not compatible with the MTS rules. In the case of the Windward Islands, a long-term aid policy targeted at the area's supply-side constraints, e.g. enhancing agricultural technology so as to make the growth of other crops more viable, might have served the population's interests better than trade preferences.

Moreover, the accordance of trade preferences particularly when it is targeted only to selected groups of countries (e.g. AGOA), has the potential to create divisions among the group of developing countries, which are already finding it difficult to coordinate in international fora, such as the WTO. This is because developing countries usually have less bargaining power than their developed counterparts in international arenas, thus by hanging on to their old 'imperial' preferences

they create a situation that does not seem to augment their international status. As Tangermann says, "a crucial question for developing countries is whether the 'negotiating capital' they have is better used in WTO negotiations on further reductions of MFN tariffs in agriculture, or in attempts at deepening tariff preferences under GSP schemes" (Tangermann, 2002).

Box 3: The India-EU Case at the WTO: A Battle between Two Goliaths

In 2002, India challenged the EU in the WTO forum in relation to a preferential agreement that the EU had granted to 12 countries, including Pakistan, in order to create a bulwark against drug-trafficking (the Drug Arrangements). This preference was obviously 'over and above' the EU's preference margins under the GSP, and India challenged it on the grounds that it was inconsistent with GATT Article I, since it discriminated against developing countries. In the end, both the panel and the Appellate Body upheld the 'developing Goliath's' case. The Appellate Body ruled the same on the grounds that 'the Drug Arrangements failed to establish any clear prerequisites or objective criteria that, if met, would allow for other developing countries similarly affected by the drug problem to be included as beneficiaries'. Indeed, it seems likely that the EU included Pakistan in the scheme as a 'reward' for the country's cooperation against global terrorism after the September 11 attacks.

This indictment suggests two things: 1) preferential schemes that do not follow multilaterally set rules are prone to fall victims of power politics; and 2) the WTO can provide a neutral forum for the redress of 'trade wrongs', which is a further incentive for all countries to 'play by the rules'.

Source: Shaffer, G. and Apea, Y. (2006), "Institutional Choice in the General System of Preferences Case: Who Decides the Conditions for Trade Preferences? The Law and Politics of Rights".

One last argument that calls for a critical reflection of the importance accorded to trade preferences stems from their 'internal' political economy, by answering the question: who benefits from preferential treatment? Of course, poor producers of commodities do, to an extent; the question is the extent to which monetary gains are redistributed equally between producers and the traders' lobbies who successfully influence trade policy in order to gain preferential treatment. This case is exemplified by the banana preference accorded to the Caribbean by the EU: even after years of preferential treatment, the producers are still poor and depend on small-scale banana production for their livelihood. They have not innovated; they have not significantly expanded their production; and they have not invested money in order to diversify. On the other hand, the European banana traders have accrued most of the benefits: one analysis found that only one-sixth of the costs imposed on consumers in the EU went back to growers as direct aid (Cadot & Webber, 2001).

Conclusion

In sum, it seems that trade preferences are a double-edged sword in the development discourse. This is not to say that they have not worked in certain cases or that the existing ones should suddenly be scrapped altogether. The primary concern for policymakers should be the livelihood of the poor stakeholders, and it is understood that trade preferences can provide relief from dire poverty for some. However, at this point of time, when the MTS is going slowly but surely towards greater liberalisation, it is questionable how profitable it is to focus on discussions about trade preferences. This is even more so since the issue of preferential treatment has the potential to divide the front of the developing countries in multilateral trade negotiations (e.g. developing countries against LDCs, Asia vs. Africa), just at the time when it is important to create unity on these issues.

Furthermore, two elements, which have been disregarded in this discussion about trade preferences, i.e. supply-side constraints and strengthening of institutions, are crucial for a country's economic development. If there are no adequate roads or ports, how can a country export its merchandise in a timely and effective manner that is consistent with RoO? This is even more relevant in the case of institutions since RoO often require very cumbersome proofs, which developing countries and LDCs are ill-equipped to provide. Recent initiatives, such as 'Aid for Trade', tackle these shortcomings directly.

The underlying principle of any type of aid, be it aid flows or tariff reduction should be to generate self-sufficiency of the beneficiary country. In the case of trade preferences, this result does not emerge incontestably from empirical evidence. It is, therefore, advisable to shift the world's attention towards more efficient methods for helping the world's social and economic development.

Endnotes

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