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Roland Siebeke\*

## Is the GSP Antiquated?

*The second decade of the Generalized System of Preferences (GSP) ends in 1990. Should it be continued for another, third decade and if so, what changes should be made? Can the present Uruguay Round of GATT negotiations be used to effect improvements in the GSP?*

The Generalized System of Preferences (GSP) for developing countries, once a major bone of contention in international fora, has again come under discussion lately. A recent publication<sup>1</sup> has not much applause in store for the industrialized countries' generalized tariff preferences in favour of developing countries: "After more than a decade of operation, there is not much evidence of the effectiveness of the GSP."<sup>2</sup> From a different angle, the GSP has been, at best, an innocuous palliative to ward off demands by developing countries for thorough trade liberalization: "By concentrating positive assistance to developing countries in preferences, developed countries were able to minimize the potential inconvenience to themselves, for preferences are not bound under GATT."<sup>3</sup>

Guy Karsenty and Sam Laird have estimated<sup>4</sup> that the GSP increased the volume of total developing countries' exports by about 2% in 1983. This result does look modest; the figure would be higher if not total, but industrial, exports were taken as the base (GSP, after all, is intended to raise industrial, not primary, exports of developing countries). The results of other studies<sup>5</sup> confirm the limited, though not negligible, effects of the GSP on developing countries' exports.

### Actual versus Potential Exports

Guy Karsenty and Sam Laird estimate that "the full extension of the GSP through the inclusion of other products and the elimination of restrictions on the

amount of goods subject to preferential treatment would yield additional direct trade gains to the developing countries of \$ 20.6 billion, i.e. three times the benefits that they presently enjoy".<sup>6</sup>

Besides exclusions of products and restrictions there is another impediment to GSP utilization: rules of origin. Ostensibly a technical means for avoiding deflection of trade, rules of origin have become an impediment to GSP utilization due to several reasons:

□ Lack of transparency: "Under all (GSP) schemes, the basic requirement for a good to be considered as originating in a beneficiary country is for it to have been wholly produced there or for it to have been produced there through the substantial transformation of imported materials."<sup>7</sup> But the requirement of substantial transformation is interpreted very differently by GSP-"donor" countries; preferential origin rules have not

<sup>1</sup> R. J. Langhammer and A. Sapir: Economic Impact of Generalized Tariff Preferences, Aldershot 1987.

<sup>2</sup> Op. cit., p. 69.

<sup>3</sup> M. Wolf: Differential and more favourable treatment of developing countries and the international trade system, in: The World Bank Economic Review, Vol. 1, Sept. 1987, p. 657.

<sup>4</sup> G. Karsenty and S. Laird: The GSP, policy options, and the New Round, in: Weltwirtschaftliches Archiv, Vol. 123 (1987), pp. 262-296.

<sup>5</sup> Cf. in particular A. Borrmann, C. Borrmann, C. Langer, K.-W. Menck: The Significance of the EEC's Generalized System of Preferences, Hamburg 1985; A. Borrmann: The Significance of the EEC's Generalized System of Preferences, in: INTERECONOMICS, Vol. 21, 1986, No. 1; U. Möbius: Wie wirksam sind die Allgemeinen Zollpräferenzen der EG für Industrieprodukte?, in: DIW-Wochenbericht, 10/1986; R. J. Langhammer and A. Sapir, op. cit., chapter 3.

<sup>6</sup> G. Karsenty and S. Laird, op. cit., p. 286.

<sup>7</sup> OECD: The Generalised System of Preferences, Paris 1983, p. 25.

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been harmonized. Therefore, it is often difficult for exporters and governments in developing countries to judge whether a transformation is sufficient in terms of the origin rules of a specific donor country.

□ Preferential origin rules are stricter, i.e. require more substantial transformation of imported materials, in some donor countries than non-preferential origin rules<sup>8</sup>, for no obvious reason. Frequently, more than one stage of transformation or processing is required; for example in the EC GSP scheme, the following transformations of imported materials are not sufficient and the products not eligible for GSP treatment:

- weaving of imported yarn
- manufacture of finished clothing articles from imported fabrics
- manufacture of shoes from imported parts
- manufacture of radios, televisions, turntables, tape recorders, microphones, loudspeakers etc. when using imported transistors
- manufacture of cigars and cigarettes when using more than 30 % imported tobacco.

These examples show that strict origin rules precondition high degrees of vertical integration in the originating country. Small developing countries with fragmented structures of production tend to be put at a disadvantage. Moreover, insistence on high degrees of vertical integration does not make economic sense; a country may enjoy a comparative advantage in one processing stage but not in the next one downstream or upstream.<sup>9</sup> No wonder that the Bangladesh speaker at the UNCTAD Preference Committee in April 1989 denounced origin rules as the greatest barrier which least developed countries face in taking advantage of the GSP. Origin rules are probably one of the reasons why GSP benefits are concentrated on more advanced developing countries.

□ The GSP origin rules of most donor countries (including the EC, but with the notable exception of Canada) discourage cooperation among developing countries. Normally, the processing of materials from other developing countries will not be recognized; for example, a radio manufactured in India with imported

transistors from, say, Malaysia will not be eligible for GSP treatment.

There is another impediment to a full realization of GSP potential. The granting of GSP “does not constitute a binding commitment and, in particular, it does not in any way prevent their subsequent withdrawal in whole or in part . . .”.<sup>10</sup> The legal status of the GSP thus differs from the GATT bindings of most-favoured-nation tariffs on the one hand and from contractual bindings of preferences (e.g. in the EC-ACP Lomé Convention) on the other: preferences under the GSP can be suspended or withdrawn at any moment. For example, under the EC scheme there are hundreds of preferential limits on sensitive products. When duty-free imports have reached such a limit, GSP treatment can be suspended (i.e. further imports pay duty) till the end of the year. The US and the Japanese GSP schemes function somewhat differently, but in most schemes<sup>11</sup> GSP treatment is uncertain so that it is difficult to take it into account in pricing decisions by exporters in developing countries and by importers. *A fortiori*, it is not possible to base investment decisions on the expectation of GSP treatment; there is no guarantee at all for export-oriented investments in developing countries that exports to industrialized markets will benefit from GSP treatment<sup>12</sup>.

### Importance of Tariffs

If positive GSP effects on developing countries' exports have been hampered by non-neutral origin rules, insecurity and restrictions, it does not necessarily follow that a fully-fledged unrestricted GSP would really make a major difference. It could be argued that preferences have become somewhat antiquated after several GATT rounds have drastically lowered the tariff barriers of industrialized countries;<sup>13</sup> the current Uruguay Round will probably result in a gradual average decrease of nominal tariff rates by one third<sup>14</sup>.

Tariffs tend to increase the prices of imported products, thus lessening the strength of price competition. Price sensitivity varies among products, depending on market structures and elasticities. New

<sup>8</sup> Non-preferential origin rules are used in connection with country-specific import restrictions and anti-dumping duties.

<sup>9</sup> Cf. e.g. UNIDO: Industry in the 1980s, Structural Change and Interdependence, New York 1985, pp. 93-104.

<sup>10</sup> Cf. UNCTAD Trade and Development Board: Decision 75 (S-IV) of 13th October 1970, UNCTAD-Doc. TD/B/332, New York 1970.

<sup>11</sup> With the notable exception of Australia, which has introduced an unlimited preferential margin of 5 percentage points on all dutiable products.

<sup>12</sup> Cf. A. Borrmann et al., op. cit., pp. 310-311.

<sup>13</sup> Cf. R. J. Langhammer: Die Allgemeinen Zollpräferenzen der Europäischen Gemeinschaft für Entwicklungsländer – Fehlschlag oder Erfolg?, Kieler Diskussionsbeiträge, Nov. 1983, p. 19.

<sup>14</sup> Cf. GATT Mid-term Review: Final Agreement at Geneva, GATT Newsletter 61, May 1989, p. 2.

<sup>15</sup> Cf. S. Hirsch: Rich man's, poor man's, and everyman's goods, Kieler Studien No. 148, Kiel 1977, pp. 118, 120. For an interesting example see UNCTAD: International trade in the petrochemical sector: Implications for developing countries, Geneva 1985, para. 78.

products are often akin to monopoly products and therefore not subject to price competition. Developing countries' exports of manufactures contain few new products, but rather "mature" products in a later phase of the product cycle, for which price competition is keener<sup>15</sup>. Consequently, insofar as manufactured imports from developing countries include more mature and price-sensitive products than imports from industrialized countries<sup>16</sup>, tariffs impinge more on imports from developing countries.

Besides the varying price sensitivity of new and mature products, the difference between nominal and effective rates of protection is well-known. Prof. Hemmer rightly states that tariff structures of industrialized countries tend to discriminate against developing countries<sup>17</sup>. This view is corroborated by the findings of Werner and Willms<sup>18</sup>, according to which tariff

escalation from primary products to intermediate goods in the EC tariff schedule "is still important".

It follows that tariffs do matter, at least against imports from developing countries. But this does not provide sufficient rationale for generalized preferences. After all, preferences may cause trade diversion away from the most efficient supplier.

## GSP versus Free Trade?

Economists, with good reason, favour free trade. With free trade there would be no GSP. However, in a second-best world where tariffs continue to exist, the

<sup>16</sup> Disregarding state-trading countries, whose export structures are similar to advanced developing countries.

<sup>17</sup> H.-R. Hemmer: *Wirtschaftsprobleme der Entwicklungsländer*, 2nd ed., Munich 1988, pp. 761-762. Cf. also A. Cairncross et al.: *Protectionism, The impact on developing countries*, Report by a group of experts to the Commonwealth Secretariat, London 1982, paragraphs 3.51 and 3.52.

<sup>18</sup> *Zollstruktur und Effektivzölle nach der Tokio-Runde*, Inquiry of the Institute for Economic Policy at the University of Cologne, Cologne 1984, p. 63.

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question cannot be escaped whether tariffs should at least be abolished on products from developing countries, as a second-best measure<sup>19</sup>. The classical answer by Jacob Viner<sup>20</sup> is well-known: check whether the preference causes more trade creation or more trade diversion.

Whether the (static) effects of GSP are more in the direction of trade creation or trade diversion is a moot point. "... the relative magnitude of the two effects depends upon whether a product competes more with domestic producers in the (GSP) donor country or with suppliers in non-beneficiary countries."<sup>21</sup> In the case of GSP this is difficult to judge *a priori*, on theoretical grounds. Empirical results are not unequivocal, but the evidence of trade creation prevails, especially for the EC GSP scheme<sup>22</sup>. At any rate, the more competitive – in the sense of rivalling with domestic production – GSP imports are admitted, the more likely is trade creation.

Dynamic arguments, however vague, cannot be dismissed. Some authors welcome GSP if it enables the developing countries to export goods for which they may not presently enjoy a comparative advantage but are likely to do so in the future; the industrialized countries would then – via the GSP duty relief – carry part of the costs of learning in the developing countries<sup>23</sup>.

In addition, positive discrimination in favour of developing countries may help to accelerate industrialization of these countries which are, economically speaking, latecomers in the world economy, partly for historical reasons, partly due to policy mistakes by their governments<sup>24</sup>. To the extent that there are economic benefits not only to the developing countries, but to the world economy at large from the increased participation and integration of these latecomers<sup>25</sup>, GSP benefits the world economy.

If GSP is worth being continued, at least for another decade<sup>26</sup>, it should be made effective, i.e. origin rules

should be neutralized, GSP benefits should be rendered calculable, etc. This, however, appears politically infeasible, unless GSP beneficiaries offer some trade concession in return. A *quid pro quo* from GSP beneficiaries would, of course, mean an abandonment of the sacrosanct GSP principle of non-reciprocity<sup>27</sup>. But perhaps, as we shall attempt to set forth below, it is this principle which is antiquated, rather than the GSP.

The principle of non-reciprocity has been – together with Art. XVIII B GATT (see below) – a justification for many developing countries to conduct long-term restrictive trade policies with high tariff rates, sometimes above 100% on import value, import prohibitions, quantitative restrictions or licensing procedures with similar effects, etc. The results of such inward-oriented trade regimes have been so negative<sup>28</sup> in terms of growth, employment, and balance of payments that Martin Wolf concludes "... developing countries have won a series of largely Pyrrhic victories" by having their way and not participating in reciprocal trade bargaining in GATT<sup>29</sup>. The main reason for the disappointing trade performance of developing countries has been, besides protectionist policies on the part of industrialized countries, the repercussion on exchange rates of restrictive developing countries' import regimes with the result of implicit taxation of exports<sup>30</sup>.

### The Uruguay Round

So far, developing countries have liberalized their import regimes only hesitatingly, sometimes only because of pressure by the World Bank, under the terms of structural adjustment loans. The question arises if there is room in the current Uruguay Round negotiations within GATT for mutually (for both developing and developed countries) advantageous solutions.

The OECD Secretariat holds that a *conditio sine qua non* for progress in this matter is a reform of the GATT

<sup>19</sup> Cf. e.g. R. Pomfret: The theory of preferential trading arrangements, in: *Weltwirtschaftliches Archiv*, Vol. 122, 1986, p. 439.

<sup>20</sup> J. Viner: The Customs Union Issue, New York 1950, p. 44.

<sup>21</sup> R. J. Langhammer and A. Sapir, op. cit., p. 30.

<sup>22</sup> G. Karsenty and S. Laird, op. cit., p. 9; D. G. Beckmann: A note on estimating the static effects of the GSP, in: *Weltwirtschaftliches Archiv*, Vol. 124, 1988, p. 566; R. J. Langhammer and A. Sapir, op. cit., pp. 30-39.

<sup>23</sup> Cf. H.-R. Hemmer, op. cit., p. 767. See also OECD: The Generalised System of Preferences – Review of the First Decade, Paris 1983, p. 9.

<sup>24</sup> This point is put quite drastically by M. Wolf, op. cit. According to him GSP was invented to compensate for the uncompetitiveness of developing countries caused by their inward-looking trade policies (p. 655).

<sup>25</sup> Cf. OECD: World Economic Interdependence and the Evolving North-South Relationship, Paris 1983, p. 10.

<sup>26</sup> Political commitments within UNCTAD by developed countries to grant generalized preferences have been made for the decades 1971-80 and 1981-90. A basic review for the decade 1991-2000 is due for 1990.

<sup>27</sup> Cf. e.g. Final Act of UNCTAD VII, United Nations, New York 1987, para. 105 (5) which requires of GSP donors a "strict compliance with multilaterally agreed principles related to their generalised, non-discriminatory and non-reciprocal character".

<sup>28</sup> Cf. for example: World Bank: World Development Report 1987, Chapter 5; Balassa: Inward-oriented Strategies, in: G. M. Meier (ed.): Leading Issues in Economic Development, 4th ed., New York & Oxford 1984, pp. 516-521.

<sup>29</sup> M. Wolf, op. cit., p. 649.

<sup>30</sup> Cf. B. Balassa, op. cit., p. 517.

balance of payments safeguard clause, viz. Art. XVIII B GATT, the central sentence of which reads as follows: "A contracting party the economy of which can only support low standards of living and is in the early stages of development, may . . . control the general level of its imports by restricting the quantity or value of merchandise permitted to be imported, provided that the import restrictions instituted, maintained or intensified shall not exceed those necessary to forestall the threat of, or to stop, a serious decline in its monetary reserves . . ." (paras. 9 and 4 combined).

Judging by the text, newly industrialized countries with a strong balance of payments position should not be entitled to invoke this safeguard clause for import restrictions. The fact that the Republic of Korea has nevertheless got away for a long time with basing import restrictions on Art. XVIII B GATT is a sign that in practice this provision has been broadly interpreted and "provided developing countries with what amounts to a carte blanche for quantitative restrictions on imports that in some cases have lasted for years and in a few for decades"<sup>31</sup>.

In order to avoid misunderstandings, Art. XVIII B GATT does *not* concern infant industry protection. Infant industry protection is treated in Art. XVIII A and, in particular, C GATT, and is, as long as it is selective and does not lead to serious exchange rate repercussions, not of interest here<sup>32</sup>. This article, rather, deals with pervasive inward-looking trade strategies which have been accommodated by Art. XVIII B or condoned in the wake of this provision<sup>33</sup>.

There is another aspect which makes Art. XVIII B GATT look somewhat outmoded and which has been succinctly expressed by Shailendra J. Anjaria: "It is evident that the balance of payments provisions of the GATT permitting the use of quantitative import restrictions were formulated on the assumption of fixed exchange rates – or at least they presumed that exchange rate adjustments, in the absence of "fundamental disequilibrium", were undesirable. Following the abandonment of the par value system from the early 1970s, there is a greater awareness of the role of exchange rate policy in balance of payments

adjustment. Even if they do not float freely in many developing countries, exchange rates are often actively used for balance of payments adjustment. Hence, a fundamental assumption on which the GATT provisions and practice are based is no longer applicable."<sup>34</sup>

In conclusion, there appears to be a case for reforming Art. XVIII B GATT, with a view to strictly limiting its purview. Some OECD countries have already raised this issue in the current Uruguay Round. Developing countries have not reacted enthusiastically, if only for tactical reasons. There is a risk that negotiations on this issue will not really start because OECD countries may fear the "price" to be paid for an Art. XVIII B reform to be too high. Here a closer look at the countries which invoke this safeguard clause may give a clue. With the exception of South Korea and Yugoslavia these countries are low or middle income developing countries, a perhaps typical example being India. Thus any reciprocal concession for reforming Art. XVIII B should be aimed at these countries. Two types of measures in favour of these contracting parties are conceivable:

- ☐ simplification, relaxation and harmonization of GSP origin rules,
- ☐ binding of GSP treatment under GATT for the next GSP decade in favour of low and middle income developing contracting parties<sup>35</sup>.

The temporary binding of GSP treatment in favour of low and middle income developing countries<sup>36</sup> in return for an Art. XVIII B liberalization would serve several purposes:

- ☐ GSP would become more effective for those countries that need it most, the NICs (newly industrialized countries) having proved that they can export without GSP;
- ☐ the GSP would become more integrated into the GATT system;
- ☐ the reform of Art. XVIII B GATT would represent a major step in the direction of developing countries' trade liberalization.

<sup>31</sup> M. Wolf, op. cit., p. 650.

<sup>32</sup> The case for (limited) tariff protection in certain cases by low-income countries has been made by H. Dehn: External Orientation and Domestic Market Promotion, in: INTERECONOMICS, Vol. 23, No. 2, March-April 1988, p. 73.

<sup>33</sup> Cf. S. J. Anjaria: Balance of Payments and Related Issues in the Uruguay Round of Trade Negotiations, in: The World Bank Economic Review, Vol. 1, Sept. 1987, pp. 669-688.

<sup>34</sup> S. J. Anjaria, op. cit., p. 681.

<sup>35</sup> Extension of this binding towards other developing countries when they join GATT (for example the People's Republic of China) need not be automatic; the entry conditions for each new GATT contracting party are laid down in an individual accession protocol.

<sup>36</sup> It could be an advantage, though, for the European Community to bind some GSP benefits in favour of oil-exporting developing countries in order to ward off pressure to conclude a preferential trade agreement EC-Gulf Cooperation Council countries, which risks not fulfilling the requirements of Art. XXIV GATT for such agreements.