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**Working Paper**

## Special and differential treatment in the WTO: Why, when and how?

WTO Staff Working Paper, No. ERSD-2004-03

**Provided in Cooperation with:**

World Trade Organization (WTO), Economic Research and Statistics Division, Geneva

*Suggested Citation:* Keck, Alexander; Low, Patrick (2004) : Special and differential treatment in the WTO: Why, when and how?, WTO Staff Working Paper, No. ERSD-2004-03, World Trade Organization (WTO), Geneva,  
<https://doi.org/10.30875/f567d449-en>

This Version is available at:

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**World Trade Organization**

Economic Research and Statistics Division

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**Special and Differential Treatment in the WTO: Why, When and How?**

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Manuscript date: January, 2004

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## **SPECIAL AND DIFFERENTIAL TREATMENT IN THE WTO: WHY, WHEN AND HOW?**

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### **Abstract**

Special and differential treatment (S&D) for developing countries continues to be a defining feature of the multilateral trading system. This paper seeks to address key aspects of what has become an increasingly entangled and multi-faceted discussion. The paper begins by reviewing the historical context in which the relationship of developing countries with the multilateral trading system evolved, in order to shed some light on how the lines of the debate are drawn today. The paper distinguishes several elements in the case typically made for S&D. It argues that concerns about graduation – the definition of which countries qualify for special treatment – have complicated progress on this issue, suggesting that a focus on measures rather than on country status would obviate this difficulty, while at the same time increasing the analytical underpinning of the case for special and differential treatment. The paper explores various forms of S&D and develops arguments for particular approaches to the design and management of access to S&D. An illustration is provided of how a more analytical approach would work by defining eligibility automatically in relation to measures rather than countries.

**JEL classification: F13, O19, O24.**

**Keywords: special and differential treatment, WTO, trade policy, development.**

Disclaimer and acknowledgements: The opinions expressed in this paper should be attributed to the authors. They are not meant to represent the positions or opinions of the WTO and its Members and are without prejudice to Members' rights and obligations under the WTO. The authors would like to thank Bernard Hoekman, Shiela Page and participants at the World Trade Forum 2003 (Berne, 16-17 June 2003) organized by the World Trade Institute and World Bank for their comments on earlier drafts of this paper. All remaining errors and omissions are the fault of the authors.

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## I. INTRODUCTION

In one form or another, special and differential treatment (S&D) has been a defining feature of the multilateral trading system for most of the post-war period. The battle to establish the principle that a set of uniform multilateral rights and obligations among a deeply diverse set of nations could not serve the best interests of all parties was won a long time ago. The current S&D debate occasionally gives the impression that some beneficiary governments want to fight that battle again. The impulse may stem from frustration – from the sense that more advanced countries in the system are unresponsive to the real needs of developing countries. It may also reflect a reluctance or an inability to engage debate and undertake analysis at a level of detail and specificity that is indispensable to a worthwhile outcome. The WTO is an international agreement subscribed to by over twelve dozen governments with widely differing priorities, presiding over economies with widely divergent characteristics. If accommodation on the key issue of how these divergences are to be managed in the common interest eludes the Members, the system itself will be under threat. Its multilateral character and all the benefits flowing from a "universalist" vision will be vulnerable. In the immediate context, better understandings among Members on how to define S&D and manage the question of which members should have access to it seem to be an indispensable condition of success in the Doha negotiations.

This paper seeks to address key aspects of what has become an increasingly entangled and multi-faceted discussion.<sup>1</sup> It begins in Section II by reviewing briefly the historical context in which the relationship of developing countries with the multilateral trading system evolved. The historical perspective may help in explaining how the lines of the debate are drawn today. Section III is the body of the paper. It distinguishes five elements in the case typically made for special and differential treatment – a political right, a right to preferential market access, a right to additional levels of import restriction, a right to export subsidies otherwise prohibited, and a right to flexibility in the application of a range of non-tariff or "behind-the-border" rules. On the basis of these distinctions, the paper explores, in section IV, various elements of S&D and develops arguments for particular approaches to the design and management of access to special and differential treatment. Section V summarizes the conclusions of the paper.

## II. A BRIEF HISTORY OF SPECIAL AND DIFFERENTIAL TREATMENT

An appreciation of the evolution of provisions designed specifically for developing countries in the multilateral trading system provides a helpful perspective in considering the issue of S&D today in the context of the Doha agenda. For this very brief account of how the S&D issue has evolved in the GATT/WTO system, four phases can usefully be distinguished.<sup>2</sup> The first phase is from the creation of the GATT in 1948 to the beginning of the Tokyo Round in 1973. The second phase is the Tokyo Round itself, from 1973 to 1979. The third phase is from the end of the Tokyo Round to the end of the Uruguay Round, that is from 1979 to 1995. The fourth phase is from the end of the Uruguay Round until the present. These phases have been chosen because they each encompass significant events and tendencies in relation to the participation of developing countries in the multilateral trading system.

The first phase, up to the beginning of the Tokyo Round in 1973, was dominated by market access questions, in particular the conditions of access for developing country exports to developed country markets. A notable landmark during this period was the twelfth session of the GATT Contracting Parties, held at Ministerial level in 1957. At that meeting, agricultural protectionism, fluctuating commodity prices and the failure of export earnings to keep pace with import demand in developing

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<sup>1</sup> For further discussions on S&D, see for example, Fukasaku (2000), Hoekman et al. (2003), Hudec (1987), Kessie (2000), Michalopoulos (2000), Pangestu (2000), Prowse (2002), Stevens (2002), Whalley (1999), and WTO Secretariat (1999).

<sup>2</sup> Parts of this section have also been used in WTO Secretariat (2003a).

countries were identified as undesirable features of the international trading environment. A Panel of Experts was established to examine trends in international trade in light of these concerns. The Panel was chaired by Professor Gottfried Haberler. The 1958 Haberler Report confirmed the view that developing country export earnings were insufficient to meet development needs and focused primarily on developed country trade barriers as a significant part of the problem, although the report also criticized some developing country trade barriers. In response to Haberler, GATT Contracting Parties established three committees to develop a co-ordinated Programme of Action Directed Towards an Expansion of International Trade. Committee III focused on barriers to exports maintained by developed countries. By 1963, Committee III had drawn up an eight-point Plan of Action, which among other things called for a freeze on all developed country trade barriers on products of interest to developing countries and the removal of all duties on tropical and other primary products. The Programme of Action became part of the Kennedy Round (1964-1967) and was never implemented to a significant degree. The impression of repetitious similarity between what was happening in this area forty years ago and the discussion today is unavoidable.

On the institutional front, the shift in development thinking initiated by the Prebisch-Singer thesis was enshrined in the United Nations Conference on Trade and Development (UNCTAD), established in 1964.<sup>3</sup> The birth of UNCTAD, the growing number of newly independent states following decolonization in Africa, Asia and the Caribbean, the Cold War, and the success of developing countries in placing their issues centre-stage in the GATT all contributed to the decision to establish Part IV of the GATT in 1965.<sup>4</sup> Part IV consisted of three Articles on Trade and Development.<sup>5</sup> While designed to promote development and developing country interests in the trading system, Part IV was never more than a set of “best endeavour” undertakings with no legal force – a fact that has been the source of dissatisfaction among many developing countries to the present day. One particularly significant feature of Part IV, however, was the assertion of the principle of non-reciprocity in Article XXXVI:8. Non-reciprocity meant that developing countries would not be expected, in the course of trade negotiations, to make contributions inconsistent with their individual development, financial and trade needs. Non-reciprocity has never been more clearly defined than that, and just like the later and closely linked concept of S&D, a definition of reciprocity or its inverse has eluded the precision that might have avoided some of the debates which continue to dominate the discussion of developing country participation in the trading system.

By the time of the second phase in the evolution of this debate (Tokyo Round, 1973-1979), the pendulum in trade policy discussions had started to swing away from import substitution and towards favouring greater export orientation. The inherent limitations and trade-distorting effects of excessive reliance on import substitution were becoming better understood. The move towards a more neutral stance in respect of trade policy incentives implied opening up more to import competition as well as removing the policy bias against exports. From the institutional perspective, Part IV already presaged this second aspect of the trade and development debate in GATT, which was to focus increasingly on developing countries’ own trade policies as well as market access for their exports. It was this tendency, coupled with a strong emphasis on non-tariff trade measures in the Tokyo Round that distinguishes the second phase from the first.

Much of the negotiating involvement of developing countries in the Tokyo Round aimed at limiting the extent to which the new agreements (the Tokyo Round “Codes”) on non-tariff measures would

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<sup>3</sup> It was curious that developing countries were pushing hard in GATT for improved market access for their primary exports at the same time that “export pessimism”, and fear of deteriorating developing country terms of trade resulting from reliance on primary product exports dominated the development debate. The latter reasoning provided part of the justification behind the argument that developing countries should diversify into manufacturing industry through import substitution policies.

<sup>4</sup> The numerical preponderance of developing countries was beginning to assert itself at this time. In 1960, 21 members of GATT were developed countries and 16 developing countries. By 1970 the figures were 25 developed countries and 52 developing countries.

<sup>5</sup> Article XXXVI – Principles and Objectives, Article XXXVII – Commitments, and Article XXXVIII – Joint Action.

impose policy limitations or undue administrative or financial burdens on developing countries. This objective, together with continued insistence on the importance of non-reciprocity in market access negotiations, led to three principle results for developing countries. First, developing countries agreed to limited market access commitments and relatively few tariff bindings. Second, the “code approach” was adopted in respect of the new non-tariff measure agreements, meaning that the agreements only applied to signatories. Many developing countries refrained from signing the various codes, which covered technical barriers to trade, customs valuation, import licensing, subsidies and countervailing measures, anti-dumping and government procurement.

Third, a new framework was established to define and codify key legal rights and obligations of developing countries under the GATT. The 1979 Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries, also known as the Enabling Clause, provided permanent legal cover for the Generalized System of Preferences, for S&D provisions under GATT agreements, for certain aspects of regional or global preferential agreements among developing countries, and for special treatment for least-developed countries. The Enabling Clause also restated the principle of non-reciprocity, as first spelled out in Part IV, and further stated that developing countries expected their capacity to make contributions or negotiate commitments to improve with the progressive development of their economies and improvement in their trade situation. This was the origin of the notion of “graduation”.

Some commentators lauded the flexibility that the Tokyo Round results afforded developing countries, believing it supportive of their development needs. Others considered that the degree of non-engagement implied by these arrangements meant that developing countries gained little from the system. This argument was based on two points – that the GATT did not support developing countries in the formulation of better trade policies, and that because developing countries offered as little as they did in the negotiations, they received little in return from their trading partners. The problem with both these positions, which tended to inform a good deal of the debate during the post-Tokyo Round years, is that they over-simplified reality by failing to distinguish adequately among the dozens of developing countries in the system who faced very different situations and had very different needs. This is a tendency that has persisted to the present and underlies some of the difficulty that the WTO is currently experiencing in its efforts to address S&D issues.

The third phase in the evolution of developing countries in the trading system saw a change in direction in the S&D debate. By the end of this period in 1995, when the Uruguay Round was completed, developing countries had assumed a much higher level of commitments within the system than ever before. A number of factors explain this trend. First, some developing countries had enjoyed rapid growth and had succeeded in diversifying their economies, particularly in Asia and to some degree in Latin America. This made them better equipped to participate more fully in the trading system and changed the nature of their interests in international negotiations. Second, the decade of the 1980s opened with a significant realignment in economic thinking in some major economies, especially the United States. This approach, while not always pursued consistently in the trade policy field by the large trading nations, nevertheless militated against government intervention and emphasized the role of markets, including for development.

A third factor was the sense that the trading system itself needed fixing. The system was trying to confront the challenge of contingency protection provisions, with the increased use of voluntary export restraint arrangements. Regionalism was appearing on the trade policy scene in a more significant way and governments were concerned about the multilateral consequences of this development. Some governments felt it was time for the GATT to tackle agriculture, something it had failed to do for the forty years of its existence. Similar sentiments applied in the case of textiles and clothing. In addition, some developed country governments wished to see the trading system encompass new areas, in particular investment, trade in services and intellectual property rights. Finally, the idea that developing countries ought to assume higher levels of obligation within the system was also increasing in currency.

The single undertaking of the Uruguay Round meant that all WTO members had to accept all agreements<sup>6</sup>, in sharp distinction to the code approach of the Tokyo Round. This alone meant an important range of new developing country commitments within the system. Many developing countries significantly increased their tariff bindings, especially in agriculture. In addition, new agreements in services and intellectual property applied to all through the single undertaking.

The fourth phase began with a significant challenge for developing countries as they prepared to absorb their new Uruguay Round obligations legislatively and administratively, although in many instances developing countries were accorded phase-in periods for the assumption of new obligations. This period also began with a sense among many developing countries that they had not been given an adequate opportunity to participate in the closing stages of the Uruguay Round and had been presented with a *fait accompli*, particularly as a result of the single undertaking. Linked to this feeling of exclusion was the conviction that not all the obligations assumed under the Uruguay Round package were consistent with national economic interests and development priorities.

Discussions have been held in different contexts over the last few years on how to improve the internal working methods of the WTO in order to ensure that all parties who wish to participate in negotiations and decision-making are able to do so. This matter is very important and will continue to be discussed, but does not explicitly form part of the Doha agenda. On the policy side, however, the “implementation” debate was soon engaged and became a major element in the discussions at Seattle, at Doha and beyond. Two distinct elements inform the implementation discussions. One concerns the difficulty some developing countries are encountering as they seek to implement their obligations, bearing in mind the costs, administrative aspects and human capital requirements of implementation. Efforts are being made to address this aspect of implementation through augmented technical assistance and capacity building efforts. The other aspect of implementation relates to the substantive provisions of various WTO agreements. Developing countries are seeking modifications to many provisions on the grounds that they need to be made more supportive of development and/or less restrictive in relation to the degree of policy flexibility afforded developing countries.

Some progress was made on implementation issues at Doha, but elements of this discussion are continuing. At Doha, another exercise was launched, focusing specifically on making S&D provisions more effective. At the same time, Paragraph 44 of the Doha Declaration calls for a review of all S&D provisions “with a view to strengthening them and making them more precise, effective and operational”. Both the implementation and S&D discussions have been the focus of many hours of meetings and many issues remain unresolved.

### **III. WHAT IS THE CASE FOR SPECIAL AND DIFFERENTIAL TREATMENT?**

Discussions on S&D have evolved into a web of propositions upon which the case for differentiated GATT/WTO provisions has been built over the years. The astonishing array of proposals for new and improved S&D provisions currently on the table must be disentangled in order to understand and evaluate the underlying rationale of the proposals. The analysis that follows distinguishes five arguments that have been advanced for S&D treatment. The five categories are as follows:

1. Special and differential treatment is an acquired political right.
2. Developing countries should enjoy privileged access to the markets of their trading partners, particularly the developed countries.
3. Developing countries should have the right to restrict imports to a greater degree than developed countries.

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<sup>6</sup> The only exceptions were the plurilateral agreements on government procurement, trade in civil aircraft and dairy and meat products.



4. Developing countries should be allowed additional freedom to subsidize exports.
5. Developing countries should be allowed flexibility in respect of the application of certain WTO rules, or to postpone the application of rules.

Many of the S&D proposals currently under consideration in the Doha negotiations and work programme fit within one or other of the categories in the above taxonomy. Some, however, do not. The provisions falling outside the designated categories are those that entreat WTO Members to take or prioritize action favouring developing country trade interests, or to refrain from new actions that prejudice those interests. This includes provisions entreating developed countries to provide technical assistance to developing countries. The key characteristic of these provisions is that their effectiveness depends on the willingness of governments to take action or refrain from doing so, and not on legally enforceable commitments. This essentially voluntary character of certain provisions intended to benefit developing countries is usually obvious from the language in which they are couched.

Article XXXVII:3 of GATT 1947, for example, states that developed countries shall "give active consideration to the adoption of other measures designed to provide greater scope for the development of imports from less-developed contracting parties....".<sup>7</sup> The same Article also says that developed countries shall "have special regard to the trade interests of developing contracting parties when considering the application of other measures permitted under this Agreement to meet particular problems....".<sup>8</sup> It is difficult to see how these "best-endeavour" provisions could be given legal force through dispute settlement. Should such provisions be considered as substantive components of special and differential treatment? The answer is probably that they should not, simply because the provisions are devoid of legal security and do not offer an opportunity, beyond moral suasion, for putative beneficiaries to insist on their enforcement.

In Paragraph 12(i) of the Doha Decision on Implementation-Related Decisions and Concerns, developing countries sought to address this question. The mandate calls for Members "to identify those special and differential treatment provisions that are ..... non-binding in character, to consider the legal and practical implications ..... of converting [them] into mandatory provisions, [and] to identify those that Members consider should be made mandatory..." Although this was supposed to have been accomplished by July 2002, agreement has proved elusive. Even for the limited number of proposals on the table in respect of which agreement may be forthcoming as the Doha negotiations proceed, it remains far from clear whether a significant number of best-endeavour provisions will be converted into meaningful mandatory S&D obligations as a result of the exercise.

Some best-endeavour provisions simply could not be made mandatory without creating a legal nonsense. Progress has also been limited because developed countries appear to have been reluctant to consider changing the balance of legal rights and obligations under any agreement outside the framework of negotiations. Developing countries promoting the S&D agenda have been unwilling to prioritize their proposals so as to focus on a smaller number than the six dozen or more on the table. This has rendered difficult an analytical approach to assessing proposals in relation to development needs and has instead made space for a more politicized debate.

For the present purposes, then, provisions of a best-endeavour character are excluded from further discussion. Were developing countries to negotiate successfully for the conversion of non-mandatory

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<sup>7</sup> Article XXXVII:3(b), GATT 1947. The reference to "other measures" is intended to cover such actions as promoting domestic structural changes, encouraging consumption of particular products, or introducing measures of trade promotion.

<sup>8</sup> Article XXXVII:3(c), GATT 1947.

provisions into mandatory ones, it is presumed that they would fit within the taxonomy specified above.<sup>9</sup> Each of the categories will be discussed in turn.

Before proceeding, however, one other assumption underlying this paper must be made explicit. The taxonomy established here does not attempt to deal with the question whether new subjects and areas of responsibility should be added to the WTO's mandate. Much contention has surrounded this issue ever since non-tariff measure agreements were negotiated in the Tokyo Round. The challenge of reaching agreement on the scope of the WTO continues today, with a decision imminent on how to approach the four Singapore issues (investment, competition, transparency in government procurement and trade facilitation). The fact that this paper fails to address this matter has nothing to do with its degree of importance. The question whether or how new subjects should be included in the WTO may have far-reaching implications for developing countries. But this is not a special and differential treatment issue in the sense that S&D provisions are no substitute for the avoidance of rules that do not support development. Special and differential treatment should not be seen as a balm for bad rules. The rules themselves must reflect national economic interests, not exemptions from the rules. Good rules can and probably must contain elements of special and differential treatment, but that is a different matter.

If rules are properly designed to accommodate divergent national interests, the S&D provisions they contain should respond to development needs and be transitory in nature, as countries attain higher levels of development. Many WTO Members appear to take the view that all S&D provisions should be transitory, and there is a certain logic to this position in a world of well designed rules. But if rules are poorly designed and access to S&D is phased out over time, countries may then find themselves party to rules they do not consider supportive of their development. That is the main reason for eschewing S&D as a substitute for quality in rules. A related consideration that will not be analyzed further here is whether developing countries might be offered the opportunity to opt out altogether from particular rules<sup>10</sup> until some future date. While such a possibility may seem alluring at first sight, it carries the risk that countries opting out will have limited influence on the design of new provisions, but later will be obliged to live with those provisions.

#### A. SPECIAL AND DIFFERENTIAL TREATMENT AS A POLITICAL RIGHT

Few would challenge the proposition that the WTO system of rights and obligations would be inequitable if it did not allow for differentiation among Members. Equity is fundamentally a moral construct, easy to state in broad political terms. If the WTO rules are perceived as inequitable, the legitimacy of the system is called into question. But views may differ as to what is equitable. Some might argue, for example, that equity requires equal outcomes, while others would say it is about equality of opportunity. Thus, even if acceptance of the principle of equity is virtually universal, this does not take the analysis very far. The same may be said of acceptance of the need for S&D treatment in the rules of the trading system. Simply to affirm that S&D means attenuated obligations and extended rights for developing countries is not to say very much.

Dwelling on the legitimacy of the principle of S&D as a political right tends to frustrate the quest for effective S&D provisions – that is, provisions that respond to the development needs of developing countries. This is because the political "overlay" of the asserted right can crowd out the detailed economic and legal analysis essential to the identification of optimal rules. A particular problem arising from a generalized insistence on the political right to enjoy S&D is the tendency to assume that the best contribution the WTO can make to development is to ensure developing countries

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<sup>9</sup> This may not be strictly true in at least one instance. If the provision of technical assistance were to become a legally binding obligation, it is unclear where this would fit in the taxonomy. But this is an unlikely outcome.

<sup>10</sup> The "opt-in, opt-out" approach to rule-making was mooted in the run-up to Doha, but met resistance from a number of developing countries.

assume minimum obligations under the system – the fewer the better. A failure to think beyond the political right to S&D easily leads to this unspoken assumption that less is better than more.

To the extent that developing countries limit their commitment to the system in this manner, they weaken their negotiating position and lessen the degree to which their trading partners are willing to pursue policies that support development. They limit their ability to fashion new rules in a development-friendly manner. They also weaken the scope for challenging elements in the system which are arguably unbalanced, independent of any consideration of special and differential treatment.<sup>11</sup> Developing countries also forego the opportunity to use a commitment to WTO obligations as a weapon against narrowly based domestic pressure to pursue policies that do not reflect the national interest.

The best way to ensure that the WTO contributes to development is to move beyond the principle of differentiation to the substance of individual provisions, including in areas where new negotiations are proposed. Increased emphasis in recent years upon the need to see trade policy as an integral element of a broader panorama of development policies, rather than as an externally-imposed "add-on", supports such an approach. The core challenge is to link negotiating positions on liberalization commitments, WTO rules, and special and differential treatment to a clear and cogently argued identification of development needs and priorities.

Another reflection of a generalized and excessively politicized approach to S&D is the direction that the "graduation" debate has taken. Article XXXVI:8 of GATT 1947 established the principle of non-reciprocity, stating that "developed contracting parties do not expect reciprocity for commitments made by them in trade negotiations to reduce or remove tariffs and other barriers to trade of less-developed contracting parties." An interpretive note to this provision states that developing countries "should not be expected, in the course of negotiations, to make contributions which are inconsistent with their individual development, financial and trade needs...."<sup>12</sup> Some fifteen years later, Paragraph 7 of the Enabling Clause stated that "[L]ess-developed contracting parties expect that their capacity to make contributions or negotiated concessions or take other mutually agreed action under the provisions and procedures of the General Agreement would improve with the progressive development of their economies and improvement in their trade situation and would accordingly expect to participate more fully in the framework of rights and obligations under the General Agreement".<sup>13</sup>

The entry of graduation into the debate alongside non-reciprocity and differentiated rules was part of the bargain that gave developing countries formal legal cover in respect of trade preferences under GSP, S&D in non-tariff measure agreements, regional trade agreements among developing countries, and the designation of a separate category of least-developed countries. It is noteworthy that the language both on non-reciprocity and graduation is couched in terms of expectations. The fulfilment or otherwise of an expectation is not a matter that lends itself easily, if at all, to formal legal interpretation. Where supplementary explicit conditions have not been specified at the detailed level of particular provisions, giving legal precision to the broad indications of principle or policy intent, this has merely led to a politicized to and fro in discussions.

Some commentators are now arguing for agreement on a specified set of graduation criteria, like those that are implicit in the United Nations definition of least-developed countries. Two problems arise with this. First, it is very difficult to transform an historically politicized notion such as graduation

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<sup>11</sup> Among WTO provisions that might be characterized as unfair in this sense are the differentiated rules on export subsidies in the agriculture and manufacturing sector, the rules on the right to apply export subsidies in agriculture, and the different manner in which export subsidies are treated depending on whether they are fiscal or financial in nature.

<sup>12</sup> Ad Article XXXVI Paragraph 8, GATT 1947.

<sup>13</sup> Decision of 28 November 1979 on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries.

into a precise policy outcome, especially if this is presented in binary terms across the entire legal edifice of the WTO. The GATT/WTO has never been able to agree on a definition of developing countries, so it is difficult to see how countries would now agree to being graduated. Even countries such as Mexico and Korea that have joined the OECD are unwilling to change designation, whether or not they are making use of S&D provisions. That is because of the political overlay associated with country status in the WTO.

Second, such an approach applies a blunt instrument where subtler differentiation is more suitable. A well-loved aphorism that has entered S&D discussions in recent times is that "one size does not fit all". The latter notion is entirely consistent with a more analytical approach to S&D – one that measures economic need against legal provisions. Graduation specified at the national level, even expressed in terms of carefully constructed economic thresholds, does not sit well with a more analytical focus. Countries should be "graduated" out of access to particular S&D provisions at the level of individual provisions. This can be done by reference to explicit economic thresholds, such as the \$1,000 GDP per capita criterion that determines whether non-LDCs can continue to apply export subsidies to manufactures under Article 27.2(a) and Annex VII of the Agreement on Subsidies and Countervailing Measures. Alternatively, staggered time frames could be negotiated for phasing in obligations. Whether through thresholds and benchmarks, or by multi-tiered phase-in periods, negotiations relating to country-specific access to S&D provisions can be more analytically based on development considerations and economic criteria at a disaggregated, provision-specific level. Such negotiations are difficult, but they can help to lance the boil of excessive politicization and respond more effectively to real need. This approach to defining access to S&D is discussed further below, and constitutes a core recommendation of this paper.

Finally, the suggestion has been put forward that a needs-based, more customized approach to S&D could be developed through the establishment of procedures under which developing countries are given the opportunity on a continuing basis to explain in clear developmental terms why they need access to particular S&D provisions. A decision would then be taken on the basis of a judgement as to the quality of the advocacy. This idea certainly pushes S&D arrangements in the direction of responding to the reality that "one size does not fit all", but it is flawed because of its reliance on a discretionary decision-making mechanism. Who would make the decisions? Can enough technical precision be assured on a continuing basis to justify decisions as fair and consistent? Politicization could become a larger problem, not a smaller one.

## B. PRIVILEGED MARKET ACCESS

Many developing and least-developed countries enjoy preferential access to markets in developed countries. The first preferential scheme put in place by a number of countries was the Generalized System of Preferences (GSP), for which a permanent waiver from the non-discrimination requirement was eventually obtained under the Enabling Clause.<sup>14</sup> Other schemes limited to a defined subset of beneficiaries include, for example, the African Growth and Opportunity Act (AGOA) and the Caribbean Basin Initiative of the United States, and the EU's "Everything But Arms" (EBA) initiative for least-developed countries. Several other developed countries have introduced such schemes.

Much has been written about the utility of preferences to beneficiaries.<sup>15</sup> A first indication of their rather limited success can be seen in generally low and often decreasing utilization rates of preference margins. Benefits depend not only on the coverage of the schemes but also on the magnitude of

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<sup>14</sup> Preferences under GSP schemes developed in the 1960s and most of the 1970s were covered by a waiver before the Enabling Clause came into force. Currently, WTO Members which grant GSP preferences under the Enabling Clause include: Australia, Belarus, Bulgaria, Canada, the Czech Republic, the European Communities, Hungary, Japan, New Zealand, Norway, Poland, Russia, the Slovak Republic, Switzerland, and the United States (WTO document WT/COMTD/W/93). This document also cites the references to UNCTAD's GSP Handbooks on the Schemes of the United States of America, the European Community, Canada, etc.

<sup>15</sup> One of the most comprehensive overviews is contained in UNCTAD (1999).

current trade restrictions. Real trade advantages can only be derived if schemes include products that are subject to significant MFN protection. AGOA, for instance, offers zero tariffs and quotas on textiles, where MFN tariffs are high and competitors are also subject to quotas. The value of preferences may be worth less than seems at first glance if items are included for which MFN tariffs are low, preference margins are small or exclusions from preferential access include tariff lines that attract high rates.

(a) Rules of origin and other requirements can be costly to fulfil

Even where highly protected items are covered and margins are substantial, the size of the benefits ultimately depends on other conditions that need to be fulfilled to qualify for preferential treatment, notably rules of origin. For instance, some of the beneficiaries under AGOA are required to source fabrics and yarns from other African beneficiaries or the United States itself. A constrained choice of inputs involves incremental switching costs from established to new channels of supply, potentially higher transport costs as well as costs for validation and record-keeping of production and shipping documents. As a consequence, close to 90 per cent of otherwise eligible exports of South Africa and Mauritius did not qualify for preferential treatment under AGOA (Mattoo et al., 2002); by contrast, Caribbean exporters, albeit subject to the same origin requirements, were able to comply to a much larger extent with sourcing conditions, most probably due to lower transport costs of inputs from the United States.

Bearing these factors in mind, an assessment of the value of preference schemes to beneficiaries is not straightforward. While preferences under the EBA, which offers duty-free and quota-free access to all LDCs, seem a better deal for LDCs than the Cotonou Agreement, more lenient rules on cumulation of inputs from other countries as well as higher tolerance thresholds of non-originating materials under Cotonou may explain why preferences have not been taken up under the EBA, even for products where the EBA nominally offers better access (Brenton, 2003). Given that exports from non-ACP LDCs can only obtain preferential access to the EU market under the EBA, discrimination amongst LDCs is introduced by overlapping schemes. Restrictive rules of origin are also more problematic for small countries which generally face more limited possibilities to source inputs domestically (Hewitt et al., 1995). However, one of the key advantages of the EBA initiative as opposed to other unilateral schemes is that preferences are granted for an unlimited period of time and are not subject to periodic review (Brenton, 2003). This greater certainty in maintaining access to European markets may help to attract lasting FDI, stimulate diversification into a broader range of exports and contribute to building a sound industrial structure.

A variety of other costly requirements are often attached to preference schemes. In relation to origin determinations, EU schemes require that goods be shipped directly to the EU or else must remain under the supervision of customs authorities in transit countries. The latter considerably adds to the costs of LDC exporters. Under AGOA, beneficiaries have to meet additional criteria relating to labour standards and workers' rights. All in all, relatively few countries have been able to take significant, systematic advantage of preference schemes. Benefits normally remain highly concentrated among a few countries, with the top ten beneficiaries generally occupying a share of between 80 and 90 per cent of total imports receiving preferences under any individual scheme.

Preferential schemes can affect the production structure within beneficiary countries and the distribution of production among developing countries. On the one hand, the requirement that a certain percentage of value be added in beneficiary countries is important in order not to defeat the purpose of GSP schemes aimed at stimulating production in poor countries and not mere transshipments or packaging operations. On the other hand, excessively strict requirements may hinder efforts by developing countries to enter international production networks, whereby product parts, components and modules are produced in different countries according to each location's comparative advantage. Interestingly, rules of origin are akin to local-content requirements, which, in the form of TRIMs, are not well perceived. While important legal differences remain, the economic effects are

similar in that inputs are sourced from less efficient suppliers and trade is diverted in favour of domestic input industries.

(b) Preferences are inherently unstable and discriminatory

Once a country has specialized and successfully expanded the production of certain goods, preferences may be withdrawn at the discretion of the preference-provider by graduating the country or excluding specific products. Although criteria for graduation are set in advance, there is usually scope for *ad hoc* decisions if either domestic import-competing industries lobby for a ceiling on imports or if it is felt that benefits are mostly appropriated by a limited number of countries. Preference schemes may also provide for nuanced treatment of beneficiaries. If it is understood that poorer countries should benefit most, more lenient rules of origin may be applied to them. If, in addition, those countries have lower labour costs than more advanced beneficiaries, where production has expanded owing to the preference scheme and labour costs have increased, investment may shift. As countries advance or are dropped altogether from the scheme, they may be left with overcapacity and a production structure not based on comparative advantage.

The same may happen when preferences are eroded through tariff reductions on an MFN basis in the context of multilateral negotiations or in regional trade agreements.<sup>16</sup> It is understandable that preference-receivers invest considerable negotiating resources into a prolongation of preferential treatment and to slowing down further non-discriminatory tariff reductions. Some countries have proposed that as a matter of S&D, preference-receiving countries should be financially compensated by providers for reductions in preference margins. Clearly, the higher the initial advantage enjoyed by beneficiaries over other suppliers, the more substantial will be the subsequent decline in prices when restrictions are abolished, as is for instance the case for textiles quotas in 2005. Ultimately, if preferences have had an impact on the export earnings of beneficiaries, they may also have led to trade diversion, so the gains of some have represented losses for others. Despite the significant benefits enjoyed by some countries benefiting from preferential schemes over relatively short periods of time, there is ample reason to caution against relying on a strategy that is fundamentally unstable and carries the seeds of its own demise.

In recent years, bilateral and regional free trade agreements among developed and developing countries have flourished. A particular reason why some developing countries may be seeking trade agreements with their larger developed country partners is that they are losing the preferential access to those markets they previously enjoyed, for instance when being excluded from GSP schemes. Another reason may be that the developed country in question is negotiating preferential agreements with other developing countries or that competitors continue to qualify for inclusion under GSP. Governments may simply fear exclusion from markets, and regard participation in RTAs as an insurance policy against being placed at a competitive disadvantage through discriminatory policies. The phrase "domino regionalism" has been coined in the literature to capture this kind of motivation, explaining to a degree the explosion of membership in regional arrangements. In contrast to GSP schemes, these agreements are supposed to be reciprocal and cover substantially all trade. However, in practice, many of the associated problems of trade diversion, product exclusions as well as economic costs, for instance related to origin requirements, remain the same.

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<sup>16</sup> However, there are strong indications that the erosion of preferences through MFN liberalization may not be so strong as is commonly assumed. Many developing country exports already enter markets under bound duty-free rates, and access to the markets of all countries is improving through lower non-preferential rates. A certain form of compensation for preference erosion is therefore inherent in further MFN tariff cuts. This is especially true if tariffs are eliminated in sensitive sectors that are of particular export interest to developing and least-developed countries but commonly excluded from preference schemes. Such an approach is an important element of the draft modalities paper by the Chairman of the Negotiating Group on Market Access (TN/MA/W/35). Preference erosion can be anticipated and spread out over time due to the phased nature of further MFN reductions. Subramanian (2003) also holds that losses from erstwhile preferences could be financed within existing adjustment facilities and programmes by the international financial institutions to ensure adjustment over the medium-term.

The more countries move away from unified schemes, the higher the likelihood of overlapping eligibilities. This increases the degree of complexity in determining benefits and increases opacity in trade relationships. For instance, the ACP countries, many of whom are also EBA beneficiaries, are due to negotiate broader Economic Partnership Agreements with the European Union under the Cotonou Agreement. Sub-groups of countries are expected to establish reciprocal free trade agreements among themselves and with the European Union, while at the same time being entitled to duty-free and quota-free access under the EBA initiative. A "spaghetti bowl" of trade relationships increases the transactions costs of conducting trade and the possibility of mutually inconsistent provisions. It strengthens vested interests that are hostile to non-discriminatory outcomes and resist beneficial liberalization for those excluded from preferential agreements.

All this led Hudec to believe that an MFN-based regime is the only genuine protection available to developing countries. This is not just an argument he makes for more advanced developing countries who are most susceptible to protection-driven discrimination, but for smaller countries as well that are likely to face more uncertainty and unpredictable elements of discrimination under multiple preferential arrangements. Hudec sees MFN first and foremost as "a legal substitute for economic power on behalf of smaller countries" (Hudec, 1987: 216-17). If Hudec had been writing on this issue more recently, he would probably have had similar things to say about the risks of regionalism.

(c) A case can be made for reciprocal tariff reductions at the multilateral level

Ultimately, contractually based non-discriminatory liberalization is likely to be a safer bet. Multilateral commitments provide the necessary stability and predictability to act as effective incentives for traders and investors. Conversely, a further expansion of trade preferences will result in more countries relying heavily on the unilateral goodwill and policy choices of preference providers. Also, the larger the number of countries seeking preferential treatment and the more similar their export structures, the less will be the competitive benefits each country enjoys. Hudec observes that preferences "tend to operate in a similar way to the sorcerer's apprentice – generating more and more discrimination until the system finally breaks down under its own weight" (Hudec, 1987: 209-210). He refers to preferences as systems of "refined complexity", built on an "orgy of fine-tuning" (Hudec, 1987: 211) and argues that the legal costs of such systems may well outweigh their economic benefits.

Moreover, as already noted, preferences generate interests opposed to non-discriminatory liberalization. Özden and Reinhardt (2003) argue that GSP schemes reduce the need for the export sector in beneficiary countries to oppose protectionist policies by their own government. Vested interests in both the export and import-competing sectors are created that resist change to the status quo, in particular further multilateral trade liberalization. Conversely, Özden and Reinhardt (2003) establish empirically that sometimes when GSP eligibility is withdrawn and access to export markets becomes conditional on a country's own trade policy on the basis of reciprocity, countries reduce their protectionist policies and reap associated gains in efficiency and competitiveness.

Regardless of the above considerations, some developing countries continue to attach considerable importance to preferential market access. In the post-Doha S&D discussions, it has been proposed that developed countries consult in the Committee on Trade and Development (CTD) on the products to be covered by their respective preference schemes. According to the proponents of this idea, developed countries would also be required to demonstrate that products included are indeed of export interest to developing countries and that meaningful market access is not subverted by non-tariff barriers. Some developing countries went as far as to suggest that targets for shares in developed country markets be set by the Committee. For the range of reasons already discussed, preference schemes could doubtlessly be improved in ways that are advantageous for their beneficiaries. But setting target market shares in a political process does not seem a very promising approach, considering the inherent difficulties of such a process and the numerous factors that determine export performance. For instance, for the majority of LDCs, export values to the EU fell in 2001, when the

European "Everything But Arms" (EBA) came into effect, due to declining prices for primary exports that could not be compensated for in quantity given domestic supply-side constraints (Brenton, 2003).

Although the evidence for preferential market access is mixed, in the S&D debate proposals have been made both in regard to agriculture as well as industrial goods that developed country Members bind preferences in their schedules of commitments. Such bindings would limit future MFN tariff reductions on affected products or influence how parameters are set in the negotiations.<sup>17</sup> The question of binding existing or enhanced preferences for certain groups of countries, e.g. the ACP or small island states, is resisted by other developing countries. Many of those who have not traditionally benefited much from GSP or have been excluded from special preference schemes feel that trade preferences work directly to their disadvantage. They argue that where developing countries are the key exporters, it would be better if preferences under GSP schemes were transformed into bound MFN cuts. Such an approach would have minimal consequences for the direction of trade, while offering greater security of access and lower administrative costs.

### C. INCREASED FLEXIBILITY TO RESTRICT IMPORTS

Broadly speaking, import restrictions can take the form of import tariffs or non-tariff restrictions of one kind or another. Most of the discussion that follows addresses the latter kind of restriction. This reflects the fact that tariff levels and decisions about what to negotiate in relation to tariffs are not strictly a matter of special and differential treatment. Market access in the negotiating sense is about what developing and developed countries are willing to offer one another by way of a mutually beneficial bargain. Non-reciprocity considerations no doubt form part of the reckoning in regard to the balance of the bargain, and this becomes more explicit if a formula approach is adopted to tariff reductions. Revenue considerations<sup>18</sup> and other factors linked to a country's development policies will also enter the picture, but will not lead to the same specific kind of concern in relation to development relevance as is the case with negotiations on rules. It should be noted, however, that much of the discussion below about the role of trade policies in development applies regardless of whether tariffs or non-tariff measures are at issue.

#### (a) S&D for TRIMs?

Despite reduced enthusiasm for import-substitution policies in the 1970s and 1980s, particularly beyond a certain time period and level of protection, successful development is still widely perceived as including economic diversification through the expansion of domestic manufacturing activities. New technologies and a higher skill component in production are commonly seen as important stimulants of growth, spurred through trade. High tariffs on finished products aimed at stimulating domestic production will not always lead to increased domestic value-added. In some industries, components for the production of final goods can be imported as knock-down kits, leading to mere assembly operations in the protected sector. An example of this kind of situation would be motor vehicle assembly. However, in the car sector many parts involve limited technological components and should be relatively straightforward to produce at home, thereby increasing domestic value-added and forging backward linkages in local industry. This is why some countries continue to advocate the need for trade-related investment measures (TRIMs), such as local content requirements. Typically, these requirements would allow the producer to choose the specific components to be sourced locally, but impose an overall proportion of local content to be achieved. In line with the classical infant

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<sup>17</sup> Similarly, in services, it has been proposed to give priority to developing countries in sectors of export interest to them, for instance through the allocation of sectoral quotas.

<sup>18</sup> Tariffs on imports continue to be a major source of tax revenue for several developing countries, including some of the poorest (Baunsgaard et al., 2003). This is a reason why liberalization in such cases needs to be stretched over longer time periods until compensatory measures, in particular the strengthening of the domestic tax system, can be effected. By the same token, lower tariffs may lead to an expansion of imports and rising tariff revenues. Tariff revenue collections could also be improved in some countries through customs reform.



industry argument, both the tariffs shielding the final goods industry and the local content threshold would come down over time to increase pressure on producers to become competitive.

So much for the theory. Experience suggests that in many instances barriers and distortions persist, local component and finished goods producers remain uncompetitive, and economic growth does not take off. Besides this, TRIMs have immediate drawbacks. While the market guaranteed by local content can be expected to attract investment in the input sectors, higher input prices, more uncertain quality and other costs of switching suppliers may act as a deterrent to foreign investors in the final goods sector. A partial compensation for their cost disadvantages is, of course, provided through high tariff protection in the domestic market. Given that a protective tariff will cause an anti-export bias in the finished goods sector, export requirements are sometimes introduced subsequently in an attempt to increase production, efficiency and the overall export-orientation of the economy (WTO document G/C/W/307/Add.1). In the form of trade-balancing requirements, export performance is tied to the right to import inputs at reduced tariff rates. While efficiency-seeking FDI with a natural tendency to export may not be affected as much by this form of TRIM, market-seeking investment will be negatively influenced by a requirement to cross-subsidize exports through increased domestic sales or reduced input costs. All forms of TRIMs have comparatively stronger negative effects on FDI in smaller and lesser-developed countries. Investors will often be unwilling to incur the additional costs implicit in TRIMs to gain to a small market. In sum, besides introducing trade distortions, TRIMs have an ambiguous effect on net foreign direct investment.

No least-developed countries except one have notified the use of TRIMs, but they have all sought a total exemption from the TRIMs Agreement in the context of S&D in order to increase their "development space". There are a number of practical reasons to doubt the contribution of TRIMs to economic development, particularly in small, low-income countries. First, TRIMs are predicated on the somewhat dubious assumption that a government is in a position to identify growth sectors with more accuracy than the market, evaluate the appropriate distorting policies, and design corrective measures with equal precision. Secondly, TRIMs lead to bureaucratic micro-management of the industry and high transaction costs for the government and the private sector. Once such schemes are established, they may be very difficult to remove owing to their lack of transparency and the vested interests of international and domestic firms that rely upon them. The TRIMs Agreement is a useful counterweight to such lobby pressures. Finally, despite increasing exports in certain cases, TRIMs do not bring about real export capability and international competitiveness. Because of their inherent incompatibility with open, non-discriminatory international trade and their distorting/chill effect on FDI, they may retard technical change, be responsible for a misallocation of resources and ultimately produce costly and inefficient production structures. This retards growth and reduces employment prospects over time.

(b) Should it be easier to protect infant industries?

While many countries have already dismantled their TRIMs or, in the case of the poorest ones, never had such measures in place, the practice of protecting a strategic sector through high tariffs is still very much alive. Traditional infant industry protection, based on the existence of market imperfections and dynamic external economies, also surfaced again in current debates on special and differential treatment. A number of developing countries have claimed that non-utilization of GATT Articles XVIII:A and C are evidence of the over-restrictiveness of its requirements. In a bold move, it was proposed that developing countries should be in a position to reject any conditions attached to infant industry protection as too cumbersome. In particular, no compensation should be offered for any modifications or withdrawals of concessions if this was deemed inconsistent with a country's development needs. Another proposal also aiming at considerable discretion suggested that protection should last until its objective was achieved. However, it was conceded that compensation/retaliation should be waived only initially. While developed countries seemed ready to exercise restraint in seeking compensation from LDCs under Article XVIII:A and C provisions, they were opposed to changing the compensation rules. In addition, some other developing countries were not ready to provide flexibility to LDCs if they were not entitled to the same treatment themselves.

Considerable doubts remain in the minds of some Members as to whether action under Sections A and C of Article XVIII should be made less conditional. Many countries have bound tariffs at high ceiling rates, such that recourse to GATT Article XVIII:A may not be necessary to raise applied rates. Measures taken under Section C typically take the form of quantitative import restrictions. Risks of distortions and suspension of market processes may explain why Section C is considered a matter of last resort and subject also to the condition that action under Section A would be unsatisfactory or ineffective. A number of flexibility elements exist. Under the 1979 Decision on Safeguard Action for Development Purposes (BISD 26S, 1980: 209-210), developing countries have the possibility of introducing quantitative restrictions on a provisional basis with immediate effect. Article XVIII also specifies that protection to a "particular industry" is defined not only as a new industry, but also a new branch of an existing industry and the substantial transformation of an existing industry (Interpretative Note Ad Article XVIII, para. 2).

If infant industry protection is to be granted on grounds of market imperfections and dynamic external economies of scale, two conditions that could be attached to such measures are worth bearing in mind. First, a time-table for the reduction and eventual elimination of restrictions should be spelled out in advance so as to motivate firms to catch up in terms of productivity and competitiveness. Secondly, if firms fail because they cannot compete when protection is relaxed, they should be allowed to go out of business. If limits to protection are not clearly specified, rent-seeking behaviour will set in with all the associated deadweight costs for the economy in terms of wasted resources, higher prices, lower quality and less choice. It must be clear that, at a certain point, domestic producers are required to compete. Special and differential treatment provisions could be designed in a calibrated manner to meet these conditions in a manner consistent with development needs.

The Article XVIII provisions on infant industry exceptions have rarely been invoked. One likely reason for this is that countries have preferred to apply import restrictions under the Article XVIII:B justification for balance-of-payments protection, as Article XVIII:B is easier to apply and does not call for compensation following the introduction of new trade restrictions. Article XVIII:B has been used in the past by more than 20 countries.

This perception that Article XVIII:B has served purposes other than those intended led to closer scrutiny of the provision. The Tokyo Round Declaration on Trade Measures Taken for Balance-of-Payment Purposes (BISD 26S, 1979: 205-209) requires Members to give priority to price-based measures over quantitative restrictions and to announce time-schedules for removing the measures. In the Uruguay Round, more procedural requirements were introduced. Most notably, in all cases of balance-of-payments considerations, the IMF is consulted. The IMF is meant to act as a neutral guarantor that genuine BOP problems and not infant industry type protection are the underlying motivation for seeking restrictions. Therefore, WTO Members are required to accept all findings of statistical and other facts presented by the Fund relating to balances of payments, in particular the IMF's determination as to "serious decline", "very low level", or "reasonable rate of increase" in monetary reserves. These modifications were at least partly informed by the insight that fiscal and monetary instruments have greater effectiveness in meeting balance-of-payments shocks than trade restrictions and distortions. This is in the interest of users – promoting domestic and foreign confidence in a country's economic policies is the principle objective of reserve adequacy, which would likely be undermined if trade restrictions were used in order to increase reserves in the absence of a real payments crisis.

(c) Are there convincing industrial policy successes that can be emulated?

Two of the most widely quoted cases of allegedly successful industrial policies are Mauritius and South Korea. Mauritius had a highly restrictive trade regime. In order to avoid protection translating into an export tax, it effectively segmented its export sector from the rest of the economy through the creation of export processing zones (EPZs). While this did not completely offset the anti-export bias of import restrictions, the export sector thrived nevertheless on account of preferential market access

in major industrialized nations (Subramanian and Roy, 2001). Other countries followed the same strategy as Mauritius without the same results. Part of the reason for this is almost certainly associated with the challenge of managing the rent-seeking, corruption and inefficiency that is embodied in all policies of selective intervention. Mauritius ranks well above many other developing countries with respect to most indices of institutional quality and, therefore, did well where others failed. The absence of stable and competent institutions is a powerful argument against attempting to replicate the Mauritian experiment. Moreover, protectionism by major developed countries in the sugar and textiles and clothing sectors in combination with preferential access enjoyed by Mauritius were key to its expansion of production. These preferential margins are bound to come down. As was mentioned earlier, preferences lose their attractiveness the larger the number of eligible countries and the smaller the preferential margins.

Some scepticism has been voiced as to whether industrial policies were key to South Korea's success, rather than other factors and circumstances. The evidence does not support the notion that selective intervention had a decisive or even positive impact on the South Korean economy. Empirical estimates suggest that resource misallocation reduced GDP by between 1 and 3 per cent (Noland and Pack, 2003). Significant government competence was probably the main reason why the negative side-effects of interventionist policies remained within certain boundaries. Yet much of the governmental effort resulted in numerous interventions that offset each other and created a cumbersome system whose net outcome may have been achieved by simpler means, including low uniform protection. Perhaps more important to South Korea's success were heavy investments in generic infrastructure available to all sectors, such as education and roads. Initial conditions in South Korea were also different from many contemporary developing countries. South Korea pursued prudent macroeconomic policies (low inflation, stable real exchange rates, responsible fiscal policies) and featured a high rate of domestic savings. It also disposed of large endowments in human capital and a certain degree of pre-existing industrial structure.

(d) Import restrictions should be approached with caution

Hoekman et al. (2003: 35) conclude that "trade policy as an instrument to promote industrial development is simply outdated in a world where services are increasingly tradable, there are large FDI flows and, as a result, international production is increasingly becoming fragmented and more and more specialized." The study further observes that an open trade regime provides for "important channels of knowledge transmission, such as exposure to foreign clients, access to technologically sophisticated imports or knowledgeable competitors" (Hoekman et al., 2003: 32-33). The reduction of trade barriers extends the market for individual firms, particularly those located in small countries. For many developing and least-developed countries, the only option to reach the minimum scale required for sustained growth in output is integration with the rest of the world. Access to a larger market makes it easier for a firm to reach a critical mass of demand, allowing it to exploit economies of scale and further specialize in what it can do best. Moreover, when manufacturers have access to a broad variety of specialized inputs on international markets, their productivity improves, their costs are reduced and their output increases. Subsequently, they will demand more inputs. As the market grows, room is created for even more specialized producers, costs are further lowered and the virtuous cycle continues.

When barriers to trade fall, becoming part of an international production network presents a significant opportunity for firms in developing countries to upgrade their technology and skills and gain access to the world market through established marketing networks. Linkages of this kind have been instrumental in the transformation of East Asian manufacturers from unskilled labour-intensive assembly operations of imported intermediates to full-package suppliers for multinational buyers. Some East Asian companies have become multinational buyers in their own right, extending the networks into lower cost, labour-abundant developing and least-developed countries. Some of the latter countries are already in the process of following suit in upgrading their industries and moving into the higher value-added stages of production.

The phasing-out of trade-distorting measures inevitably leads to shifts in sectoral employment and output patterns. This implies adjustment and transition takes time. But in order for trade liberalization to be beneficial, it is indispensable that it takes place according to a pre-announced schedule that cannot easily be reversed. Too much flexibility and room for discretion undermines its credibility and saps efforts by exporters and importers to build secure expectations that are the foundation for expanding operations and economic growth.

#### D. ADDITIONAL FREEDOM TO SUBSIDIZE EXPORTS

A number of developing countries have advanced S&D proposals for full flexibility in applying subsidies and seem unconcerned about subsidy competition among themselves. Such proposals run counter the general wisdom that subsidies can cause severe allocative distortions and be harmful to development. For certain types of export subsidization, fast-track extension procedures were agreed at Doha for a range of developing countries not included in Annex VII of the Agreement on Subsidies and Countervailing Measures (SCM). These procedures comprise a set of economic and policy criteria setting an eligibility limit, for instance, on size and per capita income. Other countries have the possibility to request extensions on a case-by-case basis, including by making reference to competitiveness concerns in regard to countries benefiting from the fast-track procedures. One S&D proposal suggests that these criteria, which explicitly include thresholds to limit the harm that may be inflicted on other developing countries, not be strictly respected for any developing country seeking an extension.

##### (a) Can export subsidies be justified?

One argument for export subsidies is based on the objective of diversification of economic activity. The question arises whether export subsidies would represent the least costly policy measure for this purpose. This is probably not case. Panagariya (1999) reviews cases in Asia and Latin America where scanty results did not seem to warrant the costs incurred during decades of export subsidization. Conversely, he finds that as soon as trade liberalization and sound macro-economic policies were pursued, good progress on exports was made despite a simultaneous and sharp reduction of export subsidies. He cites Nogues (1989) who reviewed a large number of country experiences and concluded that the diversification of exports towards manufactures occurred when policies of more open import regimes and relative stability in real exchange rates were pursued. In contrast, the provision of export subsidies was not a common element among successful countries. He found that subsidizing countries faced large opportunity costs and an additional waste of resources through rent-seeking activities induced in the private sector.

Economic arguments for subsidization of specific industries either relate to market imperfections or external economies. In the first case, a firm that can expect learning-by-doing (dynamic) economies of scale may be profitable in the long run but faces higher costs at the beginning of its operations. Absent efficient capital markets and the possibility of obtaining sufficient funding to cover initial losses, potential investors may hold back on a genuinely worthwhile business venture. The provision of governmental subsidies would close this financing gap. This only represents a second-best policy. The preferred solution would be to correct the capital market imperfection directly, for instance through a better regulatory framework that facilitates the provision of financial services, including through liberalization. Second-best instruments inevitably trigger further distortions, such as the threat of corruption and the danger of perpetuating the support for one industry and the implicit resource transfers from other sectors. It should also be noted that suboptimal situations often result from primary policy distortions. For pragmatic reasons, a government may prefer to mitigate resulting inefficiencies through further distortions instead of the removal of the original policy. Laws on minimum wages are an example of a policy a government may hesitate to abolish. While production subsidies may be a less distorting option to remedy labour market rigidities, revenue constraints and limited administrative capabilities to collect and redistribute financial means may militate against their use and leave a government with the sole possibility of providing fiscal benefits to its exporters.

External economies occur when a firm's private costs exceed the social benefits produced and the latter cannot be fully internalized. Pioneer companies may incur costs for building an industry's reputation, generating publicly useful information or training workers that are later bid away by competitors. In all cases, the activity may not be undertaken unless subsidies pay for the positive externalities engendered. External economies are a widespread phenomenon and government interventions to remedy a situation of underinvestment can take a variety of forms. Yet, given the rather sobering experience with import-substitution policies, doubts are in order as to the ability of governments to pick "winners", which is even more unlikely where administrative capacities are limited.<sup>19</sup> A better strategy for governments may be to provide professional education programmes, and sustain functioning institutions and infrastructure, for instance in relation to trademarks and intellectual property protection. Such economy-wide measures allow for a general sponsorship of socially beneficial activities and provide a means of internalizing positive externalities by individual firms.

It is even harder to make an economic case for specific subsidies to the export sector. Panagariya (1999) raises the possibility that a pioneer exporter builds the reputation of a country that followers will benefit from. Again, first best policies to improve a country's reputation directly may rather relate to issues such as governance and economic stability. Other external economies may include learning spillovers specifically attached to exporting and not production for the domestic market. Tybout (2000) finds no evidence for this, and in addition, establishes that most exporting firms are already more efficient before they start exporting, which allows them to take on international competition in the first place. However, many developing countries confer subsidies upon firms located in export-processing zones (EPZs). It appears that access to the subsidies provided to companies in EPZs is by definition contingent upon export performance. Hence, they would seem to be subject to the prohibition in SCM Agreement Article 3 which seeks to forestall subsidy competition among governments. Hoekman et al. (2003) note that such competition would not only lead to the transfer of rents to powerful companies that can play governments off against each other, but they would almost certainly harm poorer countries, which cannot afford subsidies.

(b) Can EPZs be WTO-consistent?

Many developing countries believe EPZs have played an important role in their development.<sup>20</sup> Are they nevertheless incompatible with WTO rules? There are many examples of EPZs which, in the past, have contributed significantly to job creation and income generation in developing countries (Madani, 1999). For this reason alone, developing countries see merit in EPZs even if net exports have often remained low (given that a large portion of inputs is imported), backward linkages limited and investment concentrated in low-tech operations. In certain cases, EPZs did indeed entail positive spillovers owing to demonstration effects of entrepreneurial skills that were copied and transferred to other industries.

The concept of EPZs cannot be easily discarded. Such arrangements merit a closer look. Many developing countries have had early success in putting in place an efficient administration and sound infrastructure in a confined space of their territory. In view of resource constraints, the capacity to do this on an economy-wide scale is limited in early stages of industrial development. Such incentives

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<sup>19</sup> Hausmann and Rodrik's (2002) argument that government has a role to play in learning what a country is good at producing does not contradict the views presented here. They readily admit that governments have proven inadequate in "pruning investments that turn out to be high cost ex post" (Hausmann and Rodrik, 2002: 35), which would be a necessary precondition to undertake investment promotion in the first place. In their model, the role that one may think FDI could play in pioneering new activities under a "*laissez-faire*" scenario is put in question due to alleged difficulties in adapting imported "off-the-shelf" technology to local conditions. Yet, interestingly, some of the anecdotes the authors provide describe just that: The growth of a competitive industry, ultimately fully owned by locals, but launched through FDI.

<sup>20</sup> See Radelet (1999), which includes references to country case studies in Africa, Asia and Latin America.

may indeed be a prerequisite, even if not a sufficient condition, for attracting investment into non-traditional manufactures.

As discussed above, the case for subsidizing exports must be carefully qualified. But if EPZs are considered useful, perhaps elements of export subsidization could be transformed into WTO-compatible incentive schemes while continuing to fulfil the objectives of the zone.<sup>21</sup> If existing incentive schemes are to be kept in place, the contingency on exports could nevertheless be lifted if firms were allowed to operate in EPZs without being required to export. This implies that EPZ firms could also supply the domestic market. Companies in the Manaus EPZ in Brazil, for instance, are permitted unlimited sales within the country (Madani, 1999). Such an approach also crucially enhances the potential for forward linkages in the economy. Even if a majority of goods produced within a zone are exported, any subsidies to firms related to operation within the EPZ cease to be contingent upon export performance. Another solution that keeps incentives untouched would be to extend benefits enjoyed by exporters within the zone to firms outside. For instance, tariffs on capital goods and key raw material inputs could also be eliminated for domestic firms. Additionally, the implicit discrimination against domestic input production, which can act as an important obstacle to the creation of backward linkages, would be removed. However, developing countries argue that they cannot afford to grant income tax exemptions to all domestic firms nor forego all tariff income on capital goods, two of the major benefits frequently provided to EPZ firms. While income taxation is an important source of government revenue, it is debatable whether much would be lost if domestic industries were also to enjoy tariff-free importation of equipment, transport vehicles and other capital goods, and in parallel tax collection rates were improved.<sup>22</sup>

Alternatively, EPZ incentives could be modified in a way that would maintain only those elements of export contingency that are WTO-consistent and abolish all export subsidy components of the incentive package. For instance, exemptions from direct taxes and from import duties on goods that are not consumed in the production process would need to be eliminated. WTO-compatible duty-drawback schemes could be installed for the importation of other inputs that would remain *de facto* duty-free. Other forms of export assistance could be offered, such as the provision of export credits at interest rates at or above those actually paid by the government. It is widespread practice even in developed countries that export credit agencies raise funds in international markets and extend credits to exporters at interest rates in excess of what is paid by them. These rates may still be better than what could be obtained by the individual firm.

In view of the risks of subsidy competition, it seems doubtful that S&D exemptions on export subsidization would be beneficial to developing countries overall. Rather, it appears important, especially for the economically weaker and smaller developing countries, that common principles in the provision of incentives are respected. The multitude of tax breaks and holidays are easily matched and competed downwards by other zones around the world. Even if an attractive incentive package is offered, success may remain elusive. Madani (1999) provides an overview of experiences of African countries that undertook to match concessions provided by counterparts in the Caribbean and Central America. In most cases the establishment of EPZs and generous provision of export incentives did not lead to significant investment in export manufacturing in view of other constraints related, for instance, to education levels or inadequate private property and labour laws. It may therefore be reasonable to assume that other conditions relating to adequate infrastructure, reliable institutions, sound macro-economic policies and minimal bureaucratic red tape weigh more heavily on the success of EPZs and a country's integration into the world economy.<sup>23</sup>

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<sup>21</sup> Depending on specificity, WTO-consistent subsidies may still remain actionable and in certain cases be countervailed.

<sup>22</sup> It should be borne in mind, however, that the factor intensity of production might be adversely affected by such policies, given relative factor endowments and related efficiency considerations.

<sup>23</sup> For a country-by-country analysis of export promotion activities in Latin America see Macario (2000). The study recommends a redesign of these policies for a large variety of reasons. Numerous ideas for

## (c) Is there a systemic bias against developing countries' exporters?

Other arguments in favour of export subsidization refer to a systemic bias in the capital markets against developing countries' exporters. First, asymmetric information is alleged to lead creditors to see exporters in developing countries categorically as high risk, including creditworthy operators among them. Second, developing countries demand more flexibility to finance their exporters in view of the fact that developed countries are allowed to provide concessional financing under paragraph (k) of Annex 1 of the SCM Agreement. It is difficult to estimate the relevance of the first issue. It would appear that, in general, creditors are more likely to curtail credit to other borrowers and favour exporters who demonstrate their ability to compete successfully in international markets. Commonly, exporters are also able to access international capital markets more easily than other domestic firms to secure credit on more favourable conditions. If a country feels compelled to pursue a high interest rate policy, there is still little reason to believe that this would adversely affect the export sector in particular. Quite to the contrary, exports by developing countries are typically based on their comparative advantage in labour-intensive and not in capital-intensive industries that are more interest rate sensitive. The IMF considers that the most appropriate policy response would be to eliminate the underlying distortion rather than to introduce new distortions in the form of subsidized export credits (Tokarick et al., 2003).

On the second issue concerning the interest rate floor created in paragraph (k) of Annex 1 of the SCM Agreement, it is true that an element of export subsidization exists in comparison to a market rate of interest. This floor equally applies to all Members, but developing countries hold that they are unable to borrow funds at low enough rates that would allow them to extend export credit at the authorized floor rate. This is why they see the necessity to use other forms of export subsidization, such as interest buy-downs or export credit guarantees. They complain that an explicit safe harbour is created for *de facto* exclusive use by developed countries, while other provisions they may be interested in do not provide the same level of comfort and clarity. These issues merit further thought. Yet again, rather than calling for a wide-ranging authorization of export subsidization, redress may be sought in the current negotiations on WTO rules or within the international undertakings on official export credits referred to in paragraph (k).

## (d) Should S&amp;D be given to other forms of subsidies?

There are many other forms of subsidization that are used everywhere in the world and that are neither prohibited nor actionable under WTO rules. The provision of unemployment benefits or general subsidization of health and education programmes are of particular importance to the less well-off in all societies. The rules and disciplines set out in the SCM Agreement apply to specific subsidies granted to a specific enterprise or group of enterprises or industry or region; subsidies granted generally within an economy are therefore not covered.<sup>24</sup> However, some developing countries wish to expand the range of specific subsidies to be considered non-actionable, i.e. impossible to countervail. In the S&D discussions, a proposal was made to continue for at least 8 years the non-actionability of subsidies that may have served a genuine purpose in privatization programmes in order to ensure "good adjustment of the economy".

Rather than carving out broad exemptions for somewhat unspecific purposes under the heading of S&D, the reinstatement of the category of non-actionable subsidies seems to be amenable to a wider coalition of developing and developed countries. This provision was allowed to expire in 2000, as it was considered not to reflect the specific interests and circumstances of all the Members. It included subsidies for research activities, disadvantaged regions and adaptation of firms to new environmental

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change are provided. The need for WTO-compatibility is acknowledged, yet not examined for any of the proposed measures.

<sup>24</sup> Under Article 2.3, prohibited subsidies, such as export subsidies, are by definition specific and therefore covered by the Agreement.

requirements, subject to precise sets of conditions. Proposals on how to make this category more relevant for developing countries have so far remained at a general level, referring to subsidies targeted at technology research, production diversification and development. Only once the specifics of these ideas are known will it be clear whether the concept of "green" subsidies would be upheld to comprise only those that have little or no impact on trade.

An indication of the kind of developing country concerns that could be accommodated in a category of minimally trade-distorting support, which is nevertheless available to all Members, is given in the area of agriculture. The so-called Green Box covers, subject to specific criteria, certain direct payments to producers and a wide range of government measures, such as marketing and promotion services, a variety of infrastructural services, food security programmes and domestic food aid. The Chair's draft modalities contain elements that could possibly be added, such as payments to small-scale producers/family farms for the purpose of maintaining rural viability and cultural heritage in developing countries. However, the Agreement on Agriculture also seems to recognize the need to support production in developing countries despite trade-distorting effects, for instance in the case of investment subsidies and agricultural input subsidies generally available to low-income or resource-poor producers. Again, the Chair's draft modalities contain additional elements for possible inclusion, such as subsidies for the establishment of regional and community credit cooperatives or transportation subsidies for agricultural products and farm inputs to remote areas.

(e) Flexibility to subsidize must be carefully designed

It is difficult to make a case for subsidies that hurt the trade of other countries. There is no reason to believe that a downward spiral of subsidy competition would not set in, also among developing countries. Even under purely domestic considerations subsidies may frequently not be the best instrument to achieve some of the objectives commonly advanced by developing countries. The case is not entirely clear-cut with EPZs. In order to determine whether S&D may be warranted, it may be useful also to consider whether EPZs are a step towards further economy-wide reforms or whether they reduce the need to liberalize the rest of the economy. The latter may be the case if the subsidized export sector earns foreign exchange and creates new employment opportunities to an extent the government considers sufficient. This may lead to a protraction of policies of high protection for import-competing industries that many countries pursue in parallel to export promotion. Even if this is the case, export policies that merely offset the effects of import protection, such as duty drawback schemes, are preferable to policies with an export subsidy component. Subsidies cannot be condemned across the board: First, there are cases where developing countries could usefully provide production subsidies that are limited to at most minimally trade distorting measures, for instance in supporting subsistence farmers. Second, a practice that contains an export subsidy element, such as average compensation for duties paid, may be tolerated for a given amount of time owing to its administrative simplicity. Two conditions may be attached. Given that in the latter case the government inevitably encourages lobbying for the continuation of a scheme, a pre-determined time-plan for phase-out or conversion into a WTO-compatible scheme is crucial. In addition, such time-limited exceptions, despite being of development value, may have to be limited to the poorest and smallest countries in order to reduce adverse effects on others.

E. POSTPONING THE APPLICATION OF CERTAIN RULES

The implementation of certain multilateral commitments and concomitant domestic reforms may involve considerable adjustment costs. With the acceptance of the Uruguay Round Agreements as a single undertaking, most developing countries saw a sharp rise in their obligations. While a number of developing countries were in the process of liberalising unilaterally (i.e. reducing trade protection at the border), many had yet to address "behind-the-border" measures in a systematic fashion on the scale implied by the agreements.



- (a) There may be a need for more time to adjust to new rules

Some of the WTO Agreements require investments in capacity to support their implementation and derive the benefits. Examples are the cost of training and infrastructure to implement commitments under the Agreement on Implementation of Article VII of GATT 1994 (customs valuation agreement) or the Agreement on Technical Barriers to Trade. A distinction needs to be made between adjustment related to a lack of implementation capacity as opposed to political difficulties in reaching compliance. As was discussed in sections C and D above, adjustment in the latter sense often refers to political economy costs stemming from changes in sectoral employment and output patterns associated with the phasing-out of trade distorting measures. Ultimately, the removal of distortions must be considered beneficial, e.g. when the elimination of a protectionist bias in favour of industrial lobbies removes the implicit taxation of the rural agricultural sector, where the majority of the poor may be engaged. Hoekman et al. (2003) therefore argue against exceptions on core disciplines, such as tariffs and other policy-induced distortions (notably subsidies and TRIMs).

Nevertheless, in the short-term, the existence of adjustment-related costs requires governments to devise flanking policies, develop alternative measures to pursue certain non-trade policy objectives and address structural obstacles (such as insufficient inter-sectoral factor mobility) which may otherwise amplify costs or cause them to persist. Other costs may relate to the establishment of social safety nets to cushion the overall liberalization process. Despite the gains from an improved allocation of resources in the long-run, liberalization may imply transitory hardships stemming from changes in production patterns (WTO Secretariat, 2003b). This is why temporary exceptions may be necessary even in areas where the economic case for trade policy measures is weak. But as was said before, in order to ensure predictability, provide the incentive to undertake reform and not merely postpone the day of reckoning in the hope of further extensions, a clear deadline for temporarily authorized trade-distorting measures must be set.

While difficult to bear in the short-run, costs associated with the capacity to implement WTO agreements are not dead-weight losses. Ultimately, investment in the establishment of an efficient customs or standards authority are beneficial. Implementation costs in such cases are not in themselves an argument against policy reform. However, an assessment is required in a wider policy framework as to when such costs should be incurred. In the case of customs valuation, for instance, time-limited extensions have been authorized by the WTO membership on a country-by-country basis. In each case, an attempt was made to assemble a technical assistance and capacity building plan that was supposed to address the specific constraints impeding progress in customs reform. This model provides some useful elements for consideration in the context of multi-donor technical assistance programmes. But, as was stated earlier, the WTO is not in a position to deliver most of the required assistance itself nor are donors able to guarantee successful outcomes. Again, while being an indispensable complement, technical assistance cannot substitute for legally enforceable S&D obligations. Making the provision of trade-related technical assistance mandatory is not helpful, as the donor community may simply shift the resources away from other development priorities. Also, the incentives for genuine restructuring and reform at the receiving end may be hampered if insufficient assistance could serve as a scapegoat in the face of a lack of political will.

- (b) Just how much time is enough?

In light of the above, many S&D proposals that have sought exemptions from implementation obligations for an unspecified time have not been well received. In the post-Doha discussions, some developing countries proposed, for example, that extensions of the transition period for implementation of the Customs Valuation Agreement, including the right to use minimum values, be renewed automatically upon request by a developing country Member. A number of other proposals of a similar nature have been put forward. Under such arrangements, beneficiaries of S&D would be self-selecting and would determine for themselves when they were ready to assume a higher level of obligation. Many WTO Members have reservations about such arrangements because they would be devoid of any contractual character and would not guarantee any significant reform effort in the

foreseeable future. But if autonomous decision-making is unacceptable in this field, what arrangements can be made to ensure that S&D provisions are responsive to development needs?

Three issues arise here. First, in many cases transition times for implementing various agreements are set at a standard length for a whole range of countries with markedly different levels of resources and at different stages of development. Examples of such provisions include an extended time period for implementing reduction commitments under the Agreement on Agriculture (Article 15.2), a longer elimination period for trade-related investment measures (TRIMs) under the Agreement on Trade-Related Investment Measures (Article 5.2), extended implementation periods for applying certain provisions of the Agreement on Implementation of Article VII of GATT 1994 (customs valuation – Article 20.2), delay in implementation of certain provisions of the Agreement on import Licensing (Article 2.2, footnote 5), and transitional periods for the implementation of the Agreement on Trade-Related Aspects of Intellectual Property Rights (Article 65).

A second feature of a number of S&D provisions not to the liking of many developing countries is that access to S&D will be decided by the membership upon the request of a developing country Member. In a consensus-based institution like the WTO, the concern is that the discretionary character of decisions relating to S&D may lead to undesirable forms of conditionality and arbitrariness. Governments wish for a greater degree of policy certainty. Examples of such discretionary provisions include compliance delays under the Agreement on the Application of Sanitary and Phytosanitary Measures (Article 10.2 and 10.3), time-limited exceptions to certain provisions of the Agreement on Technical Barriers to Trade (Article 12.8), and extensions to the standard S&D provisions under the Agreement on Implementation of Article VII of GATT 1994 (Customs Valuation – Annex III.1 and III.2).

Thirdly, all the S&D provisions cited above, and many more besides, refer to developing countries as the beneficiary group. As discussed at the beginning of this section of the paper, developing country status has never been formally defined in the GATT/WTO. Members have decided for themselves whether they are developing countries and by extension whether they wish to take advantage of S&D provisions. Developed countries have tried a different approach to defining developing country status by reference to graduation, but this has proved no more successful as a means of defining an explicit category.

In sum, the vast majority of S&D provisions are somewhat blunt policy instruments in that they do not distinguish among developing country Members in terms of their differing development needs,<sup>25</sup> access to some S&D provisions is left to the discretion of the WTO membership as a whole, and most provisions define beneficiaries in terms of an ill-specified group called developing countries.

As discussed further below, a possible approach to all three of these problems would be to define access to S&D provisions as an integral part of the provisions themselves. This could be done through a more differentiated approach to setting time frames for implementation on the basis of certain development-related criteria, or preferably in a more direct manner through explicit thresholds based on economic criteria. Mention has already been made of the GDP per capita criterion for access to export subsidies on manufactures. Other examples of this approach can be found in the Agreement on Subsidies and Countervailing Measures and the Agreement on Safeguards, where certain thresholds exempt developing countries from investigations or actions. These provisions are still couched in terms of developing countries as beneficiaries, but they rely on the notion of a threshold and could perhaps be designed in a manner that obviated the need for reference to developing countries as beneficiaries.

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<sup>25</sup> The obvious exception to this is the least-developed country category, although there are then no distinctions made among least-developed countries.

#### IV. A NEW APPROACH TO S&D

##### A. NEW APPROACHES TO S&D AND THEIR DEFICIENCIES

All new approaches to S&D that have recently been advanced by academics and other researchers have in common a recommendation to differentiate between developing countries in recognition of the fact that meaningful S&D can only be achieved if it responds more effectively to differing needs among developing countries. Three principle strategies have been advocated. Firstly, total flexibility could be given to all countries whose non-compliance does not cause harm to other countries (Stevens, 2002). This idea may be inspired by the observation, e.g. in the area of customs valuation, that a range of developing and least-developed countries have not asked for S&D and, hence, are supposed to have implemented the Agreement. Yet, in all likelihood they disregard their obligations while remaining unscathed due to their minor importance to trading partners. It is very doubtful that this practice, essentially an expression of disinterest in smaller and poorer countries who are most in need of being integrated in the multilateral trading system, should be formalized under the heading of S&D. It would defy the fundamental insight that WTO disciplines in many ways can help to strengthen the ability of developing countries to design trade policies that are oriented towards integration in the world economy and supportive of economic development and growth.

Secondly, it has been argued that current country groupings need to be renegotiated. Specifically, this would mean that WTO Members cease to be able to self-select their developing country status and are categorized into a larger number of sub-groups than is presently the case. Hoekman et al. (2003) contend that an "LDC+" group of small and poor developing countries determined by size and per capita criteria would by and large capture those countries in real need of S&D across all WTO agreements. In order to deal with individual countries that claim inclusion in this group on a case-by-case basis, a demanding appeals procedure is proposed. The major disadvantage with this approach is that it continues to feature two of the main elements that render current S&D less than fully functional, namely (a) making the same group of countries eligible for S&D across all agreements and (b) making eligibility for any other deserving developing country subject to discretionary decision-making by all Members.

Finally, in an attempt to adopt an agreement-specific focus and tailor the provision of S&D more to the needs of individual countries, Wang et al. (2000) and Prowse (2002) espouse somewhat similar concepts involving an assessment of the costs and the capacity of countries to implement WTO Agreements. As a result of these "audits", a time interval would be determined during which the country is exempted from the rules and a tailor-made programme of technical assistance and capacity-building is provided by a broad range of relevant donors. It is doubtful that the necessary coherence in national policy-making or between international and bilateral donors currently exists to realize such an ambitious and resource-intensive approach to S&D. Moreover, these types of assessments leading to sophisticated technical assistance plans for individual countries are already undertaken within the integrated framework for LDCs. Making assistance on the basis of needs assessments available to a broader range of developing countries should complement S&D, but this cannot substitute for a set of legally enforceable provisions.

A common critique of all of the above approaches is their strong emphasis of the creation of new country groupings. This is unrealistic. Among the reasons why WTO Members resist such an exercise, even if assured that it would be limited to S&D matters, is the fear of spillover effects to the negotiations, where the impression of belonging to a sufficiently advanced sub-group receiving comparatively less S&D is likely to lead to more extensive demands by negotiating partners. A calibration exercise that has recently been undertaken by the OECD was put on the back burner by OECD members, supposedly because whatever statistical approach chosen, some developing countries were always grouped together with developed countries and others with LDCs. Despite the understandable uneasiness about such stark differentiations, the analysis by the OECD provides a good basis for further research into economic and social indicators that could be used to define implicit thresholds defining access to individual S&D provisions. It seems that the heterogeneity of

developing countries is more appropriately reflected in the sectoral approach taken by the OECD to analyze the services area. Accordingly, the paper applauds the issue-specific analysis by Stevens (2002) in the field of agriculture, which will be further considered below as an illustration of an implicit threshold approach to S&D.

## B. AN IMPLICIT THRESHOLD APPROACH

The key element of an implicit threshold approach to S&D would consist in identifying measurable criteria that define access to S&D on a provision-specific basis. For some issues, access may be open-ended and directly linked to the fulfilment of the criteria, for others access may be time-bound. An important feature of provision-specific access thresholds would be that the group of eligible countries is initially open and may differ from the set of countries that fulfils the criteria devised for other provisions and agreements. An example of this approach is the fast-track procedures for extending transition periods under Article 27.4 of the Agreement on Subsidies and Countervailing Measures (SCM). Members fulfilling specific economic criteria and adopting defined programmes may continue to use certain kinds of export subsidies for a limited amount of time. The choice of criteria limiting eligibility to relatively poor and small countries – share of world merchandise export trade not greater than 0.10 per cent and total Gross National Income for the year 2000 as published by the World Bank at or below US \$ 20 billion – effectively allows export subsidies to be used only by countries without the ability to influence world market prices and trigger subsidy competition.

The merit of provision-specific S&D access criteria has been illustrated by Stevens (2002) in what so far has been the only scholarly exercise along these lines. His attempt to develop a pragmatic case for S&D is based on the premise that eligible countries must share a set of "differences" that are directly related to the rules for which special treatment is proposed. He undertakes an illustrative analysis of criteria that are relevant to a specific S&D concern in the agricultural area and determines the range of countries captured by various thresholds. Under the assumption that some form of S&D relating to the subsidization of domestic production is provided for food insecure countries at the end of the current negotiations on agriculture, Stevens (2002) asks which country characteristics could usefully be combined to determine access to such a hypothetical provision. He observes that low GDP and reliance upon imported food – seemingly obvious and necessary indicators of growth prospects and food trading possibilities – are not sufficient to capture the phenomenon of national food insecurity. Instead, he proposes per capita calorie supply as a basic indicator of countries with significant parts of the population being vulnerable to food insecurity. In addition, the share of agricultural value added in GDP is used as a measure of the degree to which food insecurity may be related to agricultural income and/or potentially alleviated by improved domestic production. Combining an FAO-endorsed minimum per capita calorie intake of 2500/day and a 20 per cent share of agriculture in GDP, a set of 43 countries emerges sharing both criteria and 76 fulfilling at least one. Interestingly, more than a quarter of the first set and almost 40 per cent of the second are neither net food importing developing countries nor least-developed countries. This shows that these two commonly used country categories in the WTO may not suffice to characterize countries to be targeted by S&D. In view of the negative effects that subsidization may have on other countries, Stevens (2002) suggests a third qualifier of a maximum 0.25 per cent share in world agricultural exports. This is similar in principle to the 0.10 per cent merchandise export share used in the SCM Agreement fast-track procedure aimed at limiting possible negative impacts on third countries. The precise threshold figures may obviously take different values, for instance as a function of an agreed maximum cumulative effect.

The upshot of the above analysis is that whereas LDCs may form the core of any group of countries eligible for S&D, a provision-specific approach allows for the additional, automatic (i.e. not depending on the discretion of other Members) integration of countries with specific S&D needs. The advantages of provision-specific thresholds in terms of reflecting more closely the concrete needs of eligible countries are particularly evident when Stevens' results are compared to, for example, the set of countries covered by the SCM Agreement fast-track approach. This has been done in the Annex to

this paper for the two core criteria of each provision-specific approach.<sup>26</sup> The comparison reveals significant differences between the two sets of eligible countries. It demonstrates that the application of either set of criteria to both provisions would not properly reflect the array of countries that should arguably benefit from a given S&D provision. For instance, applying Stevens' (2002) criteria to the SCM Agreement fast-track issue would have resulted in the exclusion from eligibility of several countries that have actually been granted a time-limited exemption in respect of specific export subsidy programmes (Bahrain, Barbados, Belize, Costa Rica, El Salvador, Fiji, Grenada, Jamaica, Jordan, Mauritius, St. Kitts and Nevis as well as St. Lucia). Conversely, several food insecure countries, as measured by the standards laid down by Stevens (2002), would not be eligible for S&D if the SCM Agreement fast-track criteria were to be applied (Armenia, Croatia, India, Nigeria, Pakistan, Peru, Philippines, Thailand, Venezuela). Most of the latter would presumably also have been barred from S&D if Hoekman et al.'s (2003) approach had been pursued to define a new "low income and disadvantaged country group" – consisting of very small economies as well as low-income countries – horizontally across all agreements considered to be particularly resource-intensive in their implementation.

At least two important qualifications are in order. First, of course, the nutrition indicator used in the identification of food insecure countries hardly bears any relevance for the question of a more general extension of export subsidization. Thus, while the comparison may seem absurd, it allows us to shore up an obvious, yet important insight. The intention has simply been to illustrate that the more need-specific an S&D provision is and, hence, the more diligent an effort is made to avoid leaving out countries that deserve inclusion and vice-versa, the less easily its threshold criteria may be transferred to other S&D contexts. Conversely, the blunter the criteria, the more similar the two sets of countries are likely to be, but the higher the probability that deserving countries are omitted in any individual context. For instance, if Stevens' (2002) third criterion (maximum 0.25 per cent share in world agricultural exports) was added as an overarching threshold confining eligibility to small economies, the set of countries would be reduced, e.g. by Thailand, and, hence, become more akin to the one qualifying for SCM Agreement fast-track treatment.

Second, the SCM Agreement approach reflects more of a political compromise. Unlike Stevens' (2002) selection of criteria, it was not explicitly premised on development-relevance as a guiding principle. Hoekman et al. (2003) argue that certain "developmental" preconditions, which need to be fulfilled before implementation becomes beneficial, can be proxied by indicators defining least-developed countries plus a minimum level of per capita income and size. Yet for specific S&D needs – such as the above example of food security – current constraints and options are as much, if not more, a function of past policy choices, events and wider circumstances than they are, for instance, of levels of income or country size. This calls for a more fine-tuned approach that allows individual countries to qualify for a specific S&D provision even if excluded from many others.

The single biggest challenge for a new individual threshold approach to S&D would consist in defining analytical criteria that are relevant to specific S&D concerns and measurable with existing data. This process should ideally be as depoliticized as possible and build on the insight that relatively more advanced developing country Members still gain in resigning themselves to access to fewer, but enforceable and relevant S&D provisions. It should also be acknowledged that while development-relevance is the key determinant in the selection of appropriate threshold criteria, the effect of access to S&D on other countries or on the functioning of the multilateral trading system will figure as second-order considerations. This particular problem is likely to be relevant only in a few areas, such as subsidization and certain forms of import protection, for which the economic case may be contentious and the negative impact on others strong, but for which pragmatic arguments can be adduced to justify temporary exceptions. Provision-specific S&D may, in such cases, only afford a "once-off" time interval to countries qualifying under the threshold criteria at a certain point in time. Time intervals may also vary on the basis of a set of staggered criteria, providing longer time-frames

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<sup>26</sup> As stated above, least-developed countries are assumed to qualify for access to S&D under both sets of criteria or be automatically covered as the default group.

to weaker Members. Such an approach would allow for the sequencing of trade reforms vis-à-vis other trade and broader economic reforms.

For the other type of adjustment costs – stemming from human and institutional capacity requirements – Hoekman et al. (2003) propose S&D for an "LDC-plus group" in the form of exemptions from agreements that have been identified as "resource-intensive". The underlying logic behind this argument appears to be that as countries progress to higher levels of development, they will be in a better position to undertake the various investments needed to support reform. The counter-argument is that development prospects are likely to be enhanced if reforms are undertaken in the first place, rather than delayed, as even agreements such as customs valuation contain elements that are comparatively less resource-intensive, but effective in tackling entrenched policies which hinder rather than promote development.<sup>27</sup> Provision-specific thresholds could again prove to be a pragmatic solution to this dilemma. Qualifying countries would be exempt from a specific provision, e.g. the prohibition to use minimum values in customs valuation, for as long as the objective criteria are fulfilled. In certain cases, it may be that countries lose eligibility and can subsequently fall back under the threshold, even repeatedly. Conversely, key provisions of the agreement would continue to be applicable, for instance Articles 9 and 10 of the Customs Valuation Agreement, relating to currency conversion and confidentiality requirements respectively.

The discussion here has focussed on S&D within existing agreements, bearing in mind the experience of debates in the Special Session of the Committee on Trade and Development. However, the proposed approach would be as applicable where additional elements of S&D are being designed under new agreements, or differentiated approaches to trade liberalization commitments are being negotiated.

## V. CONCLUSIONS: THE WAY FORWARD

For many developing countries, a satisfactory outcome on S&D issues will be at the core of their judgement on the results of the Doha negotiations and the utility of the WTO as an institution supportive of development. The focus here has largely been on S&D in terms of the debate as it has unfolded in the WTO. The discussion is not about whether S&D provisions are legitimate, but how they should be designed to respond to the needs of developing countries as they undergo economic transformation through a process of development. Little mention has been made of other aspects of the multilateral trading system that also influence development. The question of better market access for products of export interest to developing countries has not been addressed. Nor has much attention been paid to the ways in which obligations under the WTO can help to strengthen the ability of developing countries to pursue effective development policies.

The current S&D debate in the WTO has old and new elements. The old element springs largely from the post-Uruguay Round situation, where developing countries assumed a wide array of additional policy obligations under the WTO as result of the single undertaking. The quest for changes to these provisions through the implementation debate and the post-Doha S&D exercise has so far yielded few results. There are a number of reasons for this, relating both to the manner in which the issues have been approached and the degree of willingness of Members to make legal changes to provisions outside a negotiating framework. A more analytical approach to a sub-set of proposals on the table that carry real implications for the development prospects of developing countries might yield a more fruitful outcome. This "backlog" of S&D issues cannot be ignored where existing provisions can be shown to hamper development.

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<sup>27</sup> It is not intended here to repeat the discussion of whether the implementation of WTO rules is more burdensome or more necessary for poorer countries, or perhaps both. Suffice to recall here that WTO rules are in many instances an important tool for governments to forge ahead with necessary reforms that are in the national interest but resisted by powerful lobby groups.

The new element in the S&D debate relates to negotiations under the Doha mandate. Here there is easier opportunity to be innovative in the design of S&D provisions to ensure that they are adequately "customized" and respond to a clear and systematic formulation of the national economic interest. It would be regrettable if dissension around the old S&D agenda were allowed to obscure the search for constructive approaches in the current negotiations.

This paper has attempted to disentangle the S&D debate and point to directions in which discussions might go in searching out more promising prospects for agreement on the fundamental question of how to define and manage access to special and differential treatment provisions under the WTO. The paper has been constructed around a five-fold distinction among key elements that appear to drive the debate. The main conclusions of the paper are summarized below:

- Special and differential treatment proper is about legal rights and obligations, not legally unenforceable statements of intent or "best-endeavour" undertakings. For practical reasons, the latter provisions may or may not lend themselves to transformation into mandatory instruments. Where this is clearly not the case, or where to do so would offer little by way of support to development, progress in S&D would be promoted if such provisions were taken off the table. Where analysis shows that making a non-mandatory provision mandatory is indeed a contribution to development, then developing countries would gain from pursuing the relevant proposals.
- Special and differential treatment provisions are not a safe haven from poorly framed rules that compromise development objectives. Where new policy areas or new rules are under negotiation, or consideration for negotiation, the best interests of developing countries would be served through engagement with respect to the substance of core proposals. Seeking exemptions via S&D merely postpones any difficulties that might arise from inherently flawed rules. This does not mean that S&D provisions would be absent from a well constructed set of rules.
- Treating S&D primarily as a political right, rather than as a rule-specific instrument to support development in particular policy areas is a recipe for inconclusive discussion and mutual frustration. Reliance on generalized precepts about entitlements, or the lack of them, tends to lead to extreme positions. One such example is the often unspoken assumption behind S&D debates that since S&D is a right, the fewer the obligations developing countries assume the greater is the contribution of the WTO to development. A similarly unhelpful politicization of S&D discussions arises from the tension between non-reciprocity and graduation. Graduation, in particular, cannot be usefully discussed in a binary, aggregated fashion whereby countries calling themselves developing are deemed at one stroke to have graduated to developed country status. The process should be gradual, provision-specific and driven by detailed analysis of development needs.
- Preferences have proved helpful to some countries for certain periods of time when certain other conditions have been present. Exports from such countries have gained footholds in industrial country markets in the presence of preferences.<sup>28</sup> But the utility of preferences can be over-stated. In many cases, countries lack the supply capacity to benefit from such arrangements, yet they may pay a price for them in terms of being unable to negotiate for better benefits elsewhere. Transaction costs often reduce the value of the preference margins, or if the margins are small, nullify the benefits altogether. Also, preferences for some mean discriminatory exclusion and potential losses for others. The larger the number of countries seeking preferential treatment and the more similar their export structures, the less will be the competitive benefit each country enjoys. When beneficiary countries are "too

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<sup>28</sup> It is important to note that successful exporters will have assembled a range of necessary conditions for exports to take off and so it is difficult to gauge how much export success to attribute directly to the existence of preferences.

successful", they may be dropped from schemes and left with overcapacity or a production structure that is not based on comparative advantage. Preferential arrangements create vested interests that oppose multilateral trade liberalization. Bearing in mind the inevitably temporary nature of preferences, inherent limitations in the benefits they offer, and the potential distortions they imply, a calculation is required of their value in terms of negotiating currency.

- Local content requirements and the protection of domestic industries against foreign competition may have done more harm than good to the growth prospects of some developing countries. Were countries to have total discretion via S&D to apply such measures, protection would likely persist and lead to permanent, development-inhibiting distortions in resource allocation within and among developing countries. A good case can, however, be made for a paced phasing-out of trade-distorting measures and the provision of time to adjust. Predictability must be ensured by specifying clear time-frames. Proposals for S&D should take account of the underlying welfare analysis, rather than being based on a desire to maximize legal flexibility. The latitude to constrain imports should also be inversely related to the trade-restricting and market-distorting effects of the authorized measure (i.e. giving preference to tariffs as opposed to quantitative restrictions) and to the potential negative impact on other countries and any adverse systemic implications for the functioning of the multilateral trading system.
- Flexibility to subsidize must be carefully designed to avoid wasteful subsidy competition. Some accommodation within general rules or as a matter of S&D can be provided for clearly defined purposes which, more often than not, have only minimally trade-distorting effects. Export subsidization cannot be generally justified in economic terms. Yet, given revenue constraints militating against the use of production subsidies and limited administrative capacities in certain countries, there may be a case for extended phase-outs of export subsidy elements. To the extent that export subsidies are provided, these will typically be less distorting the more generally available and directed they are to infrastructure.
- Flexibility as to when developing countries should assume WTO obligations reflects an appreciation of the adjustment costs of change as well as administrative and infrastructural capacity needs that might be associated with implementation. But such flexibility should not be a blank cheque, as implied by some proposals in the post-Doha S&D exercise. Neither should S&D be a blunt or mechanical instrument made available on uniform terms to all developing countries. Reliance on discretionary decision-making by WTO Members as to the terms and conditions of access to S&D on the part of individual Members should also be avoided.
- Instead, S&D provisions themselves should be defined to the maximum extent possible in terms of economic needs that automatically identify the beneficiary Members. As these measurable needs diminish and disappear, so too would the right of a Member to the S&D provision in question. Eligibility thresholds should be development-related. In some cases, only once-off time periods may be obtained, with the possibility of affording longer time periods to weaker Members. In others, exemption time may be directly linked to the fulfilment of the threshold criteria. It was not the intention of the authors to provide any definitive answer as to how such criteria could be framed for individual provisions. This is a delicate and potentially time-consuming exercise that would need to be started at the earliest opportunity if such an approach were acceptable to governments.



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## VII. ANNEX

Neither list contains least-developed country Members, as they are presumed to qualify for S&D in both cases.

WTO Members meeting proposed trade share <sup>a</sup> and total GNI <sup>b</sup> under the SCM fast-track approach <sup>29</sup>	WTO Members meeting proposed per capita calorie supply <sup>c</sup> and/or agricultural value added share of GDP <sup>d</sup> under Stevens (2002)
<p>Coding:</p> <p>Members identified in <b>boldface</b> type are Members listed in Annex VII(b) whose per capita GNI was less than \$US1,000 on the basis of the most recently available data published by the World Bank.</p> <p>Members identified in <i>italics</i> type are Members who have actually been granted an extension. All the requests made have been granted.</p>	<p>Coding:</p> <p>Members identified in normal typeface fulfil both criteria simultaneously.</p> <p>Members identified in <b>boldface</b> type only fulfil the per capita calorie supply criterion.</p> <p>Members identified in <i>italics</i> type only fulfil the agricultural value added share in GDP criterion.</p>
Albania	<i>Albania</i>
<i>Antigua and Barbuda</i>	<b>Antigua and Barbuda</b>
	Armenia
<i>Bahrain</i>	
<i>Barbados</i>	
<i>Belize</i>	
<b>Bolivia</b>	<b>Bolivia</b>
Botswana	<b>Botswana</b>
Brunei Darussalam	
Bulgaria	
<b>Cameroon</b>	Cameroon
<b>Congo</b>	<b>Congo</b>
<i>Costa Rica</i>	
<b>Côte d'Ivoire</b>	<i>Côte d'Ivoire</i>
	<b>Croatia</b>
Cyprus	
<i>Dominica</i>	<i>Dominica</i>
<i>Dominican Republic</i>	<b>Dominican Republic</b>
Ecuador	
<i>El Salvador</i>	
Estonia	
<i>Fiji</i>	
Gabon	
Georgia	<i>Georgia</i>

<sup>29</sup> No attempt has been made to remove from this list non-developing country Members or any developing country Members not otherwise eligible to request an extension pursuant to Article 27.4.

<b>Ghana</b>	
<i>Grenada</i>	
<i>Guatemala</i>	Guatemala
<b>Guyana</b>	<i>Guyana</i>
<b>Honduras</b>	Honduras
Iceland	
	India
<i>Jamaica</i>	
<i>Jordan</i>	
<b>Kenya</b>	Kenya
Kyrgyz Rep.	Kyrgyz Rep.
Latvia	
Lithuania	
Macau, China	
Malta	
<i>Mauritius</i>	
Moldova, Rep. of	<i>Moldova, Rep. of</i>
Mongolia	Mongolia
Namibia	<b>Namibia</b>
<b>Nicaragua</b>	Nicaragua
	<i>Nigeria</i>
<i>Panama</i>	<b>Panama</b>
	Pakistan
<i>Papua New Guinea</i>	Papua New Guinea
Paraguay	<i>Paraguay</i>
	<b>Peru</b>
	<b>Philippines</b>
Solomon Islands	
<b>Sri Lanka</b>	Sri Lanka
<i>St. Kitts and Nevis</i>	
<i>St. Lucia</i>	
<i>St. Vincent and the Grenadines</i>	<b>St. Vincent and the Grenadines</b>
Suriname	
Swaziland	<b>Swaziland</b>
	<b>Thailand</b>
Trinidad and Tobago	
	<b>Venezuela</b>
<b>Zimbabwe</b>	<b>Zimbabwe</b>

<sup>a</sup> Source: WTO Secretariat. The threshold used is a share of world merchandise export trade not greater than 0.10 per cent. Note: The calculation of export shares was performed by the WTO Secretariat as reflected in Appendix 3 to the Report of the Chairman contained in WTO document G/SCM/38. It was done based on the methodology used in International Trade Statistics 2000, table I.5. The world trade total used in the calculations includes EU intra-trade and re-exports. To reduce

the effect of volatility in export values, average 1998-2000 shares were used. Figures for a number of countries and territories have been estimated.

<sup>b</sup> Source: World Bank. The threshold used is a total Gross National Income ("GNI") for the year 2000, as published by the World Bank, at or below US \$ 20 billion.

<sup>c</sup> Source: UNDP, Human Development Report 2000: Table 23, as quoted in Stevens (2002). The threshold used is a per capita calorie supply of under 2500.

<sup>d</sup> Source: World Bank, World Development Indicators database website, as quoted in Stevens (2002). The threshold used is agricultural value added as a share in GDP of more than 20 per cent.