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# Preference Erosion and Aid for Trade: *A South Asian Perspective*

*Janaka Wijayasiri and Shihana Samad**

## Introduction

Erosion of trade preferences is an important issue in the on-going negotiations on multilateral trade deal under the Doha Round. Tariff reductions under agriculture and non-agricultural market access (NAMA) negotiations are expected to lead to lowering of most-favoured nation (MFN) tariffs, which is expected to adversely affect countries benefiting from various preferential agreements. Reflecting this concern, the Hong Kong Ministerial Declaration made explicit reference to preference erosion, recognising it as an issue that needed to be addressed. However, the debate over this issue has become a highly divisive one amongst developing countries in the World Trade Organisation (WTO) – between those who are beneficiaries of preferential agreements, namely least developed countries (LDCs) and those who have less preferential market access and how best to deal with problem.

**Box 1: What is meant by preference erosion?**

Preference erosion refers to a decline in the competitive advantage that preferential beneficiaries enjoy in markets abroad as a result of loss of preferential trade treatment. This can happen when preference granting countries:

- eliminate preferences;
- expand the number of preference beneficiaries; and
- lower their MFN tariff rates without proportionately lowering preferential tariffs.

Preference erosion is not a new concern. In fact, it has been in practice for decades as a result of unilateral, regional and multilateral efforts to liberalise trade. Every time there is a multilateral effort to reduce MFN tariffs, beneficiary countries of preferential agreements express concern over the possible adverse impact of the preferential margins they enjoy. Earlier, it was not a particular problem because preferential schemes such as the GSP offered tariff reductions but not duty free and quota free (DFQF) access. However, subsequent initiatives such as the European Union's (EU's) Everything but Arms (EBA) and the US African Growth and Opportunity Act (AGOA) and Caribbean Basin Initiative (CBI) offered DFQF access to almost all products, which means that any reduction in the MFN rate would lead to an erosion of preferential margins.

Countries now giving DFQF access to essentially all LDCs include Canada, EU, New Zealand, Norway, and Switzerland, while Japan offers duty free access to about 63 percent on its imports. The US offers special access to some LDC exports from African and Caribbean countries. For some countries with high concentration of exports, and which enjoy preferential access, the gains from preferences are very large and thus face larger losses in case of erosion of preferences. A number of proposals have been submitted to date to address the issue of preference erosion but there is no consensus on a solution to the problem.

This policy brief provides an overview of various generalised system of preference (GSP) schemes and identifies countries and sectors in South Asia, which would be vulnerable to preference erosion in the context of trade liberalisation under the Doha Round. Further, it discusses possible options available – both trade and non-trade related measures including Aid for Trade (A4T), to mitigate adverse effects of preference erosion and suggest a way forward to deal with the problem.

## Overview of EU and US GSP Schemes

In 1968, the United Nations Conference on Trade and Development (UNCTAD) recommended the creation of a GSP under which industrialised countries would grant trade preferences to all developing countries. The objectives of the GSP scheme in favour of developing countries were to increase their export earnings; promote their industrialisation; and accelerate their economic growth rates. There are currently 13 national GSP schemes but those of the US and the EU are the most important of all.

Currently, EU extends preferential market access to 178 developing countries under its GSP scheme, which was first implemented in 1971 and was subsequently revised a number of times. The most recent revised scheme was adopted in June 2005 and came into effect on January 01, 2006 and will be in place until December 31, 2008.

At present, there are three types of arrangements under the EU GSP scheme:

- Under the General Arrangement, duty free access is given to 3300 non-sensitive products while for 3900 sensitive products, there is a duty reduction of 3.5

* Research Economists, International Economic Policy Unit, Institute of Policy Studies, Sri Lanka

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percentage points from the MFN rate and 30 percent from the specific duties. All beneficiary countries including India and Pakistan enjoy benefits under this.

- Under the GSP-plus scheme, 14 countries are given DFQF access to the EU in turn for signing onto international conventions governing standards in human and labour rights, environmental protection, fight against drugs, and good governance. Sri Lanka is the only South Asian country enjoying benefits of the GSP-plus scheme.
- Under the EBA initiative, EU grants LDCs' DFQF access to its market. Both Bangladesh and Nepal are EBA beneficiaries with DFQF access for 9800 products to the EU market.

US-GSP scheme was first implemented in 1976 under the Trade Act of 1974. Since then it has been in operation initially for two 10-year periods and thereafter it has been renewed every one or two years with the most recent renewal in 2002.Under the US scheme 139 countries are eligible for GSP benefits of which 98 are developing countries and 41 are LDCs. Approximately 4,600 articles are eligible for duty-free treatment, and in 1997, LDCs became eligible for an additional 1,783 articles. However, the scheme excludes most textiles items, watches, footwear, handbags, luggage, flat goods, work gloves, leather articles and any article determined to be import sensitive.

**Vulnerability of Countries and Sectors in South Asia**

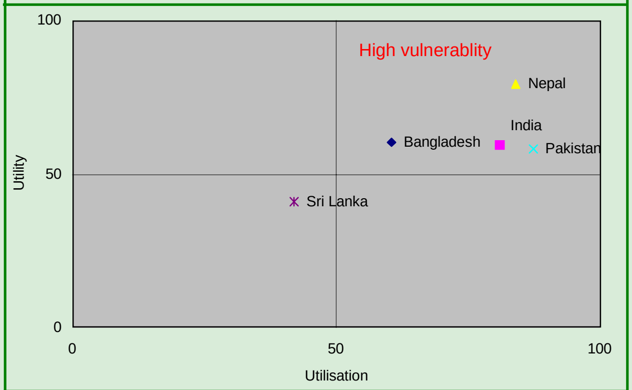
Charts 1 and 2 show the vulnerability of countries in South Asia to preference erosion in the EU and US, respectively with countries in the second quadrant being highly vulnerable while countries in the third quadrant being the least vulnerable to preference erosion. It means all the countries in the South Asian region are likely to experience preference erosion in the EU to some degree, while some countries are likely to be more affected than the others given their higher utilisation and utility levels such as Nepal, but Sri Lanka will not be affected much, as it has not been able to effectively use preferences extended by the EU and has been mostly exporting under MFN rates.

In the case of the US GSP scheme, almost none of the South Asian countries are highly vulnerable to preference as they face low utilisation and utility rates in the US market and are in the low vulnerability quadrant. This is due to low product coverage under the US GSP scheme.

India may be relative more susceptible to preference erosion compared to other countries in the region but on the whole it is not.

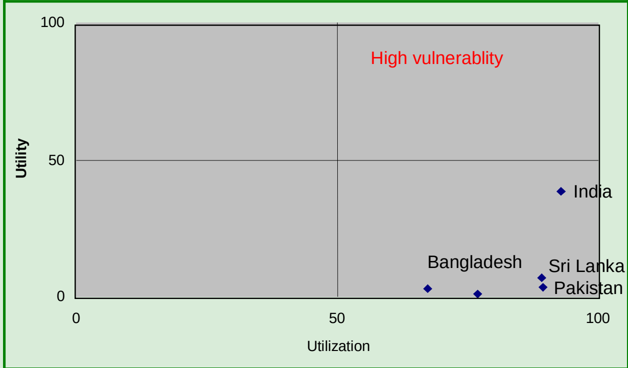
Tables 1 and 2 show sectors in South Asia, which are highly vulnerable to preference erosion in the EU and US, respectively. While there appears to be a number of export sectors vulnerable to preference erosion in the EU, many of these sectors do not account for more than five percent of the total exports except in the case of products, including: in India (textile and textile articles, precious stones, base metals, machinery & electrical appliances); in Nepal, (textiles and textile articles); in Pakistan (textile and textile articles); and in Sri Lanka (plastics and rubber; precious stones and vegetable products). In the case of the US, a few sectors in South Asia are vulnerable to preference erosion and even fewer sectors are of export importance such as precious

**Chart 1: Vulnerability to Preference Erosion in EU**




*Source: Compiled from data provided by UNCTAD*

**Chart 2: Vulnerability to Preference Erosion in US**




*Source: Compiled from data provided by UNCTAD*

**Box 2: Indicators to Determine Vulnerability to Preference Erosion**

1) Product coverage gives an idea of eligibility of products for preferences. The higher the value, the more generous the preferences may appear but a higher coverage rate does not necessarily mean that preferences are being actually used.
2) Utilisation rate gives an idea of how much of the preferences that are extended are actually used. A high utilisation rate means that a preference is valuable to the beneficiary country and thus the country is vulnerable to preference erosion and *vice versa.*
3) Utility rate gives an idea of how much of the goods are imported under preferential rates compared to MFN dutiable rates. A high utility rate means that a large part of the import enjoys a preferential rate while a low utility rate means that a small part of the import pays the preferential rate.

Beneficiary countries with high coverage, utility and utilisation rates may be expected to face higher risk from preference erosion as they export under the preferential scheme and enjoy preferential tariffs.

stones, base metals, machinery and electrical equipment in India and plastics and rubber and precious stone Sri Lanka are likely to face preference erosion in the US.

In sum, reduction in tariff rates by US under the Doha Round is unlikely to lead to a significant erosion of preferences for South Asia. This is due to low coverage rates of products of export interest to South Asia under the US GSP scheme, in particular textiles and textile articles which account for a substantial share of most South Asian countries' total exports to the US. Nevertheless, there are sectors, which are vulnerable to preference erosion in the US, but they do not account for a significant share of total exports. Therefore, tariff reductions by the US would most likely to result in gains for South Asia in the form of lower tariffs for major exports thus leading to greater competitiveness, especially in the case export of textile and textile articles.

Compared to the US, the EU scheme is more generous in providing market access to countries in the region, with a higher coverage rate. This is also reflected in the EU's utility rate – with more imports into the EU enjoying preferential rates compared to the US. Though the US scheme records a higher utilisation rate than that of the EU, it has a low coverage rate, which means that South Asian countries are making the most out of the limited preferences they receive. The region is likely to be more exposed to preference erosion in the EU than in the US, with Nepal likely to suffer the most and Sri Lanka, the least. In the case of Sri Lanka, only few sectors of export importance are vulnerable to erosion of preference and they account for about one-third of the total exports.

**Table 1: Sectors Vulnerable to Preference Erosion* under the EU GSP Scheme, 2004**

| | Description | BG | IN | NP | PK | SL |
|---|---|---|---|---|---|---|
| 1 | Live animals & products | X | X | | X | |
| 2 | Vegetable products | X | | X | | **X** |
| 3 | Fats and oils | X | X | X | X | X |
| 4 | Prepared foodstuffs, beverages, etc. | | X | | | |
| 5 | Mineral products | | | X | | |
| 6 | Chemical products | X | | X | | X |
| 7 | Plastics & rubber | X | X | X | X | **X** |
| 8 | Hides and skins, leather, etc. | X | | X | | X |
| 9 | Wood & articles of wood | X | X | X | | X |
| 10 | Pulp of wood, paper, books, etc. | | | | | |
| 11 | Textile & textile articles | | **X** | **X** | **X** | |
| 12 | Footwear, headgear, umbrellas,etc. | X | X | X | X | X |
| 13 | Articles of stone, cement, etc. | X | X | X | X | X |
| 14 | Precious stones, etc | | **X** | X | X | **X** |
| 15 | Base metals & products | | **X** | X | X | X |
| 16 | Machinery & electrical equipment | | **X** | X | | |
| 17 | Transport equipment | X | X | | X | X |
| 18 | Optical & precision instruments | X | X | X | X | X |
| 19 | Arms and ammunition | | | | | |
| 20 | Miscellaneous manufact. articles | | X | X | X | X |
| 21 | Works of art, etc | | | | | |

Note: * Utilisation and utility rates over 60 percent
X sectors vulnerable to preference erosion
**X** sectors vulnerable to preference erosion and account for 5 percent or more of total exports

**Table 2: Sectors Vulnerable to Preference Erosion* under the US GSP Scheme, 2004**

| | Description | BG | IN | NP | PK | SL |
|---|---|---|---|---|---|---|
| 1 | Live animals & products | | | | | X |
| 2 | Vegetable products | | | X | | X |
| 3 | Fats and oils | X | | | | X |
| 4 | Prepared foodstuffs, beverages, etc. | X | | | X | X |
| 5 | Mineral products | | | | X | |
| 6 | Chemical products | X | | X | X | X |
| 7 | Plastics & rubber | | X | | | **X** |
| 8 | Hides and skins, leather, etc. | | | | | |
| 9 | Wood & articles of wood | X | X | X | X | X |
| 10 | Pulp of wood, paper, books, etc. | | | | | |
| 11 | Textile & textile articles | | | | | |
| 12 | Footwear, headgear, umbrellas, etc. | | | | | |
| 13 | Articles of stone, cement, etc. | X | X | X | X | X |
| 14 | Precious stones, etc | X | **X** | X | X | **X** |
| 15 | Base metals & products | | **X** | X | X | X |
| 16 | Machinery & electrical equipment | | **X** | | X | X |
| 17 | Transport equipment | X | X | | X | |
| 18 | Optical & precision instruments | | | | X | X |
| 19 | Arms and ammunition | | X | | X | |
| 20 | Miscellaneous manufact. articles | X | X | X | | X |
| 21 | Works of art, etc | | | | | |

Note: * Utilisation and utility rates over 60 percent
X sectors vulnerable to preference erosion
**X** sectors vulnerable to preference erosion and account for 5 percent or more of total exports

## Measures to Deal with Preference Erosion

In principle, two broad approaches have been suggested to address the loss from preference erosion in multilateral discussions: one to be dealt within the WTO or a 'trade solution'; and the other outside the WTO or an 'aid solution'.

### *Trade Solutions*

The short-term objective of trade solutions is to partly compensate for immediate losses stemming from preference erosion, while the long-term objective would be to prepare preferential beneficiaries to survive without depending on preferences. Potential trade based solutions include: 1) measures to increase preference utilisation; and 2) extending the product coverage.

***Measures to increase preference utilisation*** - There are a number of factors, which lead to lower the utilisation rates, but most studies identify rules of origin (RoO) as one of the main reasons. One means of dealing with preference erosion would be to increase preference utilisation by relaxing restrictive RoO, which are used in preferential trade agreements in order to ensure that there is minimum level of domestic value addition in the product exported and to promote backward linkages in the economy. Restrictive RoO are a binding constraint on the utilisation of the EU GSP scheme *vis-à-vis* South Asia, especially in the case of Bangladesh and Sri Lanka. Their major export sector i.e. textile and textile articles are unable to meet the RoO criteria stipulated in the EU GSP scheme. The advantage of relaxing RoO to deal with preference erosion is that it ensures greater market access while tariffs are in place and provides a foothold in the markets prior to tariff reduction.

***Extending the product coverage*** - Negative consequences of preference erosion could be partially addressed by extending product coverage of the preferential schemes through efforts to provide DFQF market access to products of interests to LDCs. There are a number of 'sensitive' products of interest to LDCs such as garments and agricultural products that still attract relatively high tariffs and currently are partially or not covered by preference schemes. Thus, an obvious trade solution to preference erosion would be to extend preferential treatment to such products. Providing duty free access to all products from the LDCs essentially means duty free access to the US (and Japan). There is still great scope to extend duty free treatment in the US where about 27 percent of the tariff lines in the case of Bangladesh and Nepal do not receive any preferential treatment under the US GSP scheme. But the prospects of extending of product coverage by the US under its GSP scheme is unlikely given that these sectors are considered sensitive, as demonstrated by the reluctance of both the US and Japan to give DFQF market access to all exports of LDCs at the Hong Kong Ministerial meeting. In the case of the EU, the scope to extend duty free preferences in order to compensate for preference erosion is very limited as almost all exports from LDCs including Bangladesh and Nepal (99 percent) already receive duty free treatment under the EBA initiative.

***Compensating preference erosion through preferences in other markets*** - Part of a solution to preference erosion from MFN liberalisation could also be addressed by obtaining preferential treatment in emerging markets such as through South-South trade. In the case of Bangladesh, this is not promising with over 80 percent of exports directed to the developed countries and to a lesser degree in the case of Sri Lanka (70 percent). In the case of India, Nepal and Pakistan, a substantial of portion of their exports goes to countries other than the developed, so there seems to be a possibility of addressing the problem by entering into preferential agreements with other countries or strengthening existing ones. But in the case of Nepal, most of its exports are destined to India with which it already has a free trade agreement (FTA). Hence, there appears to be limited scope to address preference erosion in this regard. In the case of India and Pakistan, both East Asia and the Middle East are important export markets of their own so preference erosion could be partly dealt by entering into preferential trade arrangements (PTAs) with countries in these regions. The possibility of addressing the problem within the region remains doubtful even with region moving to a FTA given the past track record.

***Multilateral trade concessions designed to protect preference dependent countries*** - This can involve delaying the liberalisation of sensitive sectors and accelerating liberalisation on goods that developing countries have a comparative advantage. However, countries, which are non-beneficiary of preferential agreements, are unlikely to support such a move. Moreover, it would entail a substantial welfare loss from a global perspective. But considering the negotiating positions that have been taken by LDCs, one cannot entirely dismiss this option.

**Non-trade Solution: Aid for Trade**

An aid solution is considered to be a better approach to address the problem of preference erosion as it does not further distort trade and ensures that trade is liberalised by bringing down tariffs. In 2005, A4T became part of the international discourse and was officially put on the WTO agenda at the 6th Ministerial Conference in Hong Kong. The Hong Kong Declaration states that *'…Aid for Trade should aim to help developing countries, particularly LDCs to build supply capacity and trade-related infrastructure that they need to assist them to implement and benefit from WTO agreements and more broadly to expand their trade…'* Following the Ministerial, a task force was established to recommend how to operationalise A4T while the WTO Director-General was asked to consult the appropriate financing mechanisms. In showing their support for A4T, the EU, Japan and the US announced increases in resources for A4T prior to, at and after Hong Kong.

**Box 3: Six Categories of A4T**

The A4T Task Force in its report submitted on July 27, 2006 covers six broad categories:

1) Trade policy and regulations – to help countries negotiate, reform and prepare for closer integration in multilateral trading system.
2) Trade development – to help enterprises engage in trade, reinforce business support structures and develop the business climate.
3) Infrastructure covers trade related infrastructure such as transport, communications, and energy.
4) Building productive capacity – to improve the capacity of a country to produce goods and services.
5) Trade related adjustment which includes financial assistance to meet adjustment costs from trade policy reform, including balance of payment problems resulting from lost tariff revenues, erosion of preferences.
6) Other trade related needs.

Since 2001, donors have significantly scaled up their efforts towards trade-related technical assistance (TRTA) and capacity building for developing countries. Volume of trade related commitments for 'trade policy and regulations' and 'trade development' rose by 50 percent between 2001 and 2004 to reach US$3bn. Despite the substantial increases, only a fraction of total aid goes into TRTA. In 2004, about 4.4 percent of total worldwide aid budget was devoted to trade-capacity building, with 'infrastructure' accounting for a 25 percent share. In the case of South Asia, assistance for trade policy and regulation and trade development has fallen while assistance for infrastructure has increased overtime. If the region is expected to participate effectively it is necessary that there should be more assistance available not only to support existing categories of trade related assistance but also to support the broader A4T agenda, which includes building productive capacity and trade, related adjustment.

A4T or TRTA is currently being delivered though a variety of mechanisms. Some of which include:

- Bilateral donor programmes;
- Multilateral/multi donor funded programmes;
- Individual international organisation and agency programmes; and
- Regional organisations and regional financial institutions.

In terms of the existing mechanisms, however the Integrated Framework (IF) figures prominently in discussions as a vehicle to deliver A4T.

The IF was set up in 1996 to ensure effective participation of LDCs in world trading system. Currently, six multilateral institutions are participating in this framework together with 12 bilateral donors. More than 40 LDCs have applied for assistance under the IF but it has had limited success to date. IF suffers from a number of shortcomings which include: weak in-country capacity and ownership; lack of implementation; insufficient and uncertain financing; and variable donor response to priorities identified. These shortcomings have to be addressed before it can play an effective role in delivering A4T. In the light of the above problems, the IF task force recommended: increased, predictable and additional funding; strengthening country ownership, effective follow up and implementation, greater and effective coordination amongst stakeholders and improving its management.

Another initiative is the IMF's Trade Integration Mechanism (TIM), which was established in 2004 to assist developing countries facing balance of payment problems due to multilateral trade liberalisation such as loss of trade preferences, elimination of textile quotas. TIM is not a special facility providing new resources under special terms, but a policy designed to increase the predictability of resources that are available under existing IMF lending facilities. TIM funds are disbursed only in the form of loans, with repayment conditions depending on the arrangement a country comes up. So far three countries have made use of this mechanism – Bangladesh, Dominican Republican and Madagascar. It is doubtful whether TIM would be a useful mechanism to deal with the problem of preference erosion.

Although some have suggested setting up of a new dedicated fund, there is emerging consensus that A4T initiative needs to be built on already existing mechanisms. Moreover, these mechanisms need to be reformed in order to improve their poor record in relation to the delivery and effectiveness of A4T by applying the aid effectiveness principles of the 2005 Paris Declaration. But there is considerable skepticism surrounding A4T due to a number of questions relating to: additionality (whether A4T would supplement current aid for development or repackage and divert funds from existing aid commitments); adequacy (whether there will be enough money to meet the full agenda of A4T); predictability (whether the promises made would be met; ownership, whether A4T will reflect the needs of developing countries and not the priorities of donors); coherence (whether donors would be able to coordinate their efforts within a broad national development strategy); and conditionality (whether aid would be linked or made conditional upon developing countries' positions in multilateral negotiations).

## A Way Forward

A pragmatic and realistic approach to address preference erosion would be based on some form of trade and aid based approaches to the problem. Trade measures are likely to address preference erosion in the short term by providing a foothold in the preference granting countries' market before MFN liberalisation is complete. Ongoing discussions on the losses from preference erosion should lead to efforts on the part of preference-giving countries to improve utilisation of the schemes by way of relaxing RoO criteria, extending coverage of existing preferences to products of export interest to developing countries while preference dependent countries should negotiate preferences in other markets and protect preferences already extended to them.

Given that preferences will continue to erode as countries around the world continue to reduce their levels of protection and conclude trade agreements, which has proliferated over the recent years and is likely to accelerate with the current impasse with multilateral trade negotiations, measures need to be taken to improve productivity and lowering transaction costs in order to improve the competitiveness of exports from developing countries. This could be encouraged by A4T. Building supply capacities and thereby improving competitiveness ultimately remains the only long-term solution to the challenge of overcoming preference erosion

Moreover it has been argued that solutions to preference erosion undertaken within the trading system may pose a significant opportunity cost from a global perspective as they lead to additional discrimination and would reduce the overall benefits from a new Round. And this is not likely to be agreeable to countries, which are currently non-beneficiaries of preference schemes. However, to date the success of various trade related assistance has been mixed. For A4T to be effective, it is necessary to learn from existing initiatives and address them.

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