

Economic Rationale for Nonreciprocal Preferences

Nonreciprocal trade preference programs began with the postcolonization movement of the 1950s and 1960s. In their infancy, trade preference programs of developed countries were aimed at assisting former colonies to become successful independent states. As early as 1955, amendments to the General Agreement on Tariffs and Trade (GATT) recognized the need for special provisions for developing countries to facilitate economic development. In 1964, a “trade and development” provision was added to the GATT that formally recognized the need for rapid and sustained expansion of export earnings of less developed countries to help foster economic growth. While this provision acknowledged the need for development and a general commitment by developed countries, it did not provide specific measures.

Also in 1964, Secretary-General Raul Prebisch of the first United Nations Conference on Trade and Development (UNCTAD) proposed the creation of a nonreciprocal system of tariff preferences in favor of the developing countries. But it was not until 1968, during UNCTAD II, that there was unanimous agreement to establish a mutually acceptable system of widespread, nonreciprocal, and nondiscriminatory preferences in order to assist economic development in developing countries, generally referred to as the Generalized System of Preferences (GSP). In order to put the GSP into effect, however, it was necessary to exempt developed countries from the GATT’s nondiscriminatory MFN obligation to extend a tariff reduction given to one contracting party to all contracting parties. In 1971, GATT members agreed to grant a 10-year MFN waiver for the GSP, and later that year the EU became the first to put a GSP program into place. The MFN waiver was later made permanent with the adoption of the GATT Enabling Clause in 1979 (see box on legal basis of trade preference programs). By 2003, 17 countries (counting the EU as one country) had GSP schemes in operation.¹ With the expansion of the EU in 2004, five of those countries now come under the EU scheme. Since the GSP was created, several developed countries have implemented programs that go beyond the GSP in terms of eligible country and product coverage. The programs offered by the EU and United States are the two largest examples and are discussed in the following sections.

Proponents of these programs cite two direct ways in which nonreciprocal trade preference programs provide advantages to recipient countries. First, they increase the value of exports from recipient countries by granting exporters a price premium that is roughly equal to the size of the tariff preference minus any additional costs for exporters to meet eligibility requirements. Second, this tariff advantage stimulates export growth of the recipient countries. Because of the discriminatory aspect of preferences (imports from recipient countries facing lower tariffs than those from nonrecipients), preference-granting countries may switch from importing the now higher priced products from nonrecipients to importing more of the lower priced products from recipients (a trade diversion effect). Nonbeneficiary exporters stand to lose, as their exports are “crowded out” by the exports benefiting from the preferences.

The economic rationale for offering developing countries preferential access, according to Raul Prebisch, is that: “[P]referential treatment for

¹The countries include Australia, Belarus, Bulgaria, Canada, Czech Republic, Estonia, European Union, Hungary, Japan, New Zealand, Norway, Poland, Russian Federation, Slovak Republic, Switzerland, Turkey, and the United States.

exports of developing countries ... would help the industries of [these] countries to overcome the difficulties that they encounter in export markets because of high costs” (Prebisch, 1964). As countries increased the volume of output for exports, they would be in a position to better exploit economies of scale and reduce those high costs. Most studies conclude that while preferences have increased exports from some developing countries, they can raise them significantly only for products that enjoy large “margins of preference”—the difference between the MFN tariff and the preferential tariff—and in countries with sufficient productive and export capacity to take advantage of the added economic incentives. The extent to which recipient countries will be able to respond to these tariff incentives will depend upon their supply response (the elasticity of supply). The higher the elasticity, the larger the response, and the larger the trade diversion effect will be. Depending on the share of exports of the program recipients in the

The Legal Basis of Trade Preference Programs

The “most favored nation” (MFN) principle requires that GATT/WTO members treat their fellow members in a nondiscriminatory fashion when levying tariffs. Implicitly, the MFN principle precluded special trading arrangements. In 1964, the first United Nations Conference on Trade and Development advocated the granting of special trade preferences to developing countries, which eventually resulted in the concept of a Generalized System of Preferences (GSP). To implement the GSP, members adopted the “Enabling Clause” in 1971, originally for 10 years, but renewed in 1979 for an indefinite period of time. It provides a permanent exception from MFN obligations so that developed countries “may accord differential and more favorable treatment to developing countries” through a “system of generalized, nonreciprocal, and nondiscriminatory preferences” (GSP). Countries identified as Least Developed Countries (LDCs) by the United Nations may be granted even more favorable treatment.

WTO rules provide another exception to MFN obligations, very different from that of the Enabling Clause. WTO members may establish free trade areas (FTAs), within which the duties and other restrictive regulations of commerce (except where expressly permitted within WTO rules) are eliminated on substantially all the trade between the constituent countries. While nonreciprocal arrangements do not expose domestic production in developing countries to additional competition from imports, FTAs expose all partners to economic competition with all other partners at zero duties on almost all traded goods. WTO provisions for FTA agreements are important now because the European Union and the United States are pursuing agreements under those rules with developing countries.

The WTO rules are important to developing countries because the EU has included quantitative restrictions (as tariff-rate quotas) in many of its trading arrangements with developing countries. In 2001, the EU banana import regime, which included discriminatory quotas for former African, Caribbean, and Pacific (ACP) colonies, was found to be incompatible with WTO requirements because it favored EU banana distributors over distributors of other countries and favored former colonies over other developing countries. Following the WTO panel finding, the EU requested and received a waiver to operate a revised banana regime for an interim period while implementing a tariff-only system.

donor preference-granting country, the scheme could lower the internal prices in the donor country. Trade creation would occur in addition to trade diversion, benefiting consumers in the donor country as domestic prices drop and consumption increases.

Increased export earnings are one of several dynamic, long-term effects that preference programs can have on the internal market of recipient countries. Preference programs generally change the relative price relationships or terms of trade in recipient countries. Prices for exports increase relative to their import prices, creating an incentive to invest in the export sector. If this leads to an overall increase in investment, then the recipient country's economy should grow as well.² It was the potential that these programs held for promoting industrialization and accelerating rates of economic growth in developing countries that led early proponents to view them as another form of development aid. The slogan "trade rather than aid" became associated with these programs because of the financial transfer made to recipients through the higher price received for their exports and the belief that these increased exports would ultimately lead to more rapid development.

In practice, the economic implications of preferential market access programs on recipients are complex and depend on a variety of factors. The possible benefits of preferences to developing countries that depend on increased export volumes, increased production, more jobs, and greater economic growth may face considerable constraints because of the internal economic situation of the program recipients. If resources in recipient countries are limited and/or are not mobile among sectors and products, countries might not be able to take advantage of market access preferences. Also, if the preferences result in a country moving scarce resources into financing high-cost production of goods in which it has no indigenous comparative advantage in producing, it could hamper long-term growth in other sectors of the economy.

Donors' program design also influences the outcome. In most preferential programs, the tariff advantages are granted to selected commodities. The less important these products are in the export profile of the recipient countries, the smaller the export expansion and revenue gains are. Even when the preferences are on products of interest to recipients, the margins of preference may be too low to provide an economic incentive.

Changes in the global trading system and/or policies of the preference-granting country also will influence the impact of the programs on recipients. For example, any decreases in MFN tariff rates of preference-granting countries as a result of regional or global trade liberalization erode the margins of preference—measured as the extent to which preferential tariffs are below the MFN tariff—granted under preferential trade programs and reduce the export incentives for the recipient countries. The deeper the cuts in these rates, the more diluted these programs become.

Other nonprogram costs, such as compliance with a donor country's import regulations, also can impede recipients from benefiting from preferences. As a result of these restrictions, some supporters believe that donor countries should incorporate financial aid and technical assistance into nonreciprocal preferential trade programs to help build recipient countries' economic capacity to take advantage of preferences.

²The outcome is less certain if the country merely shifts resources away from nonpreference commodities to the production and export of commodities covered by the programs. The relative price between the preferred commodity and nontraded commodities and/or export commodities not covered under the program in the recipient country is an important factor influencing the extent of the export growth and the revenue gains.