

TARIFF PREFERENCES

Summary

- Virtually all countries receive some sort of tariff preference in the EU market, and the system is complex.
- Significant differences in the margins of preference between the various groups of recipients lie mainly in agricultural products
- Preferences can act as a brake on more general trade liberalisation.
- The evidence suggests that there are very strong and widespread gains from agricultural trade liberalisation, in which even the poorest African countries would benefit.
- There is no evidence that preferences provide anything like such gains for their recipients. Indeed, the evidence suggests fairly limited gains.
- Preferences tend to narrow the production base and increase the vulnerability to shock of the recipient economies.
- Reliance on preferences can have a significant adverse effect on production costs and long-term competitiveness in recipient industries.
- Preferences are not the most efficient way of fostering economic development in developing countries.

Preference

Systems

1. The EU has a number of preferential schemes for developing countries. Only 9 countries (i.e. developed countries such as the USA, Canada, Australia and Japan) actually face the full MFN tariff on their imports into the EU. All other countries, including all developing countries, receive some sort of preferential treatment through bilateral arrangements or more general preferential systems. The preferential arrangements for developing countries constitute a quite complex hierarchy of favourable treatment. The most favourable access is granted to the 49 Least Developed Countries (LDCs), who, apart from time-limited restrictions on sugar, rice and bananas, receive duty and quota free access for their exports to the EU. In general, the next most favourable preferences are available to those ACP countries that are not LDCs. In addition, the EU has a number of bilateral trade agreements with other developing countries (e.g. with the North Africans), whereby those countries receive some preferential concessions over and above normal GSP ones. All other developing countries (e.g. India, Brazil, and China) qualify for the concessions available under the Generalised System of Preferences (GSP).
2. Other developed countries also have preference systems. 15 countries have GSP systems for developing countries. These vary in terms of country and, more especially, product coverage. In general, coverage of agricultural products is less extensive than for other goods. In addition, countries may offer additional preferences to LDCs or to countries from specific regions (e.g. the US preferences for countries in Africa and the Caribbean).
3. The degree of preference offered on any product is likely to be related to the level of the MFN tariff – the higher the tariff, the bigger the margin of preference. This is certainly true of preferences for LDCs.

This means that in the EU the large margins of preference are found mainly in agricultural products. A recent study by the World Bank found that in the EU the number of tariff peaks (i.e. MFN tariffs greater than 15%) relating to agricultural products far exceeded those on industrial products. At 6-digit tariff line level, there are 290 peak tariffs on agricultural products, compared to only 27 on industrial products (mainly on clothing and footwear). The average, unweighted tariff on the peak lines is 40.3%, compared to 7.3% on all products. (Source: Hoekman, Ng, Ollarreaga, "Eliminating excessive tariffs on imports from LDCs", World Bank, 2001).

4. The Bank paper estimates the preferential margin in the EU for different groups of developing countries. On all products, countries receiving just GSP preferences get an average reduction of 3.8% from the MFN tariff of 7.4%. Non-LDC ACP countries get a reduction of 6.5% and (at least when EBA is fully implemented) the reduction for LDCs is 7.4%. This suggests little difference between the average rate for non-LDC ACP countries and LDCs over all tariff lines, reflecting the fact that ACP countries already face a zero rate on many lines. The gap of 2.7% between the ACP/LDC rate and the GSP rate is also relatively small.
5. There is a very different picture however, when the analysis is confined to the tariff lines with peak rates. On these, countries receiving the standard GSP terms get a reduction of 20.5% off the MFN rate of 40.3%. Non-LDC ACP countries get a reduction of 27.9%, and LDCs (eventually) one of 40.3%. There are thus significant differences between the rates facing different groups of developing countries for these products, and between the rates facing developing countries and those developed countries that face full MFN tariffs. These are the products where the preferences may well influence trade flows.
6. The correlation between the margin of preference granted and the income of the recipient country is not perfect. Albeit the LDCs (who constitute most but not all of the world's poorest countries) will receive the maximum preference possible. But for other developing countries the link is less clear – Barbados receives a higher degree of preference than India. And developed countries with bilateral trade agreements with the EU (e.g. EFTA or Macedonia) will receive higher preferences than the majority of developing countries. The situation becomes even more complex when quota allocations are taken into account. A share of a quota allocation is a preference – but it is not evident that these are allocated on an income basis.

Do Preferences benefit the recipients?

7. Preferences – if they are sufficiently large- are usually regarded as beneficial to the recipient, because they should allow it to extend its share of the donor country market, either by displacing domestic production or imports from other sources. This is held to translate into higher growth in the recipient country. Certainly, recipients do place a positive value on preferences.

8. One fundamental argument against preferences however, is that the widespread use of preference arrangements acts a brake on the development of worldwide liberalisation. It is evident that protectionist lobbies in recipient countries do often use the existence of trade preferences to obtain external support for the status quo. Industries that benefit from preferences in recipient countries have motivation to lobby for their continuation and against any general policy changes that would reduce their value. One recent study also provides evidence that the availability of unreciprocated preferences has undermined the incentives of recipients to engage in domestic trade liberalisation and at times has perpetrated anti-export biases in their trade regimes. (Source: Ozden and Reinhardt, *"The perversity of preferences: GSP and developing country trade policies, 1976-2000"*, 2002).
9. The logic of this argument is that the value of preferences to recipients – and the loss to them of any preference erosion through liberalisation- has to be set against the wider benefits of liberalisation. The benefits of liberalisation appear substantial on a global scale. The benefits to certain countries of preferential access appear to be much lower.
10. Taking just the benefits from agricultural liberalisation, a recent World Bank simulation estimated that if the developed countries provided free access for agricultural imports from developing countries, the developing countries would have an income gain of between \$31billion and \$99 billion. The reason for the difference between the two figures is that the latter includes estimates of beneficial second-round effects on investment and productivity. If the developing countries also liberalised, the gains to them would rise to between \$142 billion to \$390 billion. Liberalisation in other areas would lead to even higher gains. Even taking the lowest figure, the benefits to developing countries would be substantial. (Source: World Bank, *Global Economic Prospects, 2002*).
11. The Bank do not provide a break-down between developing countries, but evidence from other simulations suggest that all groups gain, including the African countries, who generally receive the largest preferences in the EU market. One recent Australian Government study put the gains to Africa from full liberalisation at between \$2 billion to \$4billion. (Source: ABARE, *"The impact of agricultural trade liberalisation on developing countries"*, 2000).
12. In contrast, there is a distinct lack of evidence that preferences provide significant benefits for their recipients. When the OECD reviewed the research on GSP schemes in 1997, it concluded, "in general these studies suggest modest trade gains attributable to preferences". Unfortunately, it is not possible to use the models employed to estimate the liberalisation gains to also identify the value of preferences, although the IMF/WB view is that incorporating the effect of preferences would not markedly influence the results. An alternative approach to try to quantify the effect of preferences is to compare the amount of revenue that the donor country would have earned on imports from the recipient country if it had subjected them

to MFN rates with the amount it actually received on these imports. This is an approximation of the gains to the exporter. The benefits suggested by this approach are extremely small. UNCTAD calculations for the benefits of preferences offered by the Quad produce remarkably low figures. Its calculation for the EU was that the financial value of preferences to LDCs was only \$44 million, or just 1.2% of the value of LDC exports to the EU. EBA has probably increased that figure, but compared to the figures for the benefits of trade liberalisation, it will still be minute. (Source: UNCTAD, “*Quantifying the benefits obtained by developing countries from the GSP*”, 1999).

13. There are a number of reasons why the actual benefits derived from preferences might be small. Preferences of any sort are of no value to a country that lacks the means – e.g. the infrastructure to export – to take advantage of them. Nor are straightforward tariff preferences of any value to a high cost producer if the preference margin is less than its additional costs. There are also costs for the exporter in obtaining a preference. Preference utilisation is remarkably low under all preference schemes. For instance, UNCTAD calculate that although 99.2% of all EU imports were eligible for preferences in 1999, only 33.7% actually received them. So for two thirds of LDC exports – either through lack of knowledge or because the costs of complying with the scheme were held to be greater than the value of the preference- no preference was sought by the exporter. (Source; UNCTAD, “*Improving market access for LDCs*”, 2001).
14. The general conclusion to be drawn from the existing evidence is therefore that the potential benefits of trade liberalisation to developing countries far outweigh the benefits of trade preferences to any group of them. This is not to deny, that certainly in the short-run, there could be large adjustment costs for specific exporters in certain countries. All trade liberalisation generally produces some losers. But all countries have the potential to benefit in the longer run.

Do preferences help development?

15. The fundamental justification for preferences is to encourage economic development in the recipient countries. Critics of preferences question whether they do that, even if they do provide new export opportunities for industries that receive high preferences.
16. Perhaps the most damaging aspect of the major preferential agreements has been the extent to which industries have become dependent on preferences. One of their main effects is to divert resources in the recipient country towards the industries with the greatest degree of preference. (Even where the preference covers all goods, as in EBA, the incentive is to divert resources to the products where the preference margin is greatest e.g. agricultural products). As a result, the production base of the country becomes narrower, with a disproportionately high share of land and other resources being directed towards the preference receiving industries. This lack of diversification, and often an accompanying failure to expand other industries where comparative advantage may be greater, can make the economy vulnerable to external shocks. Many of the world’s

poorest countries are characterised by a very narrow production/export base, to which preference-related distortions have made some contribution. In the words of a Commonwealth Secretariat study, preferences “do more to preserve the past than to promote the future” (Source: Commonwealth Secretariat, “A future for small states: overcoming vulnerability”, 1997)

17. A further, related problem is that industries that are substantial recipients of preferences frequently end up being high-cost producers by world standards. As preferences raise the average price they receive, more resources are attracted into the industry than is optimal, and average costs rise. The preference system may also reduce the competitive pressures on them. It is calculated that the cost of production for sugar and bananas in the main exporters reliant on preferences is twice the level of that in the non-subsidised exporters. (Source: Stoeckel and Borrell, “Preferential trade and developing countries: bad aid, bad trade”, Canberra 2001). Preferences have plainly had some role in fostering these high costs. The Trinidad sugar industry is a classic case of a protected industry – half its output goes under preferences to the EU and its domestic prices are kept well above world prices- yet it is notoriously high-cost and ill-run and still requires yet more assistance from Government subsidies to keep it going. The Jamaican sugar industry has a very similar profile.
18. A further general criticism of preferences is that, as a mechanism for raising living standards in poor countries, they are a crude and untargeted instrument. This raises fundamental questions about the best way to offer development aid. However, it is certainly true that the major beneficiaries are likely to be owners of land – or even international traders- and there is no guarantee that the most needy groups will receive a substantial proportion of the benefits. Trade preferences can lead to a leakage of benefits to other groups. One estimate for the EU banana regime was that it cost EU consumers \$5.30 for every dollar received as aid by the recipients. (Source: Borrell, “Bananas: straightening out bent ideas on trade as aid”, 1999).