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Reforming trade preferences for LDCs

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'While it is difficult to deny the advantages of reforming trade preferences for LDCs' exports, there are conceptual and political challenges which may undermine some of the proposed reforms'

There is renewed interest in making the current system of trade preferences more effective for the development of exports from developing countries, and from Least Developed Countries (LDCs) in particular. Ahead of the G-20 Summit in Pittsburgh in 2009, the EU recommended that the G-20 Leaders 'should adopt the Everything But Arms' (EBA) initiative without delay to support people in developing countries suffering from the [financial] crisis' (CGD, 2010). This was soon followed by China announcing that it would expand its LDC trade preferences for Africa, and Brazil that it would introduce trade preferences for LDCs in 2010. Along with recognition that poor countries need help to recover from the global crisis, the forthcoming review of the Millennium Development Goals (MDGs) in September 2010 provides another important boost – as the granting of trade preferences to LDCs is contained in MDG8, on global partnership.

A recent report by a Working Group on Global Trade Preference Reform convened by the Center for Global Development (ibid.) elaborates on these statements and proposes a series of recommendations aimed at making trade preferences work more effectively for the LDCs. These include not only the expansion of the duty free quota free (DFQF) scheme to all exports from all LDCs, but extending the pool to some advanced developing countries (chosen by CGD). They also recommend the modification of existing rules of preference programmes, including rules of origin that currently restrict accumulation of input sourcing and ensuring programme stability and predictability. Finally, the report calls for a reduction in the costs of regulatory requirements in preference-giving countries and efforts to tackle supply-side constraints in poor countries that limit exporters' ability to take advantage of market access.

While it is difficult to deny the advantages of these measures for LDCs' exports, at least in the short term, there are conceptual and political challenges for the implementation of some of these measures, which may undermine some of the proposed reforms.

First, any extension of preferences to one group of countries implies a corresponding deterioration of the competitive position of the other developing countries exporting to the preference-granting country. Thus, expanding the preferences offered to LDCs implicitly attributes a more important value to the welfare of LDCs than to that of other developing countries.

Simulations run through computable general equilibrium (CGE) models (Bouet et al., 2010) suggest that this should not be a source of concern, however, as the expected losses for non-LDC developing countries would be negligible. These CGE results are encouraging, but are subject to potentially large margins of error stemming from the high level of aggregation for both sectors and countries. The model used computes average tariff rates over dozens of 6- or 8-digit sectors. It has data for only a handful of countries grouped into 30 geographic units that lump together, for example, most African countries as 'Rest of Africa', which includes both LDCs and non-LDCs.

For this reason, the results constitute too thin evidence on the likely export costs faced by non-LDC developing countries following the expansion of preferences for the LDCs. Moreover, in the event of an expansion of preferences by the US to all LDCs, some LDCs themselves (i.e. in Africa) would be worse off, as their preferences in the US market through the American Growth and Opportunity Act (AGOA) would be eroded. The legitimacy under the WTO of preferences rests on consent by all countries to favouring developing countries over developed, and the Enabling Clause explicitly requires that preferences be designed 'not to raise barriers to or create undue difficulties for the trade of any other contracting parties' (E.1.4 Paragraph 3(a)).

Second, granting DFQF to all exports from LDCs risks providing perverse incentives to increase the specialisation of LDCs' exports in agriculture due to the current tariff structure in many advanced countries with higher tariff rates in agriculture. Indeed, Gasiorek et al. (2010) show that LDCs currently enjoy relatively high

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preference margins in the EU market in a number of agricultural products only, which may help explain why the same authors do not find much evidence that preferences help countries diversify their exports to the EU. This runs counter to the original objective of preferences – to help poor countries diversify their exports towards the more dynamic sectors of the economy – and will impose costs on LDCs in the future in restructuring their economies away from artificially stimulated sectors (as has already happened, for instance, in sugar and clothing, and for non-LDCs in bananas).

Finally, it is not clear that providing full DFQF would yield significant benefits for exports by LDCs. The current tariff rates are generally not prohibitive in most sectors of advanced economies, thus the potential for offering a preference margin is not large and likely to decrease in the future with further liberalisation. Over half of the gains found for preferences in the past came not from tariff preferences, but from the benefits received from special regimes, such as sugar, and from exemption from controls on textiles and clothing. DFQF would not restore these advantages. In addition, supply capacity constraints and non-tariff barriers are often the most important constraints to the export of LDCs, but these are clearly more difficult to tackle than the actual tariffs.

Some of these conceptual challenges are likely to turn into political ones, which may make the implementation of DFQF for LDCs more difficult. In particular, the failure to address the costs faced by the potential losers from these measures could increase the opposition to such extension from other developing countries. Furthermore, the proposal for some advanced developing countries to provide 100% DFQF to LDCs ignores the fact that they lost out from being excluded from past preferences to LDCs – a history that may affect their attitude to giving preferences to these countries, especially on the basis of a recommendation by a developed country research institute. A further constraint is that under WTO rules, it is no longer possible for developed countries to choose which developing countries to favour.

How to create a better trade reform package for poorer countries

First, any proposal must be based on a careful calculation of potential benefits and must take seriously the concerns of those who would lose out from any change in the preference system. As always in trade, this requires detailed, line by line examination of the effect of the changes on both those who would benefit and those who might pay the costs. When the losers are developing countries, developed countries must include provisions to compensate them. Any extension of DFQF to LDCs may in future entail costs for them when Most Favoured Nation (MFN) liberalisation or regional arrangements erode these preferences.

Second, reviewing rules of origin to allow for both low enough value addition criteria, and as much cumulation as possible for LDCs in order to encourage them to source their inputs from the most efficient suppliers, would benefit both LDCs (because many are too small or have industries at too early a stage of integration to meet all the stages of production required by present rules) and other developing countries (who could supply the inputs).

Third, providing preferential access in services to LDCs would be much less likely to impose costs on other developing countries, because in most cases this would be new access, not diversion of access as is often the case in goods. It is also likely to have significant benefits, because high existing barriers would offer a significant preference margin, and encourage the development of more dynamic sectors, with a sustainable future, rather than locking LDCs into primary products production.

Lastly, a focus on effective Aid for Trade could tackle supply-side constraints with potential positive effects on exports (Calì and te Velde, 2009). It was precisely the political and economic obstacles to extending preferences which led to the initial proposals for Aid for Trade (Kleen and Page, 2005).

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