3

Preferences and Developing Country Experience

This chapter considers the evidence on the benefits of trade preferences and the implications of the erosion of preferential margins for developing countries and least developed countries. Appendix A3 provides further context and detail. After considering the relative importance of preferential trade schemes and the countries that are the major beneficiaries, evidence on the impact of preference erosion on specific countries and products is reviewed. The conclusion provides a summary of the literature and outlines some of the factors limiting the utilisation and effectiveness of preferences. Chapter 4 will address the major constraints that have prevented beneficiary countries from exploiting fully the preferential market access conditions offered under the schemes and the implied policy options.

The structure of the chapter is as follows. Section 3.1 presents an overview of the evidence on the trade effects of preferential trade arrangements; as these include preferences for members, they provide evidence on the general benefits of preferential arrangements. Section 3.2 extends this analysis to consider the benefits of particular preferences for developing and least developed countries, such as EU preferences for ACP countries and the effect of AGOA on US imports from African countries. Section 3.3 considers evidence on the costs of preference erosion. Section 3.4 summarises the main conclusions and looks at why preferences are not fully utilised and hence yield limited benefits.

3.1 Benefits of preferential trade agreements

While preferential market access permits recipients to increase their exports, the extent of the benefit (the preference margin relative to non-beneficiaries) is limited. Trade under PTAs and GSP is governed by terms and conditions, such as import quotas, that limit volume and restrict product coverage. It is often argued by low-income countries that the products in which they have the greatest export potential are either excluded from agreements or receive reduced effective preferences. A related concern is where high tariffs (tariff peaks) apply to the products of particular interest to LDC exporters that do not receive preferential access, or receive less than full preferences, e.g. where other LDCs face zero tariffs in a particular market, but some LDCs benefit only from tariffs that are lower than those faced by non-LDCs. Countries like Bangladesh and Nepal have raised such concerns, either where ACP countries receive greater preferences from the EU (this issue has been largely addressed under EBA) or where African countries receive greater preferences from the USA. Although this is not addressed specifically, any countries denied (relative) preferential access, especially LDCs, are at a disadvantage, especially where the products of most concern face relatively restricted access, including high tariffs.

Preference-giving countries want to satisfy themselves that preferential treatment is enjoyed only by specified beneficiaries for products they actually produce and export. For this reason they set criteria for establishing that the country claiming preferential treatment is substantially the originator (producer) of the goods for which preferences are claimed. The single most important criteria comprise rules of origin, which essentially specify the share of value added that must be provided in the beneficiary country for an export to be eligible for a preference; other criteria that restrict product or country eligibility (such as quantitative restrictions, product exclusions or graduation rules) are considered later. Properly designed rules of origin can encourage growth of trade in products that originate from the beneficiary country, but if they are too restrictive they can limit or discourage trade. One of the major criticisms of preferential schemes offered by the QUAD countries is that their rules of origin are restrictive and difficult to satisfy, and as a result undermine trade volume and diversity among beneficiary countries. Rules of origin are often a major limitation on the utilisation and effectiveness of preferences. As this is an issue related to policy options it is discussed further in Chapter 4.

The scale and diversity of bilateral trade between preference-giving and preference-receiving countries also depend on other factors relating to competitiveness, production and characteristics of the market (globally and in individual countries). For example, regardless of the terms and conditions of preferential arrangements, trade volume may be undermined by supply-side constraints, constraints relating to trade finance and investment, trade-related infrastructure weaknesses and gaps, unfavourable geographical location, corruption and political instability. Preference margins may also be reduced by the expansion of the number of beneficiaries, global quotas, limits on the duration of preferences and where the terms of preferences are subject to arbitrary change by the preference-giving country – short duration and arbitrariness do not provide incentives for long-term investment. These factors are also discussed in more detail in Chapter 4.

There is now considerable evidence that trade preference schemes do increase exports from beneficiary countries (see Appendix A3). Positive trade effects have been confirmed mostly where preferential arrangements involved significant policy reforms to reduce trade barriers; weak, non-existent or perverse trade effects have been found where only limited actual trade liberalisation was implemented (Greenaway and Milner, 2002; Persson and Wilhelmsson, 2006).

Preferential margins or premiums underpin the expansion of bilateral trade flows beyond what they might otherwise be, that is, under normal competitive market conditions (trading at MFN tariff rates and on an equal footing with other world exporters) in the preference-giving countries. That developing countries have only been able to expand exports because of preferences above the lower or even zero export levels that they might have achieved signifies that preference erosion poses a clear threat for highly preference-dependent products and developing countries (see Section 3.4).

3.2 Benefits of targeted trade preferences

Targeted schemes seem to have a more pronounced effect. In terms of EU preferences, the Lomé Convention preferences had a greater effect in stimulating the growth of ACP exports to the EU than did EU provision of GSP to ACP countries. In general, GSP targeted at LDCs were found to have a significant and large effect on LDC exports. EU preferences for Mediterranean countries have had a significant effect in helping to increase exports by the beneficiaries. This section considers the evidence for the benefits of specific targeted preference schemes offered by developed countries, concentrating on the EU (schemes such as the Lomé Convention and EUROMED) and the USA (in particular, AGOA).[7] The aim is to identify which countries and products have tended to benefit most from preferences and which countries are most vulnerable to preference erosion, given the scale of benefits received and the product composition of their exports.

US preference schemes

The African Growth and Opportunity Act, signed into US law on 18 May 2000, provides eligible countries and products with duty and quota free access to the US market. Not all sub-Saharan African countries meet AGOA's eligibility criteria (Table AT12). Countries excluded from AGOA as of 2 January 2005 because they did not meet basic levels of political and democratic freedom included Zimbabwe, Côte d'Ivoire, Somalia, Liberia, Sudan, Burundi, Central African Republic, Eritrea, Equatorial Guinea and Togo. Although Burundi and Equatorial Guinea subsequently became eligible, their exports to the USA declined (see below). By the summer of 2007, 38 of the 48 sub-Saharan African countries were declared eligible for benefits under AGOA and many received assistance to utilise the benefits. Table 3.1 shows trade flows for 33 countries for the period 1991–2006, and compares the situation pre- and post-AGOA (indicated by the percentage change); although it omits some very small countries and others that only recently became eligible, it captures AGOA's broad impact.

Tadesse and Fayissa (2008) consider the effect of AGOA on the initiation of imports (trade initiation, when pre-AGOA product/country imports were negligible) and on the volume of imports (trade intensification), using data at the HS 2-digit level. The trade values are negligible for many HS-2 products, so only products that accounted for at least 2 per cent of exports under AGOA are taken into account. There is significant evidence of a trade-intensification effect for coffee, tea, maté and spices, and for knit apparel, which together account for over 15 per cent of AGOA exports (and for 14 other HS-2 products with low shares). There is evidence of significant export initiation for 12 products, most of which had very small trade shares (although knit apparel is included), such as cosmetics, plastics and cotton (Tadesse and Fayissa, 2008: 934–7). US trade with sub-Saharan Africa is limited to a few countries: South Africa accounts for more than half US imports under AGOA (i.e. of AGOA-eligible products from AGOA-eligible countries); Lesotho, Madagascar, Mauritius and Kenya (in order) have the next largest

Table 3.1 Annual average US imports from sub-Saharan Africa (1991–2006)

	Pre-AGOA	Post-AGOA	Percentage change	Mean change
Angola	8,708	45,206	419	282
Benin	3,608	827	−77	−214
Botswana	17,938	87,608	388	251
Burkina Faso	1,739	1,162	−33	−170
Burundi	6,728	1,310	−81	−218
Cameroon	21,655	41,352	91	−46
Chad	3,759	10,390	176	39
Congo	2,575	1,243	−52	−189
Congo (DRC)	18,431	18,277	−1	−138
Equatorial Guinea	110,000	72,858	−34	−171
Ethiopia	32,923	42,034	28	−109
Gabon	6,544	7,458	14	−123
Gambia, The	3,629	3,512	−3	−140
Ghana	160,000	99,860	−38	−175
Kenya	98,092	230,000	134	−3
Lesotho	74,574	320,000	329	192
Madagascar	69,804	300,000	330	193
Malawi	62,884	68,858	10	−127
Mali	4,175	4,800	15	−122
Mauritius	220,000	240,000	9	−128
Mozambique	6,453	7,689	19	−118
Namibia	30,637	110,000	259	122
Niger	5,864	4,872	−17	−154
Nigeria	49,218	48,858	−1	−138
Rwanda	4,110	5,500	34	−103
Senegal	6,628	19,176	189	52
Seychelles	2,905	11,548	298	161
Sierra Leone	17,883	72,386	305	168
South Africa	2,300,000	5,100,000	122	−15
Swaziland	31,372	130,000	314	177
Tanzania	21,489	28,113	31	−106
Uganda	19,867	22,980	16	−121
Zambia	51,561	20,988	−59	−196
All AGOA (mean)	**92,938**	**220,000**	**137**	

Note: The table shows annual average exports (excluding petroleum products, pearls and natural stone) in $US 000 to the USA in the 10–15 years before the country became AGOA-eligible and the 2–6 years after it became eligible; the percentage change in these averages; and the change relative to the mean for all AGOA countries (subtracting 137). Countries which have a very small volume of trade have been omitted (e.g. Djibouti).
Source: Derived from Tadesse and Fayissa (2008), Table 1: 927.

sub-Saharan African shares of post-AGOA US imports from sub-Saharan Africa (and are the only other countries with a share above 5 per cent), although the volumes are relatively small (Tadesse and Fayissa, 2008: 927).

Table 3.1 summarises the results by country. Overall, US AGOA imports more than doubled in the first six years of the scheme (annual average imports increased by 137 per cent relative to the pre-AGOA situation). In addition to the main beneficiaries listed above, countries such as Angola, Botswana, Sierra Leone and Swaziland experienced large increases in exports to the USA (above the all-AGOA figure, indicted by a positive value in the final column), but volumes are very small. It is unlikely that the total amount of any increase can be attributed to AGOA and there may have been some displacement; post-AGOA exports to the USA declined for 11 of the listed countries, although only one of these countries, Ghana, had relatively large volumes.

Exports appear to have increased. According to Tadesse and Fayissa (2008: 921):

> '… between 2004 and 2005 alone, there has been a 40 per cent increase in the total volume of US imports from sub-Saharan African countries. Analysis of US-SSA trade data that extend from 1989 to 2004 also reveals a 46.3 per cent increase in US imports of non-manufactured goods and a 130.4 per cent increase in US imports of manufactured goods from SSA countries pre- to post-AGOA periods.

Hence, AGOA

> … has enhanced the propensity of US imports from eligible sub-Saharan African countries … Compared to the trade initiation effects it has had, the impact of the initiative in raising the volume of US imports from eligible sub-Saharan African countries has, however, remained minimal.

Frazer and Van Biesebroeck (2007), using product-level data, find that AGOA had a significant impact on US imports, especially of apparel (where they are concentrated in particular countries) and of eligible agricultural and manufactured products (where they are broad-based), and that these effects were larger in product categories where the tariffs removed were higher. They estimate a large import response to AGOA for apparel products with tariffs of over 50 per cent (with a lower bound of 17 per cent), compared to 14 per cent for agricultural products and 19 per cent for manufactures. Furthermore, they find that AGOA did not result in a fall in exports of AGOA-eligible products to the EU.

However, the benefits to African economies should not be overstated (Stevens and Kennan, 2004b). For example, although Kenya appears as a major beneficiary, in the sense that clothing exports to the USA increased by about four times, this was from a very small pre-AGOA base and most of the firms involved are recent, non-Kenyan, arrivals, located in export processing zones. Another example is that of Lesotho, where clothing exports under AGOA are 'cut, make and trim' by subsidiaries of (mostly Asian) multinationals that provide all the inputs; there are few linkages to the local economy and the exports are very vulnerable to changes in AGOA rules of origin. Almost half of South Africa's clothing exports to the USA do not benefit from AGOA preferences because producers find it more cost-efficient to import textiles (from Asia) and therefore do not meet rules of origin requirements. Although AGOA has helped to increase exports, it is

far from evident that it has helped to establish a sustainable, competitive export sector in African countries.

EU preferences for ACP countries

The EU has provided trade preferences to former colonies in the African, Caribbean and Pacific regions since 1975 under successive Lomé Conventions. Although ACP exports to the EU are higher than they would have been in the absence of such schemes, these preferences have been of limited value. One reason for this is the conditions under which preferences were granted. Restrictions were placed on which products were eligible for full preferences (often excluding products of particular benefit to developing countries) or, especially in the context of EU preferences for the ACP, very restrictive rules of origin requirements were imposed, thus limiting opportunities for diversification. The EU also tends to require high product standards, especially regarding health or sanitary and phyto-sanitary (SPS) standards, which can be altered at relatively short notice and require considerable documentation. These standards impose high trade costs on producers exporting to the EU. Furthermore, imports to developed country markets have to comply with stringent private standards imposed by the firms or buyers that dominate the supply chain. While these private standards and supply chain contractual requirements are clearly important determinants of trade for many products, this study restricts attention to public policy, specifically trade policy (i.e. preferences and compliance requirements).

Another reason why exporters have derived less benefit from EU trade preferences than might have been anticipated relates to policy-induced distortions in the ACP countries, so that actual incentives for production diversification are weak, exacerbating the problem of a narrow production structure and primary commodity resource base. This is especially true for Africa, but also applies more generally to other ACP countries. Furthermore, there is excessive emphasis on expanding manufacturing, and recently services, exports. Thus, it is argued that achieving sustained growth in Africa requires the implementation of policies to expand exports and diversify exports away from dependence on a narrow range of (unprocessed) primary commodities. Trade preferences can play a role in this.

Trade preferences offered by the EU have been especially important for sugar and bananas. This is illustrated in Table 3.2: although the list comprises the non-LDCs most vulnerable to export losses from preference erosion by the QUAD, it is dominated by sugar exporters, specifically countries exporting sugar to the EU under the Sugar Protocol, which permits some ACP countries to export a specified quantity of sugar to the EU at the EU intervention price, typically well above the world price (Milner *et al.*, 2004).[8] This conferred significant quota rents; for the largest beneficiary, Mauritius, these were in some years equivalent to over 4 per cent of cent of GDP (Milner *et al.*, 2007). Other important preferential products are bananas, and to a lesser extent clothing and textiles. Mauritius tops the list, but at a regional level Caribbean middle-income

countries dependent on sugar and banana exports have the largest preference margins, and would therefore suffer the highest export losses from preference erosion.

Table 3.2 also shows the relative significance of the preference margins accounted for by sugar, bananas, and textiles and clothing for the non-LDCs with the greatest preference margins (most are ACP countries, the exceptions being Albania, Serbia, Honduras, Tunisia and Morocco). These three products receive special attention and preferential treatment in the QUAD, notably sugar and bananas for the EU; exports by beneficiaries have flourished under the lucrative preferential tariff and quota regimes. The ten countries with the highest margins are all members of the ACP group; five derive more than two-thirds of the benefit from the preference margins that apply to sugar, and three derive almost all the benefit from bananas. In this way, the major beneficiaries of EU preferences are highly concentrated.

Table 3.2 Non-LDCs preference margins and main products

Most vulnerable	Trade preference margin[a]	Percentage of preference margin accounted for by			
		Sugar	Bananas	Textiles and clothing	Other products
Middle-income countries[b]	**4.9**	**42**	**19**	**12**	**27**
Largest beneficiaries[c]	**15.6**	**51**	**24**	**8**	**17**
Mauritius	39.9	84	0	13	3
St Lucia	32.9	0	94	2	4
Belize	29.3	47	23	0	30
St Kitts and Nevis	28.7	94	0	0	6
Guyana	24.2	95	0	1	4
Fiji Islands	24.1	96	0	1	2
Dominica	15.9	0	97	0	3
Seychelles	12.2	0	0	0	100
Jamaica	9.7	67	8	7	18
St Vincent and the Grenadines	9.4	0	89	0	11
Albania	8.9	0	0	48	52
Swaziland	8.2	97	0	1	2
Serbia and Montenegro	7.6	28	7	10	56
Honduras	6.7	56	9	19	15
Tunisia	5.9	0	1	79	20
Côte d'Ivoire	5.7	8	51	2	38
Morocco	5.7	0	4	64	33
Dominican Republic	5.5	23	16	27	34

[a]As a percentage of the trade-weighted average world market price of the country's exports.
[b]Average for 76 middle-income developing countries, weighted by margin.
[c]Eighteen countries with average preference margins greater than 5 per cent.
Source: Alexandraki and Lankes (2004).

The changing regime for EU-ACP preferences

A specific feature of preferences under the Lomé Conventions is that they were granted to countries that were not selected on clear economic criteria, but simply because they were deemed ACP; this was found to be 'illegal' under WTO rules. To continue preferences, the EU agreed a waiver in the WTO in 2001 to remain in effect until December 2007, when a new WTO-compliant regime was to be in place. The Cotonou Agreement proposed introducing reciprocity through the establishment of a series of economic partnership agreements, under which the EU and regional groupings of ACP countries offer reciprocal trade preferences to each other (Morrissey and Zgovu, 2007). Negotiations between the EU and ACP regional groups began in 2003. 'Framework agreements' with commitments and an implementation timetable have been signed and 'final agreements' were expected to be signed by the end of 2009.

In principle, EPAs offer potential benefits to ACP countries beyond what was available under the Lomé Conventions. The preferential access to the EU is less restrictive – all ACP countries should have tariff-free access to the EU for almost all products. This should be available once the agreements are in place, and restrictions such as rules of origin requirements should be less restrictive than under the previous regime.[9] The ACP member countries should derive some benefit from enhanced regional integration as a precursor to EPAs. A range of trade-related policy reform commitments are included in the EU proposals, covering trade facilitation and investment, and perhaps also competition policy and government procurement. If implemented properly these could enhance the business environment in ACP countries, attracting investment and promoting exports. There is an expectation that aid will be made available by the EU to support implementing and adjusting to EPAs.

There are potential costs to ACP countries through reciprocity as they are required to grant tariff-free access to imports from the EU. Although there is concern in ACP countries that such opening up to import competition from the EU will displace domestic production, there will not necessarily be substantial adverse effects (Morrissey and Zgovu, 2007). The welfare impact of import liberalisation depends on the production and trade structure of the country in question, and as such is an empirical question. Of greater practical concern is the potential loss of revenue from tariffs on imports from the EU. However, ACP countries have at least 10 years to phase in tariff elimination and can continue to exclude a range of designated 'sensitive products' for some time. However, identifying these has been a sticking point in negotiations. Thus countries will have a fair amount of time to plan both their adjustment to the economic effects of increased imports and the revenue effect of the elimination of tariffs.

The ACP countries have been aware that EPAs offer limited benefits, although the situation of LDCs differs from that of non-LDCs. LDCs are entitled to essentially tariff-free access to the EU under EBA without having to commit to reciprocity. Non-LDCs, however, could lose their Lomé-type preferences and would be granted only GSP access if EPAs were not in place (although there have been proposals for a preferential GSP++

scheme). This loss of preferences could significantly undermine export competitiveness and damage major sectors that depend on exports to the EU, such as beef in Namibia and horticulture in Kenya. Thus, non-LDCs had a stronger incentive than LDCs to sign EPAs to maintain preferential access for their exports to the EU.

3.3 Costs of preference erosion

As noted above, the incidence of trade preferences is quite concentrated, i.e. a relatively small number of countries (and products) benefit from high preference margins. As the export benefits from preferences are quite concentrated, the potential losses from preference erosion are also concentrated. Estimates of the cost of preference erosion obviously vary, depending on the extent of the reduction in each preference-receiving country's preference margin and how responsive export supply is assumed to be. The effect of preference erosion for developing countries overall is likely to be small: if preference margins were reduced by half, the major beneficiary middle-income countries would lose between 0.5 and 1.5 per cent of total exports. However, the impacts are significant for certain countries, typically those with a heavy reliance on a narrow range of export products, particularly products that benefit from deep preferential access and rely heavily on QUAD markets. The scale of the adverse effects will be more challenging for countries with fragile macroeconomic frameworks – for example, some small island economies.

Table 3.3 presents the estimated export losses for the most vulnerable non-LDCs from a 40 per cent reduction in QUAD preferences, i.e. a reduction in preference margins, rather than an elimination of tariff preferences (see also Table A3.2). As noted above, some of the countries have already experienced loss of preferences because of recent reforms implemented outside the multilateral trade negotiations (e.g. the EU sugar and banana regimes). Mauritius tops the list, largely due to losses of sugar exports to the EU, but at a regional level Caribbean middle-income countries that depend on sugar and banana exports suffer the highest export losses.

On the basis of evidence on middle-income countries, 'the problem of preference erosion is heavily concentrated in a sub-set of products and preference beneficiaries' (Alexandraki and Lankes, 2004: 4). Clearly, these products and the countries dependent on them would deserve greater attention and adjustment support to deal with the effects of preference erosion. Table 3.3 expresses the potential export losses in relation to macroeconomic indicators for the most vulnerable countries. Mauritius shows the deepest impacts, both in absolute terms and in relation to all the selected macroeconomic aggregates (except for GDP, where Guyana could lose the equivalent of 5.8 per cent of gross domestic output from preference erosion). Guyana's export revenue losses are estimated to be significant in relation to government revenue, the equivalent of 17.7 per cent, second only to Mauritius, which has a 24.4 per cent government revenue loss.

In summary, for the countries that have derived the greatest benefit from QUAD trade preferences, a reduction of preference margins by about a half would represent potential losses of 2–10 per cent of exports, 2–20 per cent of government revenue and 0.5–6 per cent of GDP. For other beneficiaries, losses would be less. These estimates are

based on across the board preference erosion. We next consider estimates of the costs of preference erosion implied by proposals under the Doha Round of WTO negotiations.

Table 3.3 Export losses due to preference erosion as a percentage of macroeconomic aggregates

	Loss as a percentage of:			
Most vulnerable	Exports of goods	Exports of goods and services	Government revenue	GDP
Mauritius	−11.5	−7.2	−24.4	−4.4
St Lucia	−9.8	−1.1	−1.9	−0.6
Belize	−9.1	−4.1	−8.0	−2.1
St Kitts and Nevis	−8.9	−1.8	−1.9	−0.8
Guyana	−7.9	−6.2	−17.7	−5.8
Fiji Islands	−7.8	−3.8	−9.1	−2.2
Dominica	−5.5	−1.9	−2.3	−0.9
Seychelles	−4.2	−1.9	−3.7	−1.6
Jamaica	−3.5	−1.4	−2.2	−0.6
St Vincent and the Grenadines	−3.4	−2.7	−4.3	−1.3
Albania	−3.3	−1.2	−1.0	−0.2
Swaziland	−3.0	−1.8	−5.8	−1.6
Serbia and Montenegro	−2.8	−2.2	−3.9	−0.4
Tunisia	−2.2	−1.5	−2.5	−0.7
Côte d'Ivoire	−2.2	−1.6	−3.7	−0.6
Morocco	−2.1	−1.4	−1.8	−0.4
Dominican Republic	−2.1	−1.2	−2.7	−0.5

Note: The table reports estimates of export losses for the 17 most affected beneficiaries due to preference erosion (40 per cent reduction in average margin of preferences), assuming a zero export supply elasticity. Table A3.2 provides a range of estimates.
Source: Alexandraki and Lankes (2004).

Table 3.4 lists the 16 non-LDCs that are estimated to suffer the greatest impact from preference erosion caused by MFN liberalisation by the QUAD under Doha (see also Appendix A3). Results are provided for agricultural and non-agricultural market access (NAMA) and estimate the potential reduction in exports (percentage loss). The first set of results (without competition effects) assumes that an export share corresponding to the preference margin is lost. The second set (with competition) allows for the reduction for other preference-receiving countries, i.e. other suppliers also becoming less competitive. The estimated losses from preference erosion generally fall when competition from other preference-receiving countries is taken into account. These estimates do not account for other countries that may gain improved market access, for example through a bilateral free trade agreement.[10] On the other hand, as the reduction in the margin does not eliminate the competitive advantage (preference margin), it is possible that beneficiaries may be able to maintain the level of exports at the lower margin.

Table 3.4 Preference loss of QUAD MFN tariff reduction, 2003: 16 most affected non-LDCs

Agricultural products				Non-agricultural products			
Without competition effect		With competition effect		Without competition effect		With competition effect	
Country	% loss	Country	% loss	Country	% loss	Country	% loss
St Kitts & Nevis	−40.5	*Botswana*	−15.5	*El Salvador*	−9.1	*El Salvador*	−5.2
Mauritius	−38.0	**St Lucia**	−12.1	*Honduras*	−8.3	*Honduras*	−4.6
Guyana	−31.9	*St Vincent & Gren.*	−11.9	*Nicaragua*	−6.7	*Guatemala*	−4.2
Fiji Islands	−31.2	**Namibia**	−9.5	*Guatemala*	−6.5	**Swaziland**	−3.6
Swaziland	−30.1	*Dominica*	−8.9	**Swaziland**	−5.8	*Nicaragua*	−3.5
Trinidad & Tobago	−22.5	*Belize*	−8.1	**Mauritius**	−5.6	**Dominican Rep.**	−2.9
Barbados	−21.3	**Mauritius**	−7.0	**Dominican Rep.**	−5.5	**Mauritius**	−2.1
Belize	−20.8	*Cameroon*	−4.9	**Namibia**	−2.9	**Namibia**	−1.6
Botswana	−17.3	*St Kitts & Nevis*	−4.7	*Kenya*	−2.2	*Kenya*	−1.2
St Lucia	−15.8	*Fiji Islands*	−4.3	*Pakistan*	−2.2	**St Lucia**	−0.7
St Vincent & Gren.	−15.5	**Swaziland**	−4.3	*Albania*	−1.9	*Jamaica*	−0.6
Congo	−13.7	*Guyana*	−4.1	*Jamaica*	−1.7	*Albania*	-0.6
Jamaica	−12.5	**Dominican Rep.**	−3.1	*Ghana*	−1.4	*Ghana*	−0.3
Dominica	−12.1	*Trinidad & Tobago*	−3.1	*Ecuador*	−1.1	*Belize*	−0.3
Namibia	−11.0	*Barbados*	−2.8	*Egypt*	−1.1	*Côte d'Ivoire*	−0.2
Dominican Rep.	−8.1	*Congo*	−2.5	**St Lucia**	−1.1	*Ecuador*	−0.2

Note: Percentage loss is relative to exports to the QUAD. Estimates for agriculture do not allow for Doha-type 'flexibilities'. Countries in bold type appear in all four lists; countries in italic type appear in both columns for agricultural or non-agricultural products.
Source: Table A4 in Low *et al.* (2005); Table A5 in Low *et al.* (2006).

The estimates in Table 3.4 provide a good guide to the magnitude of the preference loss for the most affected countries. Three points are worth emphasising. First, the losses for agricultural products are much greater, as a percentage of exports, for the most affected countries than the losses for the manufacturing sector; the least affected country in the list showing the preference loss for agricultural products faces a loss almost equal to the most affected in the list for non-agricultural products. Second, five countries appear in all four lists: Dominican Republic, Mauritius, Namibia, St Lucia and Swaziland. These countries are among the most affected in relation to agricultural and non-agricultural products, so the combined loss facing them is large. (Namibia is the only one of these countries that does not also appear in Table 3.3.) Third, although allowing for competition significantly reduces the loss, especially in relation to agricultural products, the list

is almost the same in each scenario (there is one difference for agricultural products and two for non-agricultural products). As pointed out above, a small number of countries are the major beneficiaries of preferences and are therefore the most vulnerable to losses from preference erosion. Almost all of these are ACP countries.

Table 3.5 Preference loss of QUAD MFN tariff reduction, 2003: 14 most affected non-LDCs

Agricultural products				Non-agricultural products			
Without competition effect		With competition effect		Without competition effect		With competition effect	
Country	% loss	Country	% loss	Country	% loss	Country	% loss
Malawi	−8.4	*Angola*	−2.3	*Lesotho*	−12.2	*Lesotho*	−7.4
Mozambique	−6.2	*Tanzania*	−0.9	*Haiti*	−11.3	*Haiti*	−6.1
Tanzania	−4.8	*Niger*	−0.7	**Cambodia**	−11.0	*Madagascar*	−2.0
Bangladesh	−4.3	*Congo, DR*	−0.6	*Myanmar*	−9.1	**Bangladesh**	−1.0
Congo, DR	−3.4	Lesotho	−0.6	**Bangladesh**	−5.2	**Cambodia**	−1.0
Gambia, The	−2.8	**Senegal**	−0.6	Madagascar	−5.0	*Myanmar*	−1.0
Senegal	−2.8	**Bangladesh**	−0.5	**Senegal**	−4.9	**Senegal**	−0.9
Angola	−2.6	**Gambia, The**	−0.4	*Guinea-Bissau*	−3.2	*Mozambique*	−0.8
Zambia	−2.4	**Cambodia**	−0.3	Maldives	−2.5	Malawi	−0.6
Mauritania	−1.6	*Malawi*	−0.3	*Mozambique*	−2.5	*Guinea-Bissau*	−0.5
Cambodia	−1.2	*Togo*	−0.3	**Mauritania**	−2.3	*Solomon Islands*	−0.5
Uganda	−1.1	**Uganda**	−0.2	**Gambia, The**	−1.8	**Mauritania**	−0.4
Niger	−1.1	Solomon Islands	−0.2	*Solomon Islands*	−1.2	**Gambia, The**	−0.4
Togo	−1.0	**Mauritania**	−0.2	**Uganda**	−1.0	**Uganda**	−0.2

Note: Percentage loss is relative to exports to the QUAD. Estimates for agriculture do not allow for Doha-type 'flexibilities'. Countries in bold type appear in all four lists; countries in italic type appear in both columns for agricultural or non-agricultural products.
Source: Table A4 in Low *et al.* (2005); Table A5 in Low *et al.* (2006).

Table 3.5 provides a comparable list of the 14 LDCs that are estimated to suffer the greatest preference erosion from MFN liberalisation by the QUAD. Again, three points are worth emphasising. First, in this case the losses in manufacturing tend to be greater for the most affected than the losses for agriculture; this probably reflects the importance of textiles and apparel for the top six in the list for non-agricultural products. Second, six countries appear in all four lists: Bangladesh, Cambodia, The Gambia, Mauritania, Senegal and Uganda. However, as some of these are relatively low down the list, the combined loss facing them is not necessarily larger than that facing the most affected on the list for non-agricultural products (Lesotho, Haiti and Cambodia) or agricultural

products (Malawi and Mozambique). Third, although allowing for competition significantly reduces the loss, it is almost the same list in each scenario (one change for non-agricultural products and two changes for agricultural). As in the case of non-LDCs, a small number of LDCs are the major beneficiaries of preferences and hence are most vulnerable to losses from preference erosion. Although a majority are ACP countries, Asian LDCs are among the most vulnerable.

Estimates of the costs of preference erosion using general equilibrium modelling approaches yield consistent overall results, although they are less likely to identify specific countries (unless they are large enough to feature individually in a global model). For example, François *et al.* (2005) consider MFN liberalisation under Doha by OECD countries and find that generally African and a few non-African preference-receiving countries are the most adversely affected (see Table A3.4 and discussion). This is consistent with the other evidence that a relatively small number of LDCs and non-LDCs derive large benefits from preferences and face potentially large losses from erosion.

3.4 Implications of the evidence on costs and benefits

The literature reviewed in the previous section has shown that the countries that benefit most from preferences, and face the greatest costs of preference erosion, tend to be ACP non-LDCs (mostly small islands benefiting from EU preferences for sugar and bananas) and LDCs that are either ACP countries or Asian exporters of textiles and apparel. Whatever the state of preference usage, the available preferences are increasingly coming under pressure as a result of: (a) unilateral liberalisation and reforms by preference-giving countries; (b) an increasing number of preference-receiving countries (as the preference-givers extend the number of preferential trade arrangements with other countries); and (c) most importantly, the general reduction of tariffs under multilateral trade negotiations (in particular in the Doha Round).

At the heart of the preference-receiving countries' concern about the Doha Round and future multilateral trade negotiations is the fear that tariff cuts by preference-giving countries will erode the gap between MFN tariffs and preferential tariffs. Consequently, the competitive position of preference-receiving countries will deteriorate vis-à-vis other suppliers. Preference-receiving countries may experience trade losses as some of their exports are displaced by competitive exports from other (non-preference receiving) countries. Trade diversion takes place, but in part this 'corrects' earlier trade diversion created by preferential treatment in favour of preference-receiving countries. There are opportunities for countries that relied less on preferences or those that now face reduced competition as some of the heavy preference users lose ground in the markets of preference-giving countries as a result of MFN liberalisation.

Trade theory and empirical evidence have long shown that multilateral MFN tariff liberalisation improves welfare and would therefore also, in principle, be supportive of the preference-receiving countries' development objectives, at least if trade gains from lower MFN tariffs offset the expected losses from preference erosion. The evidence

reviewed here shows that preference erosion is a major concern for some countries and products that are heavily dependent on preferences. However, most developing and least developed countries derive negligible benefits from preferences and are likely to gain, if only by limited amounts, from the erosion of preferences for the major beneficiaries. This observation does not diminish the potential trade and developmental effects of preference schemes, as their limited impact owes so much to their design and implementation, and weak capacity of some beneficiaries to make fully utilise them.

It is also important to bear in mind that even after the Doha Round many preferential tariffs would still remain below MFN tariffs and therefore provide a reservoir of preference rents for all eligible preference-receiving countries. Even under diminished preference margins, opportunities for preferential schemes to deliver their fullest benefits to beneficiary countries will remain, if the ability of countries to utilise preferences is enhanced. Dealing with the costs of imminent erosion of preferences and improving the delivery and effectiveness of preferences are difficult challenges facing some developing and least developed countries. These are considered in the next chapter.

Individual country situations, unlike the overall or aggregate picture, are more revealing of the adverse effects of preference erosion. For example, most middle-income countries and non-LDCs face modest to insignificant export losses due to preference erosion. Focusing on the overall picture runs the risk of missing the opportunity to prescribe policy options suited to the needs of the relatively few, and easily identified, countries which face significant adjustment challenges. Policy options can also focus on the specific sectors that will be most negatively impacted by preference erosion – in particular, sugar, bananas and apparel.

It is worth re-emphasising the major impact that rules of origin have on the utilisation of trade preferences, mostly in respect of manufactures. The presence of complex, ill-defined and/or costly to comply with rules of origin is one reason why preferences have not been fully utilised (Inama, 2003; Mold, 2005). For example, Brenton (2006) argues that EU rules of origin are very restrictive and have limited the growth of ACP garment exports to the EU, whereas AGOA, when it was first introduced, had relatively lax rules of origin and supported a sharp rise in exports from sub-Saharan Africa to the USA. Collier and Venables (2007) cite the benefits of AGOA and argue that trade preferences can support the growth of African exports of manufactured goods, supporting growth in exports and employment, especially if the preferences recognise the fragmentation of international production. That is, rather than being designed to favour final products, preferences should reflect the stages of production most appropriate for African countries. This implies laxer and more flexible rules of origin, which permit imported inputs from any source and allow preferences on the value added by African exporters.

Even under AGOA, rules of origin are important, especially for apparel. De Melo and Portugal-Pérez (2008) observe that the preferential market access for apparel exports offered by the EU and USA to African countries differs in its rules of origin. The EU, under EBA and Cotonou, requires that yarn is woven into fabric and made up into apparel in the exporting country or in a country covered by cumulation. The USA,

under AGOA, grants a special regime so that African exporters can use fabric from any origin, although in order to benefit from AGOA apparel provision, countries must prove that in addition to the governance provisions required for eligibility they have an effective system to verify and enforce rules of origin for the fabric or yarn used in apparel production. De Melo and Portugal-Pérez (2008) contrast African apparel exports to the US and EU markets and estimate that the more preferential AGOA rules of origin increase export volume to the USA, relative to the EU, by 300 per cent for the top seven beneficiaries and have also meant that there is an increase in the number of products exported.

Some argue that as many of Africa's major exports are primary products that face low or zero MFN tariffs (especially for the EU), preferential market access is often much less valuable than it appears: about three-quarters of ACP exports to the EU are (MFN) tariff-free (Inama, 2003: 965). When the value of preference margins is expressed in an aggregate manner, such as applies to a group of beneficiaries, it will reflect the product composition of trade flows, as preferences are highly concentrated on a few countries and products. For example, in 2002 the average EU preference margin to sub-Saharan African LDCs was 4 per cent; the corresponding preference margins of the USA and Japan were 1.3 and 0.1 per cent respectively (Table 3.6). On this basis, the EU appears to grant 'greater' preferences. The same conclusion applies to preferences to LDCs overall. However, if one considers sub-Saharan Africa as a region (including non-LDCs), Japan appears to provide a higher preference margin than the EU (11 compared to 4 per cent). This highlights the difficulties of summarising preference margins at aggregate levels.

Table 3.6 Non-reciprocal preference margins for developing country exporters

	EU	USA	Japan	Canada	Australia
LDCs	6.6	3.2	2.6		
Sub-Saharan Africa	4.1	2.6	10.9	4.2	3.6
Sub-Saharan African LDCs	4.0	1.3	0.1		
All	3.4	2.6	3.4	1.6	1.5

Source: Hoekman *et al.* (2009).

Mold (2005) argues that the evidence on the value of preferential market access is often misinterpreted or misrepresented. Allowing for the fact that the majority of African exports (primary products) are zero-rated and for the benefits of Cotonou, preferential usage is actually quite high for many sub-Saharan African countries. Although preferential market access has not generated a significant supply response in terms of total exports, the response has been significant where particular products that countries could export attracted large preferential margins (e.g. in sugar, beef and garments). The proliferation of regional and bilateral trade agreements has steadily eroded the value of preferences: preference margins remain unchanged (relative to MFN tariffs), but more countries receive preferential access (i.e. there is more competition). At the same time, restrictive rules of

origin have limited utilisation; the compliance costs of rules of origin are equivalent to 5–8 per cent of export value (Brenton and Ikezuki, 2006). As preferential margins average 2–3.5 per cent of export value, the low take-up is easily explained.

Furthermore, preference-receiving countries do not receive the full amount of the preference margins because of the presence of intermediaries (including transport and logistics companies), importers with market power and administration costs of preference schemes that capture part of the preference rents.[11] Ensuring that beneficiary exporters reap the highest possible preference rents is an issue that needs to be addressed. These issues are considered in Chapter 4, in which we assess policy options to address the implications of preference erosion.

3.5 Summary conclusions

The evidence on the effect of trade preferences on export volumes relates to both reciprocated preferential trade policies (e.g. regional trading arrangements and bilateral preferential agreements) and the non-reciprocated preferences under review here. Some regional trade agreements (RTAs), especially those involving the industrialised countries, have had substantial pro-trade effects. RTAs among the developing countries (South–South arrangements) have generally had much more modest effects on trade volumes. Similarly, the overall impact of the non-reciprocal trade preferences offered by developed to developing countries has had a limited impact on the export volumes of the recipient countries. The effects have been marked, however, for specific recipient countries and under specific (targeted) schemes. EU trade preferences for the ACP countries have been concentrated on specific beneficiary countries, in particular those that depend on sugar and banana exports (e.g. Mauritius and several Caribbean countries). Similarly, AGOA has had significant positive effects on exports of apparel and a few other agricultural products from specific African countries (e.g. South Africa and Lesotho).

Given this concentration of trade effects induced by preferences, the costs of any preference erosion will also be concentrated on a relatively small number of developing and least developed countries: island economies, including Caribbean countries that are dependent on sugar and banana exports; countries in north Africa with preferential access to the EU for their apparel and agricultural products; and LDCs in sub-Saharan Africa and Asia that benefit from preferentially-treated textiles and apparel exports. The most vulnerable is a narrow set of countries with the most concentrated exports and highest preference margins (e.g. Guyana and Mauritius).

The concentration of potential losses from Doha Round-induced preference erosion (and from other sources) will give rise to a need to look for ways of compensating and supporting adjustment in these countries. The narrow range of substantial beneficiaries from preferences means that there is also a need to consider whether the benefits and beneficiaries from remaining preferences can be enhanced. The view of many commentators is that the utilisation of preferences can be increased by the adoption of laxer and more flexible rules of origin and by the lowering of non-tariff barriers.