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Ongoing WTO Negotiations and the Issue of Preference Erosion: Concerns of Asia-Pacific LDCs

Professor Mustafizur Rahman, CPD*

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INTRODUCTION

The ongoing WTO negotiations on non-agricultural market access (NAMA) aims at (a) reducing tariffs on industrial products, including reduction or elimination of tariff peaks, high tariffs and tariff escalation and (b) eliminating (or accelerating reduction of) all tariffs in particular sectors (the so-called *sectorals*). Even if tariff reductions are based on bound rates, as specified in the *July Framework,* tariff reduction commitments are expected to lead to a lowering of most-favoured nation (MFN) tariffs, since the spread between bound rates and applied rates for most industrial products imported by the developed countries is not significant. Therefore, the reduction of MFN tariffs under the current NAMA negotiations is likely to have important adverse implications for the least developed countries (LDCs) in the form of *preference erosion.*

CONCERNS AS REGARDS PREFERENCE EROSION

Preference erosion is defined as the decrease in the margin between a preferential tariff rate and the MFN tariff rate originating from multilateral tariff liberalisation. As is well known, the LDCs enjoy preferential market access in most of the developed countries' markets under the various Generalised System of Preferences (GSP) Schemes operated by those countries. The GSPs have played an important role in providing LDCs products a competitive edge in the developed country markets. This is despite the fact that some of the GSP schemes have not been utilised to their potential. Preference *utilisation* is typically assessed by comparing the volume of imports into the developed country's market actually enjoying preferential treatment with the total value of imports eligible for preferential treatment. In the EU and Japan these rates were only 54.0 per cent and 53.0 per cent respectively (UNCTAD, 2003). With the likely reduction of MFN tariffs in the developed countries under the ongoing negotiations on NAMA, the benefits enjoyed even under this limited use of the GSP schemes are likely to be even less significant.

This concern was echoed by G-90 trade ministers who, in their 13 July 2004 communication, stressed the need for resolution of the preference erosion issue within the WTO negotiations themselves. A number of proposals submitted by WTO members have tried to address the issue. The *Livingstone Declaration,* adopted at the Fourth LDC Trade Minister's Meeting during 25-26 June 2005, also called for "further strengthening of the existing preferential schemes and the incorporation of provisions in the modalities to address the erosion of preferences" (WTO, 2005b). The co-chair's summary of the recently held Informal Ministerial Meeting at Dalian, China (12-13 July 2005) noted that "while recognising that the concerns relating to preferences could not be tackled entirely under the WTO, we have already agreed that such concerns, among others, should be taken into consideration in the course of the agriculture and NAMA negotiations" (WTO, 2005c).

Table 1 reveals the margins of preference enjoyed by the LDCs in developed country markets. The data justifies the apprehension as regards the erosion of preferences

TABLE 1: TARIFFS UNDER PREFERENTIAL SCHEMES

Preferential Agreement	Average Tariff Rate (all HS-6 products)	Average Tariff Rate (tariff peak products)
Canada		
LDCs[1]	4.4	22.8
MFN	8.3	30.5
European Union		
Non-ACP LDCs	0.9	12.4
MFN	7.4	40.3
Japan		
LDCs	1.7	19.0
MFN	4.3	27.8
United States		
Non-AGOA LDCs	1.8	14.4
MFN	5.0	20.8

[1] Does not reflect the recent Canadian initiative with regard to LDCs' exports.

Sources: Hoekman, Ng, and Olarreaga (2002) and IMF staff estimates as quoted in Subramanian (2004).

** Prof. Rahman is Research Director at the Centre for Policy Dialogue (CPD), Bangladesh. The views presented here are those of the author and do not necessarily reflect the views of the United Nations. The technical and financial support of the UN Economic and Social Commission for Asia and the Pacific and the International Development Research Centre, Canada, are gratefully acknowledged.*

following MFN tariff reduction. As is well known, many products of export interest to the LDCs also face high tariffs (tariff peaks) in these markets. These tariffs are particularly likely to be subjected to deeper cuts under the current negotiations. To that extent the erosion of preferences for the LDCs is also likely to be larger for these tariff lines.

Furthermore, any MFN reduction commitment in the WTO will also have negative implications for preferential margins enjoyed by LDCs that are members of various regional trading arrangements (RTAs) where they enjoy preferential treatment from developing or developed country partners on a non-reciprocal basis. For example, in the South-Asia Preferential Trading Arrangement (SAPTA) the four South Asian LDCs (Bangladesh, Nepal, Bhutan and Maldives) enjoy preferential treatment (ranging from 10-100 per cent of MFN tariffs) from the three developing countries (India, Pakistan and Sri Lanka). If the developing countries of SAPTA reduce their MFN tariffs under the ongoing NAMA negotiation, preference erosion for the SAPTA LDCs members is inevitable. One of the issues then arising is how beneficial are these regional preferential agreements given that they add to the overall compliance costs for the LDCs.

RELEVANCE OF PREFERENCE EROSION FOR THE AP-LDCS

The dependence of the Asia Pacific Least Developed Countries (AP-LDCs) on export earnings and export-oriented activities has increased, as many have pursued export-led growth strategies in recent years. In 2003, AP-LDC merchandise exports exceeded US$12.8 billion which was equivalent to about 16 per cent of their GDP. The structure of their exports is heavily tilted towards such labour-intensive sectors as apparels, textiles, fisheries, agriculture and tourism. Of particular importance are exports of the textile and clothing sector products by these countries which together account for about two-thirds of the merchandise export of the AP-LDCs. Erosion of preferential margins in this area is likely to undermine their competitive advantage with consequent implications for their economic growth, foreign exchange reserves, livelihoods for large numbers of people, and poverty alleviation.

Indeed, MFN tariff rates on items of export interest to the AP-LDCs tend to be relatively high. For example, average tariff on apparels in the EU is about 12 per cent, whilst in USA and Canada, these vary between 10 and 30 per cent (e.g. for Bangladesh the MFN tariffs on apparels in the US market is about 15 per cent). At the same time, AP-LDCs, under the various GSP schemes, enjoy duty-free access for most of their products in the markets of many developed countries (e.g. EU, Japan, Canada, Australia, New Zealand). For example, the *Everything But Arms Initiative* of the EU (EU-EBA) enables the AP-LDCs to export, among other items, apparels to the EU markets at zero-tariff, providing their exporters, vis-à-vis those not enjoying such benefit, a competitive edge equivalent to the MFN tariff (and potentially higher in case where non-tariff barriers are imposed on these other exporters).

While it is true that LDCs have not taken full advantage of the GSPs, the impact of tariff preference erosion on AP-LDCs remains significant even if this limitation is factored in. Indeed, a study conducted at the Centre for Policy Dialogue (CPD, 2003) shows that the EU-EBA provides Bangladesh a tariff preference margin equivalent to about US$260 million which would otherwise have been paid by European union consumers had there been no zero-tariff access for Bangladeshi products to the EU market. This estimates takes into account that only about 60 per cent of the total exports to the EU from Bangladesh can at present actually enjoy the preferential access because of inability to comply with rules of origin (RoO) (EPB, 2004). The average for all LDCs is about 54.0 per cent (UNCTAD, 2003). Several factors are responsible for such low GSP utilisation rate including stringent rules of origin and weak supply side capacities originating from both lack of adequate support from development partners and insufficient domestic efforts.

Subramanian (2003) also estimates that export losses from preference erosion would be in the range of US$222.4 million for Bangladesh, US$53.6 million for Cambodia, and US$17.8 million for Nepal. Export losses for most other AP-LDCs may not be of significant magnitude and would likely be spread over time owing to the phased nature of MFN reductions. The limited magnitude of the losses is mainly attributed to (1) LDCs limited capacity to supply products to developed countries and (2) the stringent and complex RoO requirements of GSP schemes.

SUGGESTED POLICY MEASURES

A number of proposals have been floated to enable the affected countries to address the adverse impact of preference erosion. Subramanian (2003, p.14) rightly points out that the 'shocks from preference erosion are likely to be permanent', and goes on to say that these countries may need to be supported through adjustment financing and this should be an 'integral part of any response' to changes in MFN tariff levels. The author is of the view that in light of the distinguishing features of the losses from preference erosion (a permanent shock, ability to anticipate beforehand, the potential losses being spread over time), any financing will be best done in the context of 'medium-term adjustment and programme financing facilities' and that creating a dedicated facility to address this particular issue 'would seem unnecessary and inefficient'. On the other hand, some others have suggested that the level of preference erosion could be set as a floor for a 'dedicated new assistance programme' (UNESCAP, 2004).

A proposal by Benin, on behalf of the African, Caribbean and Pacific (ACP) countries, proposes construction of a *Vulnerability Index* taking into cognisance three factors: (a) export product concentration; (b) market concentration; and (c) global market share. Products would be identified on the basis of this index, and likely range of preference erosion would be assessed for these products (WTO, 2005a). Yet another proposal (Sandrey, 2005) suggests that, rather than having tariff exemption privileges at the developed country border, an adjustment package be put in place based on the level of the baseline preferences, with a phase-out over time. As preferences erode as a result of tariff reduction, the difference between the baseline and current preferences would be compensated in the form of adjustment assistance. Page (2005) has argued that the issue of how the loss is to be assessed could be seen from two perspectives: whether the 'loss' should be the *total effect* of losses due to preference erosion or *net effect* (if negative) from all parts of any WTO settlement, i.e. offsetting the preference loss by any gains on other goods or services. As the author points out, addressing the issue from the perspective of the need for special and differential treatment of the poorest countries should be the right thing to do since these countries require non-repayable support in order to make the necessary adjustments.

One way to get around the problem would be to liberalise products of export interest to LDCs at a slower pace. However, as some have argued, this will entail substantial welfare loss globally. A proposal that has been floated recently relate to switching from *unilateral preferences* to LDCs to an *import subsidy scheme* (Limao and Olarreaga, 2004). Instead of preferential access, the recipient country will receive a subsidy that will be subsequently revised depending on the reduction of MFN tariffs and its impact on the preference receiving economy. The European Commission has already proposed to establish a *financing facility* to support adjustment, in cases where 'real hardship' is likely in the face of preference erosion. Moreover, for the ACP countries support was to be assured in advance to help the process of adjustment by these countries (European Commission, 2005). The IMF has also put in place *Trade Integration Mechanism* (TIM) to address balance of payments problems in the face of tariff liberalisation (IMF, 2005). However, the TIM is not designed to make additional resources available to the recipient countries.

Another option for AP-LDCs policymakers is to argue most forcefully that the expected impact of preference erosion on their economies reinforces the need for a global zero-tariff access for all products from the LDCs. Such market access could somewhat compensate for the likely losses. The *July Framework* of the WTO also urges the developed WTO members, as well as advanced developing countries that are in a position to do so, to accord bound zero-tariff access to LDCs products. As far as developed countries are concerned, this would essentially mean zero-tariff access to the US market which is the only Quad country that is yet to allow such preferential treatment to major products of export interest to the AP-LDCs including apparels. For example, tariff revenues on exports from Cambodia and Nepal in the US stood at US$195.9 million and US$21.4 million respectively (4.4 times and 0.65 times the ODA flows from USA to these two countries). Preferential market access to USA is also justified by the fact that since 2000, most of the non-AP-LDCs have been enjoying preferential treatment for apparels under the Africa Growth and Opportunity Act (AGOA) and Caribbean Basin Initiative (CBI) of the USA. In case the *sectorals* go ahead and if these include items of export interest to AP-LDCs, the justification for such offsetting initiatives as global zero-tariff access will be further strengthened. In view of this the proposal for zero-tariff market access for apparels in the US market under the *Tariff Reduction Assistance for Developing Economies Act* (TRADE Act, 2005) which is now under consideration in the US Senate, is of great importance particularly because the countries that are being considered under this Act include most of the AP-LDCs (only Myanmar is left out).

In the context of the ongoing WTO negotiations, the LDCs have also been calling for LDC-friendly rules of origin under the various GSP schemes (lower value addition and flexible processing requirements). The justification for favourable consideration of this demand is also strengthened by the looming prospect of preference erosion.

CONCLUDING REMARKS

If the Doha Development Round is to have 'development' at the heart of its work, the concerns and interests of the AP-LDCs (and all LDCs for that matter) as regards preference erosion must be adequately addressed. The WTO Ministerial in Hong Kong in December 2005 provides a good opportunity for the developed world (and also middle and high income developing countries) to accord zero-tariff access for all products from all the LDCs, to be bound in the WTO, as part of their effort to alleviate the adverse impact of reduced preferential margins resulting from the NAMA negotiations. Policymakers of the AP-LDCs may also need to call upon other WTO member countries to favourably address their demand for more flexible RoO and technical assistance to enhance their capacity to take advantage of existing GSP schemes.

Nonetheless, even if adequate measures are taken to address the issue of preference erosion at the multilateral level, LDCs will need to take steps at the domestic level to remain competitive in the global market. Reforms to enhance competitiveness and efficiency and concrete actions to improve institutions and infrastructures related to trade facilitation are crucial in ensuring long-term competitive advantage of LDCs products in the global market.

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