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Department of Economics  
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# Trade Preferences from a Policy Perspective

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# Trade preferences from a policy perspective

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## Abstract

The aim of this paper is to offer a comprehensive overview of non-reciprocal trade preferences. Legal and economic aspects are discussed, and in particular, focus is put on how the specific design of preference programs influence whether or not preferences will have their intended effects. The paper starts by summarizing the historical and legal background of non-reciprocal trade preferences, and thereafter discusses how preferences are intended to work from an economic point of view. Further, the paper discusses ways to determine whether or not preferences meet their intended targets, and outlines in some detail how preference programs differ in their design. The question of how trade preferences could have negative effects for recipient *and* non-recipient countries is explored, and the paper concludes by discussing whether trade preferences will be a useful policy alternative in the future.

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# 1 Introduction

Focusing on North-South trading relations, this paper explores the issue of non-reciprocal trade preferences for developing countries. This refers to a policy where industrialized nations offer lower trade barriers to developing countries than those faced by other developed nations, and where the preference-receiving developing countries are not expected to make market access concessions in return. The goal is to facilitate increased export earnings and a more diversified trade.

The aim of this paper is to offer a comprehensive overview of non-reciprocal preferences. Legal and economic aspects will be discussed, and in particular, focus will be put on how the specific design of preference programs influence whether or not preferences will have their intended effects. Generally, the issues will be discussed from the perspective of how they influence developing countries' interests rather than how the preference-granting countries are affected.

Why it is important to study non-reciprocal trade preferences? A general answer is that this is one of the two major policies whereby wealthier nations have sought to assist developing countries' development efforts (the other one being development aid). Properly understanding under which conditions this policy operates, and which factors that influence its success is therefore important for policymakers and researchers who wish to understand and assess development policies. In addition, and more specifically, we are arguably at a point in time when the existing trade preference programs are in the process of being reformed. Historically, wealthy importers such as the European Union (EU) and the US have implemented a complex web of preference programs, where only some have been compatible with the relevant WTO rules. Increasingly though, developed countries now seek to modify these preference regimes into new programs that better comply with the rules. To offer policymakers input to the design of new trade preference systems, this is therefore an appropriate time to systematically go through a wide range of factors that may determine whether preferences work.

The paper starts by summarizing the historical and legal background of non-reciprocal trade preferences, and thereafter discusses how preferences are intended to work from an economic point of view. Section 4 discusses ways to determine whether or not preferences meet their intended targets. Thereafter, Section 5 discusses in some detail how preference programs differ in their design. Section 6 explores how trade preferences could have negative effects for recipient *and* non-recipient countries. Lastly, Section 7 offers concluding remarks on whether trade preferences will be a useful policy alternative in the future.

## 2 Legal and historical background

The idea of using discriminatory trading arrangements to support the development of poorer nations – in particular colonial associates – has a fairly long history. However, the policy arguably made its real debut in the context of the multilateral trading system at the first United Nations Conference on Trade and Development (UNCTAD) in 1964. While not outlining any details, the final act of UNCTAD I contained an explicit recommendation that developed nations should grant trade concessions to developing countries, and should not require concessions in return (see Bartels 2003 for a thorough overview of the details in the original recommendation).

At the second UNCTAD conference in 1968, Resolution 21 (II) called for the establishment of a “generalized, 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” (from Resolution 21 (II), cited in Grossman and Sykes 2005). The resolution also established that the goal for preferences was to (i) increase export earnings for developing countries, (ii) promote industrialization and (iii) accelerate developing countries’ rates of economic growth (for the historical and legal overview, see e.g. Bartels 2003, Grossman and Sykes 2005 or dos Santos *et al* 2005).

An obvious problem with the proposed system of preferences was that it would clearly violate the principle of non-discrimination as captured in Article 1 of GATT (Most Favoured Nation) – in fact, the whole idea of the policy was to discriminate against developed countries in favour of exports from developing nations. At the same time, the system would not meet the requirements for regional trading arrangements as outlined in Article XXIV of the GATT, because trade barriers would only be lowered for the developing countries’ exports and not in the other direction of trade. In addition, it was not clear that all barriers would be removed even for the developing country exporters (indeed, this has subsequently turned out to rarely be the case in practice). Therefore, in order for the system of preferences to become operational it needed a different legal basis, and it initially was given such a basis through a GATT waiver granted in 1971. This waiver, known as the “GSP Decision”, stated that the provisions of Article I was waived for a period of ten years, allowing the creation of a system of preferences as envisioned at UNCTAD II (for the exact phrasing of the GSP Decision, see Bartels 2003). Quickly following the 1971 waiver decision, the European Union created a Generalized System of Preferences. Over the next few years, most other industrialized countries followed suit, and the last major importer to do so was the United States in 1976.

The 1971 GSP decision on a temporary waiver was followed in 1979 by the so-called Enabling Clause. This decision, formally referring to “Differential and More Favourable Treatment, Reciprocity and

Fuller Participation of Developing Countries”, created a permanent legal basis for granting trade preferences to developing countries.

Looking at the Enabling Clause, what are the rules that trade preference-granting countries must follow? Interestingly, there has been discussion among legal scholars regarding the exact meaning of the words “generalized”, “non-reciprocal” and “non-discriminatory” which appears in the Enabling Clause (for a discussion, see Bartels 2003). In general, however, the rules have been interpreted as laying out the following conditions. Industrialized countries are allowed to offer better market access to developing countries than that offered to other industrialized countries. It is not permitted to discriminate between developing countries, with one important exception, namely that the least developed countries (LDCs) may be offered even more favourable treatment. The rules do not specify that preferential market access must be offered for *all* products, so the range of products included can vary a lot. Further, the provisions about non-reciprocity are interpreted as prohibiting the donor countries from asking for market access concessions in return, but other types of conditions for the granting of preferences are seen as acceptable.

While most developed countries have adopted their own versions of GSP regimes – and some, such as the EU, have special programs for the LDCs within the broader GSP scheme<sup>1</sup> – other preference programs that target specific groups of developing countries have been, and are still, used by some of the major donors. Typically, these programs are not covered by the Enabling Clause. For instance, the unilateral and quite substantial preferences offered by the EU to African, Caribbean and Pacific (ACP) countries in the Lomé conventions *did* discriminate between developing countries and were thus not covered by the Enabling Clause. The same can be said for the unilateral preferences offered by the EU to certain Mediterranean countries through Cooperation Agreements from the 1970s (for a discussion of these preferences and an assessment of their trade effects, see Persson and Wilhelmsson 2007). While the EU are in the process of transforming these targeted preference programs into WTO-compatible programs (see for instance Morrissey 2011 for a discussion of the future ACP trading arrangements), the US still maintains regionally based preference schemes. Examples include the African Growth and Opportunity Act (AGOA), the Caribbean Basin Initiative (CBI) Program and the Andean Trade Preference Act (ATPA) Program.

As a final note, it is worth mentioning that the interpretation of the Enabling Clause has changed somewhat lately as a result of the case *EC – Tariff preferences*. The case started in 2002, when India challenged the European Union’s *Special arrangements to combat drug production and trafficking*, also known as the “drug regime”, on the grounds that this special arrangement offering additional trade

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<sup>1</sup> Since 2001, the EU offers LDCs duty free market access for all products except arms and ammunition under the Everything But Arms (EBA) regime. The EBA is technically speaking a special arrangement within the EU GSP scheme.

preferences for some countries within the EU GSP scheme did not live up to the non-discrimination requirements of the Enabling Clause. The case went before a WTO panel and later the Appellate Body (AB), and in the final AB ruling, it was stated that preference-granting countries can treat beneficiaries differently if those differences “respond positively” to varying “development, financial and trade needs” (for a legal comment on this ruling, see Grossman and Sykes 2005 or Bartels 2007). Though it remains unclear exactly how the ruling should be interpreted, it has seemingly opened the door for an increasing legal use of trade preference schemes that discriminate between developing countries.

### 3 Economics of unilateral trade preferences

What are the expected trade effects from unilateral trade preferences? Starting with the main goal of trade preferences, i.e. to “increase export earnings for developing countries”, Figure 1 offers a simple framework for analyzing this effect in a partial equilibrium setting.<sup>2</sup>

Before preferences are granted, exports from all countries face an ad valorem MFN tariff at the rate  $T^{MFN}$ . With a domestic price of  $P_1$  in the preference-granting country, the price received by the exporters is therefore  $P_1/(1 + T^{MFN})$ . As illustrated in Figure 1, at that price, exports from the country under study will equal  $(Q_3 - Q_2)$ . When preferences are granted – and it is for now assumed that the group of countries receiving preferences collectively are small – exporters in preference-receiving countries will be exempted from paying the MFN tariff, and will therefore be able to charge the price  $P_1$  while remaining competitive in the export market. So, exports from the country in Figure 1 will increase to  $(Q_4 - Q_1)$ .

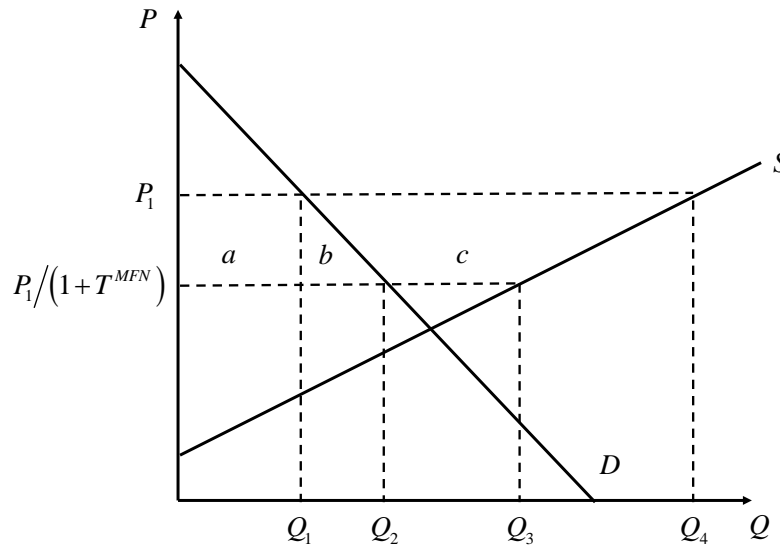
What are the welfare effects for the preference-receiving country? Consumers are worse off than before, because when the price charged for exports increase, domestic price will also increase.<sup>3</sup> Consumer surplus therefore decreases by areas  $a$  and  $b$  in Figure 1. On the other hand, producers gain, both because they can charge a higher price on their original sales, and because they will increase output. In Figure 1, the welfare gains for producers equal areas  $a$ ,  $b$  and  $c$ . The net gain in welfare is therefore given by area  $c$ .

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<sup>2</sup> The presentation closely follows Grossman and Sykes (2005). The analysis builds on the usual assumptions of perfect competition and trade in a homogeneous product.

<sup>3</sup> For simplicity it is assumed that the country receiving preferences uses an MFN tariff that is greater than the MFN tariff imposed by the country granting preferences. As explained carefully by Grossman and Sykes (2005), if this condition is not fulfilled the country will gain even more.

**Figure 1. Simple analysis of effects of trade preferences for recipient country**



So, to summarize, the country being granted preferential access gains for two reasons: (i) it can charge a higher price than before for its exports, and (ii) it will export a larger quantity of goods. Considering the fact that the difference between preferential and non-preferential export prices represent the tariff revenue that used to be collected by the donor country's government, it should be clear that trade preferences involve a voluntary transfer of resources from the donor to the recipient countries. Following Olarreaga and Özden (2005), this price difference will for future reference be called the *tariff rent*. Below, it will be discussed how the analysis changes if either the group of preference-receiving countries are large and therefore can influence the price, or firms in the importing country have market power and can capture part of the tariff rent.

It is fair to say that almost all of the discussion about effects from preferences has centred on whether or not developing countries' export earnings would rise. However, as noted above, preferences were also supposed to "promote industrialization". How should this be interpreted? Presumably, the goal should be read as a diversification of the economy, going from a dependence of a limited number of primary products to also producing and exporting a widening range of manufactured goods. Is it theoretically sound to expect trade preferences to open up possibilities to produce and export new products?



At the time non-reciprocal trade preferences were introduced, to the extent that this was discussed, theoretical explanations revolved around infant industry arguments (see Bartels and Häberli 2010 for a nice discussion of how e.g. Raúl Prebisch – the first Secretary-General of UNCTAD – explicitly linked trade preferences to infant industry arguments). Simply put, the argument is that if there are positive learning externalities in the products for which tariff preferences are offered, developing countries could protect their infant industry behind a high tariff (possible because of the non-reciprocal nature of preferences) and thanks to the export opportunities created by preferences build up production that over time would become competitive.

Infant industry arguments are today met with much more scepticism among researchers. However, it is also possible to argue for a positive diversification effect by using heterogeneous firm trade theories (see e.g. Melitz 2003 and Chaney 2008). In this type of theoretical setting, the lowering of trade barriers – such as tariffs – is expected to have a positive effect on both the intensive and the extensive margins of trade. Focusing on the extensive margin, with lower trade barriers, more firms will be productive enough to cover the costs of trading. This suggests that trade preferences could help more firms to become exporters, and from that, one could hypothesize that a larger number of export products would follow.

While there are therefore reasons for expecting a positive link between trade preferences and export diversification, it should also be pointed out that an effect in the opposite direction is not inconceivable. As will be discussed further below, preference regimes do not necessarily cover all products, and even if they do, there can be differences in preference margins between products. For a country with poor supply-side conditions, there is a risk that limited resources are pooled into the production of a few products with particularly high preference margins. In other words, the link between trade preferences and export diversification and industrialization is less theoretically clear than the link between trade preferences and export earnings.

## **4 How can one tell if preferences work?**

In the policy debate about trade preferences, a common criticism have been that they have failed to increase developing countries' *share* of industrialized nations' imports. From this observations, some commentators have drawn the conclusion that trade preferences do not work. Is that a reasonable conclusion? From a research perspective, it is not entirely convincing, because it ignores all other factors that simultaneously have an impact on recipient and non-recipient countries' trade. As argued by for instance Persson and Wilhelmsson (2007), to properly assess the effects of trade preferences, it is necessary to construct a convincing counterfactual. In other words, how would trade flows have evolved

without trade preferences? Even if trade flows have been disappointing, it is entirely possible that the trade record would have been even worse without preferences, and in that case, it is not appropriate to blame this particular policy. One way to compare the actual trade outcome under trade preferences with a reasonable counterfactual is to use the gravity model. Persson (2012) offers a review of the literature concerning the various systems of EU trade preferences. While there is no strong consensus about the magnitude of expected effects, many empirical papers do actually find significant effects when applying gravity models.

Another criticism that has often been raised is that traders that could request preferential treatment do not. Investigating *utilization rates*, i.e. the ratio between imports that do receive preferential treatment, and imports that could potentially have received preferential treatment, some analysts have used low utilization rates as evidence that trade preferences do not work. Is this a good measurement of how well trade preferences work? Well, it can be instructive to study utilization rates. For instance, low utilization rates could be a sign that there are costs associated with requesting preferential treatment – many have for instance highlighted costs associated with rules of origin. Indirectly, low utilization rates could also be indicative of small differences between preferential and non-preferential tariff rates. However, there are more direct ways to investigate both these issues, and, more importantly, by focusing on utilization rates, one misses at least two important perspectives. First of all, utilization rates cannot tell how big the trade effects actually are, and that is really what we are interested in. For instance, even if the utilization rates are 100 per cent, this could correspond to a small trade effect or a very large effect, depending on the design of the system. Those particulars matter. Second, by only focusing on products where there is actually some trade from beneficiary countries, the idea that preferences should expand the range of export products is hidden. The fact that there is no trade in many products even though they on paper can be exported under trade preferences is very informative for someone analyzing the effects of preferences, and should be taken into account.

To conclude, while it can certainly be worthwhile to investigate trade shares and utilization rates, it is not recommendable to stop there. Instead, a proper assessment of trade effects should ideally (i) create a reasonable counterfactual, (ii) look directly at actual trade outcomes (if possible preferably at the product level) and (iii) not forget to consider the extensive as well as the intensive margin of trade.

## **5 Factors influencing whether or not preferences are valuable**

In practice, preference programs often differ a lot in their precise design, and these differences help determine whether or not the recipient countries can actually use the preferences to increase and diversify

their trade. This section offers an overview of the most important characteristics in this respect. In some sense, it could be interpreted as a check list for issues that ought to be considered by policy makers when designing a system of trade preferences.

## 5.1 Preference Margins

One of the most important factors in determining the potential value of trade preferences is the preference margin, i.e. the difference between the preferential and non-preferential tariff rates. The higher the margin, the larger the value of the preference.

In the simplest setting, the preference margin can be defined as the difference between the applied MFN rate and the preferential tariff rate:

$$(Eq. 1) \quad M_{ijkt} = T_{ikt}^{MFN} - T_{ijkt}^{PREF}$$

where  $M_{ijkt}$  is the preference margin on imports to country  $i$  from exporter  $j$  in product  $k$  at time  $t$ ,  $T_{ikt}^{MFN}$  is the applied most favoured nation tariff rate and  $T_{ijkt}^{PREF}$  is the preferential tariff rate. From equation 1, it is evident that it may well be in the preference recipient country's interest for the preference granting country to maintain high MFN rates while also offering low preferential rates, since this implies high preference margins. When MFN rates go down, the preference rates will also have to fall in order for the preference margin to be maintained, but there is of course a natural limit to how low preferential rates countries can apply. When the MFN rate reaches zero – and this is now the case for a relatively large number of products imported to the major preference donors – there can by definition not be any preference margins, and the policy can no longer be effective. This issue of preference erosion has always been part of the discussion about trade preferences, and it introduces an interesting link between trade preferences and the chance of moving forward with multilateral trade negotiations. This will be discussed further below.

While the discussion above is relevant as a reference point, in most cases, the situation is more complicated. The problem arises because it is far from obvious that the MFN rate is the relevant reference rate with which to compare a country's preferential rate. Some of the major donors – examples include the US and the EU – do not just have one set of unilateral trade preferences, but offer additional regimes targeted at specific groups of countries. Because preferential rates vary across preference programs, in reality, there can therefore be a whole range of other preferential rates to compare with. If one also takes into account that other trade partners may face very low or zero tariffs as members of free trade areas or

customs unions, the idea of comparing the preferential rates to that paid by other trading partners becomes even more complicated. In essence, to capture a meaningful preference margin, it would be advisable to take into account both the complex web of preferential rates available, as well as who the actual competing exporters are for the particular product, and what rate they are paying. For a discussion on this, see e.g. Cipollina and Salvatici (2011).

## 5.2 Product Coverage

Preference regimes do not have to – and in many cases do not – include all products. In fact, in a sense, they were originally not even meant to cover all products. Instead, current thinking when the policy was first discussed in the 1960s was that in order for developing countries to achieve the goal of industrialization, preferences should cover mainly manufactures and semi-manufactures. This was even explicitly stated in Resolution 21 (II) from UNCTAD 1968 (for more on the historical background regarding product exclusions, see Bartels and Häberli 2010). As noted by Bartels and Häberli (2010), many early GSP schemes did in fact exclude all agricultural products, even though this has changed in later schemes.

What are the important things to keep in mind when analyzing how the product coverage affects the value of preferential schemes for the recipient country? A first, sometimes underappreciated, point is that it does not really matter whether products where the MFN rate is zero are included. Any empirical description of preferential regimes with respect to product coverage therefore ought to make sure to only analyze products where there can actually be a positive preferential margin.

Looking at all dutiable products, a baseline argument would be that the more of these that are included, the higher is the *potential* value of preferences. In this simple sense, more products on offer will therefore increase the value of a preferential scheme for the recipient country.

However, an argument can be made that the range of products on offer is largely irrelevant and that what matters are *which* products that are included. Empirically, it is often the case for particularly smaller developing countries that a few products, or even just one, completely dominates the country's exports. Whether or not those few key products where the country has strong comparative advantages are included could then be seen as more important than the inclusion of a large number of products that the country has never exported.

Is this a good argument? While there is certainly a point in emphasizing the importance of key products where a given country can be expected to export large volumes, it is worth remembering that trade growth does not have to happen along the intensive margin, but could also be the result of the

country starting to export new products, i.e. trade growth at the extensive margin. When countries start to export new products, this also has the added benefit to reduce the countries' overall vulnerability to price volatility on the world market. Therefore, evaluating preferences solely on the basis of what is historically perceived as comparative advantages is a risky strategy, and the inclusion in preference schemes of non-traditional export goods could be valuable. It is also worth pointing out that when only some products receive preferential treatment, the risk of distorted investments increases (see discussion below).

### 5.3 Country coverage

A central part of the rules on unilateral trade preferences is that if a country grants them, it should not discriminate between developing countries, except for the fact that LDCs can be treated even more favourably than other developing countries. In principle, one would therefore expect that preference schemes either cover all developing countries (however defined), or at least all LDCs. This is empirically speaking not always the case. The EU, for instance, has historically been granting trade preferences in a notoriously complex web of systems (see Wilhelmsson and Persson 2012 for a thorough overview), and the US has several regionally based preference schemes in addition to the GSP. In many cases, there is a geographical overlap, so that countries are eligible for, say, either ACP preferences or GSP preferences.

Does the coverage of countries within a system matter for an individual preference recipient country? Referring back to Figure 1, if the recipient group as a whole becomes large enough to be able to influence export prices, the export price for preference-receiving countries will not remain  $P_1$ , but will decrease to some lower price level because of the increase in the world export supply. This will have a negative effect on the tariff rent that recipient countries benefit from. Therefore, from this perspective, it is not in an individual country's interest that more countries are included in a program (of course, it is not simply the number of countries that matter, but rather their economic size, and whether or not they are competitors in the same product). In addition, one of the advantages of trade preferences for the countries that experience the lowest tariff rates is that this may lead to trade being diverted from countries lacking preferential access (see more on this below). The more countries that are included in the same scheme, the smaller is the likelihood that an individual country benefits from trade diversion.

However, there is interestingly also an argument to be made in the other direction. A common explanation for the low utilization of some preferential regimes is restrictive rules of origin. This will be discussed in further detail below, but note here that if the rules of origin for instance allow so-called full cumulation of origin, intermediates from other beneficiaries of the same preference system could be imported and used in the production of an export good that nevertheless will be counted as originating in

the last country. Since a larger number of preference recipients will increase the total market from which intermediates can be bought, this could therefore increase the chances of buying intermediates from the lowest-cost supplier while still following the rules of origin. This could make it easier to use the preferences on offer.

## 5.4 Stability of access

An important aspect of the Enabling Clause is that it gives developed countries the *right* to grant developing countries unilateral trade preferences as long as certain conditions (such as non-discrimination) are fulfilled, but it does not state that they have an *obligation* to do so. In other words, trade preferences given in accordance with the Enabling Clause – i.e. GSP-type preferences – are voluntary, and can therefore be withdrawn or altered unilaterally by the preference-granting countries. Before discussing the implications of this, it is worth pointing out that this sets GSP preferences apart from other preference schemes that are not covered by the Enabling Clause. For instance, EU preferences for ACP countries used to be offered in the various Lomé Conventions, signed by both the EU and the ACP countries. This contractual form created a legally binding commitment to offer the preferences for the time period that had been agreed in the conventions.

The fact that trade preferences can be unilaterally withdrawn or altered by the donor at short notice has some interesting economic implications. On the one hand, it makes sense from the perspective of the preference-granting countries that they should be able to make changes if the offering of preferences causes problems for their domestic economies. Indeed, that preferences were to be voluntary rather than an obligation is widely seen to have been a necessary condition to get industrialized countries on board with the idea in the first place. On the other hand, the right for donors to make unilateral changes at short notice also creates a great deal of uncertainty for firms potentially interested in making use of preferential access. In many cases, setting up production to produce export goods under preferential access to industrialized countries' markets will require making some degree of investments. If the firm cannot be reasonably certain of being able to make use of preferences for at least a few years, making those investments might not be rational.

One way to alleviate the problem of uncertain market access is to grant preferences for longer periods at a time – say ten years – rather than replacing and updating the regimes every year which historically was often the case. The EU has for instance gone in this direction with its GSP preferences.<sup>4</sup>

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<sup>4</sup> In fact, preferences to LDCs under the Everything But Arms (EBA) scheme is offered indefinitely, which should help reduce the problem of insecurity.

Still, even if preferences are offered for longer time periods, donor countries typically retain the right to exclude products or whole countries under certain conditions. Exclusions could be made on the basis of safeguard rules if domestic industries are threatened by sudden surges of imports, and rules on *graduation* establish that countries can lose preferences for single products or sectors, or for the country as a whole if preferences are deemed no longer necessary (the exact conditions and justifications for graduation differ between programs). The existence of safeguards and graduation implies that countries that are successful in using trade preferences could lose them, and this reinforces the difficulties with making long-term investment decisions.

While the practice of granting trade preferences for longer time periods at least increases the transparency of preferential market access – since recipient countries will then to some extent know under which conditions preferences could be withdrawn – the problem of uncertainty still remains to a large degree. However, recently, Bartels and Häberli (2010) made an interesting proposal that could be helpful. These authors point out that it is possible under existing WTO rules to use binding obligations as a tool for increasing the predictability of market access. Specifically, Bartels and Häberli (2010) propose that countries should be obligated to bind their currently voluntary preference schemes using the mechanisms outlined in Article II of the GATT. They also suggest that objective and transparent criteria for when developing countries and their products can be excluded from preference programs should be established, and that these exclusions – just as the preferences themselves – should be bound. It remains to be seen whether these proposals will be implemented in the future, but they do offer a way to make unilateral preferences easier to use for developing countries. In that sense, they would increase the actual value of preference programs.

Lastly, while the problems associated with the ability for preference donors to unilaterally change or withdraw preference schemes is likely one important reason for the underutilization of preferences, it should be pointed out that it is hard to envision a situation where countries enjoy a secure and predictable preferred market access for any longer period of time. The reasons for this are the same as the ones discussed in relation to how to properly capture the actual preference margins: preferences can be eroded for a number of reasons, such as changing MFN tariffs, changes in the number of beneficiaries, or other trading partners entering free trade areas or customs unions with the preference donor. In that sense, the actual value of preferences can be expected to change even if nothing changes with the preference regime itself.

## 5.5 Rules of origin

A potential problem with discriminatory trading arrangements is trade deflection. In the case of unilateral trade preferences for developing countries, trade deflection involves the risk that products from countries not granted preferential access – such as other developed nations – are exported to a country receiving preferences, only to then be re-exported at a preferential rate to the preference donor. If this is the case, preferences are de facto granted to other countries than the intended beneficiaries, and therefore, preference programs are usually associated with rules of origin to prevent trade deflection from taking place.

While the use of rules of origin is warranted, a common criticism is that the rules of origin associated with unilateral trade preferences are unnecessarily restrictive and cause costs that either reduce the value of preferences or even prevent countries from requesting preferential treatment. Restrictive rules of origin can cause costs for traders in at least two ways. First, there are administrative costs for proving that the rules of origin are met. Demands on documentation can be excessive, and it is well known from the literature on trade facilitation that such barriers have potentially substantial effects on trade volumes (for an overview on the literature on trade facilitation and its links to the literature on trade preferences, see Persson 2012). Second, restrictive rules of origin can also lead to resource waste, because it severely limits the use of intermediates that are not domestically produced. Unless the cheapest source of inputs happens to be in the domestic market, a producer may have to choose between buying intermediates relatively expensively at the home market, and then being able to export under preferential tariffs (because the rules of origin are fulfilled), or importing inputs from the lowest-cost source, and then exporting the final good at the MFN rate. Unless preferential margins are high enough to more than compensate for the extra cost of buying unnecessarily expensive inputs from the local market, the producer may then decide that it is not worth the trouble to use the option of preferential market access. Further, for producers in small markets, it may not even be possible to buy intermediates domestically, making it potentially impossible to use preferences for other than, for instance, agricultural goods or other primary products. This clearly does not have a positive effect on the stated goal of industrialization. For an overview on rules of origin, see e.g. Cadot and de Melo (2008).

When analyzing the impact of rules of origin on the potential value of preferences for recipient countries, an important thing to keep in mind is that there is no standardization for rules of origin. Instead, typically rules of origin not only differs between donors, but they can also vary between preference systems from the same donor country. One implication of the variation in rules of origin is that the implied costs for traders differ, and therefore, the potential value of two otherwise identical preference programs will also vary accordingly. However, the difference in rules of origin across systems could also, in itself,



cause extra costs for traders. If an exporting firm wants to export the same product to several markets under preferential tariffs, it will be costlier to learn several systems, and it may not even be possible to adjust the production process so that it conforms with all technical requirements in the product-specific rules of origin.

## 5.6 Conditionality

In order to be compatible with the Enabling Clause, trade preferences should be non-reciprocal. In other words, no claims should be made for the recipient developing country to offer matching tariff concessions. However, it is permissible for donors to make other types of demand on recipient countries, and arguably, these side-conditions can affect how much trade preferences are actually worth for the beneficiary.

Empirically, there are examples of both *negative conditionality* where trade preferences are withdrawn if countries do not live up to certain non-trade standards, for instance regarding core labour rights, and *positive conditionality* where countries that do comply with various conditions, for instance regarding environmental or labour standards, are rewarded by additional tariff cuts.<sup>5</sup>

Negative and positive conditionality in preference programs generally has less to do with responding to the economic needs of recipient countries than with advancing a political agenda seen by the donor as important. Whether or not that is appropriate is a normative question which reaches beyond the scope of this paper. However, from a practical standpoint, given that trade preferences are “gifts” of a kind, it is hard for developing countries to protest too strongly, since the donor countries could respond by removing all preferences if they choose.

What are the economic consequences of conditionality? Starting with positive conditionality, the question for any given recipient country is whether the costs – whether economic, political or otherwise – of complying with the specified standards exceed the trade benefits from additional tariff cuts or not. If benefits are higher, then the country can apply, and will be better off. However, an interesting situation arises if the compliance costs are higher than the benefits. In this situation, if the country does not apply, it may be in a worse situation than if the donor had not offered additional preferences to anyone. The reason is that when the discrimination among developing countries increases, and that is what happens with positive conditionality, there is a risk of trade diversion in favour of the preferred countries. In other words, positive conditionality may affect all developing countries, and not just the ones that can comply with the conditions.

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<sup>5</sup> For discussions about conditionality in the EU GSP regime, see Zhou and Cuyvers (2011) on negative conditionality and Bartels (2003, 2007) or Turksen (2009) on positive conditionality.

When it comes to negative conditionality, from an economic perspective the most important consequence is presumably that it increases the degree of uncertainty, because countries can become excluded from preference schemes at short notice. Typically, the rules for exclusion are not very transparent and it can be hard to know for a country whether or not it is at risk of becoming excluded. However, even if rules are reasonably clear and the government has a good chance of predicting whether the country is at risk of exclusion, for an individual firm without access to the same information, it will most often be very difficult to get a good insight into how likely an exclusion is. This uncertainty, just as discussed above, can lower the value of preferences by making it harder for countries to make effective use of them.

## **5.7 Market conditions/Competition**

As discussed above, under the assumptions of perfect competition and homogeneous goods, exporters enjoying duty free market access under a preferential agreement are expected to experience a price increase equal to the amount of the tariff. If, however, there is a lack of competition among importing firms, then, as pointed out by Olarreaga and Özden (2005), these importing firms may have the chance to influence prices and capture part of the tariff rent. In order for trade preferences to work, the question of market power among importing firms in the donor country is therefore relevant. Olarreaga and Özden (2005) use data on apparel trade under AGOA to test whether higher concentration among importers indeed leads to lower rents to the exporters. Interestingly, they do find evidence for this, with data suggesting that exporters on average receive one third of the tariff rent, with even lower shares for exporters in poor and small countries.

So, a more general conclusion would be that market structure matters when determining how much preferences are worth for exporters. What are the policy implications of this? Well, if donors are serious about their intention to assist developing countries' trade prospects, one way to do that could be to look over domestic competition policies. Also, from the perspective of the preference receiving countries, policies aimed at increasing the bargaining power of exporting firms could help make sure that they capture a larger share of the tariff rent. This would help make sure that trade preferences work as intended.

## **5.8 Export capacity**

This paper has reviewed a number of characteristics of trade preference programs that in various ways can influence whether or not recipient countries effectively can use the preferences to increase and diversify

their exports. As a final comment, it is therefore appropriate to point out that local conditions could be just as important explanations for developing countries' potential lack of export growth.

Clearly, many countries that are eligible for trade preferences have fairly poor supply-side conditions – indeed, this is part of the reason for granting preferences in the first place. Lack of an adequate infrastructure, poor institutions etc could be factors that impede production and trade of many goods, and it is far from obvious that simply lowering tariffs in major export markets will be enough to offset these problems. Therefore, properly assessing whether trade preferences work should also include asking the question: are trade barriers really the main obstacle for development, or could it be that many preference-receiving countries would not export most goods even when faced with an ideal preference program, including zero tariffs?

## **6 Unintended and problematic consequences**

This far, the discussion has focused on issues that can explain why trade preferences may not always meet the intended effects, and it has implicitly been assumed that it is a good thing if preferences do work. However, the use of trade preferences can also lead to side effects of a negative nature. This section will briefly discuss some possible side effects.

### **6.1 Trade diversion**

With any discriminatory trading arrangement, there is a risk of trade diversion. In the context of unilateral trade preferences, trade diversion refers to the situation when the preference-granting country imports products from an inefficient producer in a country granted preferences, rather than a low-cost producer in the rest of the world. That can happen if the price including MFN tariff of products from the low-cost producer in the rest of the world is higher than the price including a (lower) preferential tariff from the preference-receiving country. When trade diversion occurs, it will have negative welfare consequences for both the donor country and the rest of the world, even though the preference-receiving country will benefit.

Is this a severe problem? If there had only been two groups of countries: developed country exporters that pay MFN tariffs and developing country exporters that pay preferential tariffs, trade diversion in favour of the latter group might be seen as acceptable. After all, the point of trade preferences is – in a sense – to allow a transfer of resources from industrialized countries to developing countries (note

though that not only the country deciding to grant preferences will pay but also its trading partners). Even if we allow two groups of developing countries, where LDCs are given better market access than other developing countries, trade diversion from the latter group in favour of the former could possibly also be seen as acceptable, although that is a more controversial issue. The empirical reality is, however, even more complicated. The major donors, such as the EU and the US, have historically offered and are still offering special preference programs that are targeted towards limited groups of developing countries based on for instance geographical location, historical relationships or political rational. These programs are sometimes outside the realm of the GSP, but can also be implemented as special arrangements within wider GSP regimes. The result is that some group of developing countries is offered better market access than other groups, and this creates a risk of trade being diverted from one group of developing countries to another, where countries in the disadvantaged group could very well be on the same or even a lower developmental level than the favoured countries. This is hard to justify.

Is it an empirically relevant problem? Borchert (2009), studying various preference schemes offered by the EU, finds evidence of substantial trade diversion between developing countries. This suggests that other developing countries are indeed hurt by the trade preferences offered to a specific group of countries.

## **6.2 Investment distortions**

When a preference program has a non-universal product coverage and/or there is variation across products regarding preference margins, there is a risk for misallocation of resources within the country. Investors may choose to invest in sectors where there is a substantial tariff rent, rather than sectors with an underlying comparative advantage. This waste of resources could further be exacerbated over time, because given the uncertainty of market access under unilateral preference programs, an investment made on the basis of preferential market access today could be all but useless if the preferential advantage disappears. Section 5 will hopefully have illustrated that such a change in actual preferential market access can happen for any number of reasons, and does not have to be the result of for instance graduation.

However, preferences may not only create a risk of resource misallocation within the recipient country. Trade preferences are by definition discriminatory, and this discrimination among trade partners creates the risk of foreign direct investment flows being diverted away from countries lacking preferential market access, in favour of countries with possibly less advantageous country-specific characteristics, but preferential trading status. With a spaghetti bowl of unilateral trade preferences offering varyingly

generous market access to groups of developing countries, the countries that are disadvantaged due to investment distortions could very well be developing nations.

### **6.3 Effects on recipient country's trade policy**

It has been pointed out by Özden and Reinhardt (2005) that non-reciprocal trade preferences could have a negative effect on liberalization of developing countries' own trade policies. There are two main arguments behind this hypothesis. First, a common way to think about the benefits of reciprocity is that while the import-competing sectors may have an incentive to lobby for import barriers, this protectionist political pressure will be counteracted by the export sectors who lobby for trade liberalization at home in order to achieve better market access in their export markets. Since unilateral trade preferences are offered without demands on reciprocal concessions, this mechanism no longer works, and therefore the political balance shifts in favour of import-competing sectors. The result could be slower liberalization of the countries' own trade policies. Second, Özden and Reinhardt (2005) also point out that the effect could be made worse by domestic politics within the donor countries. With limited opportunities to influence trade policy in a protectionist direction due to ordinary MFN tariffs being bound, political pressure to protect domestic industries will be directed towards the non-reciprocal trade preferences. As argued by Özden and Reinhardt (2005), knowing that too large export increases therefore would risk leading to the removal of trade preferences, a perverse incentive arises for developing countries to adopt protectionist policies to limit its own exports. Investigating countries eligible for the US GSP from its beginning in 1976 until 2000, Özden and Reinhardt (2005) find empirical evidence to support these hypotheses. Even when considering problems of endogeneity, countries that become excluded from the GSP regime adopt more liberal trade policies than countries that remain eligible. Thus, a negative consequence of unilateral trade preferences could be that developing countries maintain high barriers to trade.

### **6.4 Obstacle for multilateral trade liberalization**

Unilateral trade preferences are by definition discriminatory, because if not at least some countries face tariffs, you cannot give other countries a competitive advantage by letting them pay lower tariffs. This creates a problem in multilateral trade negotiations, because, all else equal, if MFN tariffs are lowered, preference margins will fall, and developing countries will therefore lose. This is the well-known problem of *preference erosion*. As long as MFN tariffs are high, it is in principle possible to compensate developing countries for the preference erosion by also lowering preferential rates. This can offset the

incentive developing countries would otherwise have to block multilateral liberalization. However, the more MFN tariffs fall, and the lower the corresponding preferential rates are, the harder it is to fully compensate developing countries. In fact, empirically speaking, many developing countries – and especially the LDCs – today face zero tariffs on much of their exports to major industrialized countries, and that implies that any further lowering of MFN rates must necessarily lower the preference margins these countries enjoy. Therefore, the objective to keep preferential margins from eroding has by now created an incentive for at least some developing countries to work against further multilateral liberalization. For more on this issue, see e.g. Francois, Hoekman and Manchin (2006), Limão and Olarreaga (2006) or Amiti and Romalis (2007).

## **7 Concluding remarks**

Historically, the policy of unilateral trade preferences has been central in North-South trading relations. Will it continue to be an important tool for developed nations wishing to assist trade expansion and diversification in developing countries?

There is reason to believe that, in the short and medium term, the answer could be yes to that question. The key is then to reform preference programs so that they are as efficient as possible in answering the needs that developing countries have, while at the same time minimizing the negative side effects. This paper has discussed a large range of issues connected to the design of preference systems, and that discussion could serve as a basis for a reform agenda. To offer a few concrete examples, one reform area could be to offer universal product coverage in all preference programs. This would reduce preferences' distortive effects, increase the chance of trade growth at the extensive margin and make sure that key comparative advantage products are not systematically excluded as a response to protectionist political pressure from the donor countries' import-competing sectors. Second, by transforming the current spaghetti bowl of preferences into two preference variants per donor – one for all developing countries, and additional preferences for LDCs – the negative consequences of discrimination among developing countries could be reduced. Of course, the currently most preferred countries would lose some of their benefits, but overall there would be a reduction in trade and investment diversion. Third, increasing the security of preferential market would make it easier to make long-term investments. Concretely, donor countries could increase the transparency and predictability of safeguards, graduation and negative conditionality, and preferential tariff rates could be bound like ordinary MFN tariffs. Fourth, by liberalizing rules of origin, the costs of requesting preferential treatment could be greatly reduced. Fifth, if various rules were harmonized across donors' programs, this would reduce the costs for traders of

learning to use the various systems, without necessarily making the rules any less efficient. Examples here could include rules on safeguards, rules of origin or graduation.

While unilateral trade preferences therefore arguably could remain relevant for a period of time, it is nevertheless hard to see that this policy could be effective in the long term. At the heart of the policy is the principle that developing countries are given an advantage by paying a lower tariff rate than developed countries. In other words, for the policy to work, there must be some countries that still pay tariffs. Yet, the group of countries that pay MFN tariffs is steadily shrinking. Regardless of whether progress is made in multilateral trade negotiations, trade barriers are continuously being removed in many countries, either unilaterally or as part of agreements on free trade areas or customs unions. While the process of tariff dismantling could still take some time, it would therefore seem advisable for the stakeholders involved to start looking for other policies to replace unilateral trade preferences.

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