FAO TRADE POLICY TECHNICAL NOTES

on issues related to the WTO negotiations on agriculture

No. 7. Agricultural preferences: issues for negotiation

CONTENTS

1 Introduction

Access for developing country exports to developed country markets on preferential terms has been a long standing component of multilateral trading arrangements. The main purpose of preferences is to promote increases in the volume and value of exports from developing countries, thereby contributing to their growth and development - the logic being that through greater volumes of sales, on a more stable basis and at higher prices than would otherwise be obtained, development and growth can be realized in the recipient country.

The promotion of increased trade by developing countries through the extension of preferences is consistent with the mandate of the WTO trade negotiations, but as the drive towards greater levels of trade liberalization in agricultural markets has intensified, preferential schemes have become the focus of more attention and analysis. This has led to the importance of preferences to the developing countries and their usefulness for increasing trade and development being questioned. It has been argued that difficulties both with preference administration and utilization, and with domestic supply capacity constraints of some countries, have limited the benefits of preferences. The potential negative effect on third countries has also been raised, because some developing countries claim that preference schemes discriminate against their exports. At a fundamental level therefore, the debate informing current negotiations has been focused on whether preferences have been useful to the recipient countries, and to what extent the existence of these preferential schemes has negatively affected other countries.

Both sets of issues, i.e. those relating to the preference receiving and granting countries, and those relating to exporting countries excluded from the preference scheme need to be borne in mind in debates relating to the potential erosion of current preferences within the multilateral trading framework. There is also a concern among those seeking greater trade liberalization that the continued existence of preferences could result in less than hoped for liberalization being attained because preference receiving countries will not argue for more open trade, and preference granting countries will continue to maintain support and restrictions on the basis of providing preferences.

This technical note reviews evidence upon which a number of these different aspects of the debate in relation to the use of preferences have been based.[1] Section 2 presents, and provides examples of, the types of preferences currently offered and their compatibility with WTO rules. Section 3 explains the current status of negotiations related to preferences in the ongoing round of agriculture negotiations. Section 4 then reviews the major issues related to agricultural preferences in the multilateral trading framework. In light of these issues, Section 5 assesses the evidence related to the effects of preferences. Section 6 concludes by providing suggestions as to the future direction of negotiations on agricultural preferences.

[1] This note benefits from an informal consultation of experts on “Preferences – Modelling Approaches and Policy Alternatives”, held at FAO, Rome on February 21 and 22, 2005.

2 What constitutes preferences in the WTO?

Preferential trade programmes are categorised as reciprocal or non-reciprocal trade preferences. Reciprocal trade preferences occur when two countries mutually offer each other trade concessions which they do not offer to other countries. Non-reciprocal trade preferences refer to trade arrangements where one country unilaterally offers another, or several countries, trade concessions.

Within the WTO, an Enabling Clause[2] has created a permanent legal basis for trade preferences provided both generally for all developing countries under Generalized System of Preferences (GSP) regimes, and also for more specific preferential treatment of the least developed countries (LDCs). Under the Enabling Clause, tariff preferences granted by developed countries must not discriminate among developing countries, except for the possibility of providing more generous preferences to all LDCs. Non-reciprocal preferences falling within the definition of the Enabling Clause are not currently under debate in the WTO.

However, in some instances, specific preferences are granted by individual developed countries for limited groups of developing countries which include non-LDCs, such as those granted by the European Union (EU) to African, Caribbean and Pacific Group of States (ACP) countries under the Lomé Convention, and the Caribbean Basin Economic Recovery Act extended by the United States.

In the context of the WTO negotiations, LDCs are not required to reduce their levels of trade barriers, i.e. they are not required to provide reciprocal access. The issue therefore is whether developed countries can discriminate between non-LDC developing countries, to provide preferences to some non-LDC developing countries and not others. The general perception has been that this is not compatible with the Enabling Clause and that since this subset of non-reciprocal preferences are not offered to all non-LDC developing countries, they required a waiver to continue to be offered. However, a recent WTO appellate ruling[3] suggests that preference schemes which discriminate in favour of some non-LDC developing countries may be consistent with the Enabling Clause provided they meet certain conditions related to that clause, particularly that the discrimination is justified on the basis of development, financial and trade needs, and that the same level of preferences is extended to all developing countries of the same status.

The main preferential agreements providing access for developing country agricultural producers are the Cotonou Agreement between the EU and ACP countries, the United States Caribbean Basin Economic Recovery Act (CBERA), the United States African Growth and Opportunity Act (AGOA), and the EU's Everything But Arms (EBA) initiative.

- The Cotonou Agreement includes 77 ACP (African except South Africa, Caribbean and Pacific) countries and covers all manufactured and processed products, which are exempted from customs duties and non tariff barriers, and agricultural commodities, some of which are subject to quota (e.g. bananas and sugar). The future of this preferential arrangement is under negotiation in the framework of the EU/ACP Economic Partnership Agreements (EPAs) and is expected to result in a reciprocal and WTO compatible trade regime starting in 2007. The concern by ACP beneficiaries is how it is being undermined by increased multilateral trade liberalization. Its non-beneficiaries continue to question its existence.
- AGOA is granted by the United States and covers 37 African countries, providing duty free access to agricultural commodities, some subject to tariff rate quotas and quota free access, including among others, a range of textile and petroleum products. Rules of origin require that a product be grown, produced or manufactured in a beneficiary sub-Saharan African country. In addition there are various conditions related to national security, liberalisation and human rights, reviewed on an annual basis.
- CBERA is granted by the United States and covers 24 Caribbean Basin countries. To qualify for duty free eligibility a product must be imported directly from the beneficiary country to the United States and have a minimum of 35 percent local content. There are quotas on some agricultural products. Conditions are less wide-ranging than AGOA and relate to prohibition of child labour.
- EBA is extended by the EU to all LDCs and covers all products except arms and ammunition. Duty free and quota free access is granted on almost all products and, for those where a degree of duty applies (e.g. bananas, rice and sugar), this will be gradually reduced, and then eliminated in 2009.

The Cotonou EU/ACP agreement is the main preference scheme that has been under question in the WTO. It is on this type of non-reciprocal trade preferences that this technical note provides information and evidence, in an effort to advance

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[2] Decision on differential and more favourable treatment, reciprocity, and fuller participation of developing countries. GATT Document L/4903, 28 November 1979, BISD 26S/203.

[3] WTO (2004). European Communities – conditions for the granting of tariff preferences to developing countries. WT/DS246/AB/R 7 April 2004.

the debate on agricultural trade preferences in the ongoing negotiations.

3 Current status of preferences in the Doha Round of agriculture negotiations

Paragraph 44 of the August 2004 Framework Agreement states that:

"The importance of long-standing preferences is fully recognized. The issue of preference erosion will be addressed. For further consideration in this regard, paragraph 16 and other relevant provisions of TN/AG/W/1/Rev.1 will be used as reference."

At face value one can conclude that the importance of preferences and the commitment to address preference erosion is therefore considered as accepted by the WTO membership. However, the phrases "is fully recognized" and "will be addressed" do not inspire confidence, given the lack of concrete action on similar clauses in past agreements. It is perhaps important that parties concerned with achieving real outcomes from these statements attempt to negotiate additional detailed language that translates the intentions into actions.

Paragraph 16 of TN/AG/W/1/Rev.1 (known as the Harbinson Draft[4]) states that

" In implementing their tariff reduction commitments, participants undertake to maintain, to the maximum extent technically feasible, the nominal margins of tariff preferences and other terms and conditions of preferential arrangements they accord to their developing trading partners. As an exception to the modality under paragraph 8, tariff reductions affecting long-standing preferences in respect of products which are of vital export importance for developing country beneficiaries of such schemes may be implemented in equal annual instalments over a period of [eight] instead of [five] years by the preference-granting participants concerned, with the first instalment being deferred to the beginning of the [third] year of the implementation period that would otherwise be applicable. The products concerned shall account for at least [20] percent of the total merchandise exports of any beneficiary concerned on a three-year average out of the most recent five-year period for which data are available. Interested beneficiaries shall notify the Committee on Agriculture, Special Session accordingly and submit the relevant statistics. In addition, any in-quota duties for these products shall be eliminated. The preference-providing Members shall undertake targeted technical assistance programmes and other measures, as appropriate, to support preference-receiving countries in efforts to diversify their economies and exports."

Several issues arise from paragraph 16:

- Several factors, including domestic policy (for example, reforms to the EU's Common Agricultural Policy need to meet multilateral commitments, as reflected by recent WTO sugar and banana disputes) make it difficult for the point of departure of negotiations around preferences to be "to undertake to maintain, to the maximum extent technically feasible, the nominal margins of tariff preferences and other terms and conditions of preferential arrangements they accord to their developing trading partners."
- If it were possible to maintain preference margins, should the goal be nominal or real margins?
- How will "of vital importance" be defined?
- Are the longer periods allowed to preference granting countries for reducing tariffs affecting long standing preferences based on the needs of adjustment related to preference receiving countries, and is the time period adequate? An important question related to this is which trading partners should benefit from preferences, in other words, for which countries will WTO members be willing to accept that their preferential arrangements will not change or are "maintained to the maximum extent technically feasible"?

There are also several issues to be considered relating to the criteria:

- "... the products concerned" (i.e. the products on which preference granting countries will reduce barriers at a slower rate) "...shall account for at least [20] percent of the total merchandise exports of any beneficiary concerned..." It is important to note that this clause would provide the option for preference granting countries to implement their market access commitments more slowly on identified products if it can be demonstrated that for a particular product, a WTO developing country member has benefited from preferential access over a defined period of time and the product comprises at least 20 percent of their total merchandise exports. It is not open to the preference granting countries to create additional preferences on products that had not previously received preferential treatment, even if these products exceed 20 percent of a developing country's total merchandise exports. Examples of products for which developed countries may be able to implement reduction commitments more slowly on the basis of the criteria include bananas, which, for example, contribute in excess of 35 percent of total merchandise exports of both St Lucia and St

[4] Although WTO members have not agreed on the Harbinson Draft, they have agreed to use paragraph 16 as a reference for the negotiations.

Vincent, and which have received preferential access over the defined period.

- It is assumed that additional criteria related to "graduation" from participation in preferential schemes would determine which countries finally qualify once the products are identified.
- The paragraph also refers to provision of "targeted technical assistance" to assist diversification, raising the question as to whether there should be a concrete linkage between amounts and time periods of technical assistance programmes to support diversification of preference receiving economies and continuation of preferences.
- Finally, the WTO membership did not only commit to addressing preferences. In paragraph 43 of the Framework Agreement, they committed to the "fullest liberalization of trade in tropical agricultural products and for products of particular importance to the diversification of production from the growing of illicit narcotic crops". Paragraph 43 is important to all members and while it potentially makes implementation of paragraph 44 more difficult, it does not have to be incompatible with it.

4 Major issues related to agricultural preferences in the multilateral trading framework

As the drive towards greater levels of trade liberalization has increased, preferential schemes have become the focus of more attention and analysis. A number of key questions have provided the focus for debate and analysis:

- How important are preferences and have they been useful to increasing trade and development?
- Have preference administration and utilization limited the benefits of preferences and how does this relate to domestic supply capacity as a constraining factor?
- Are exporting countries excluded from non-reciprocal preference schemes being negatively affected?
- Are current preferences being undermined or eroded by changes in the multilateral trading framework?
- *The importance of agricultural preferences*

Table 1 shows the important contribution of two commodities that receive significant preferential treatment, sugar and bananas[5] in terms of their export shares and the importance of sugar preferences under the Cotonou Agreement as a proportion of gross domestic product (GDP) in selected countries. Many low income commodity dependent countries are similar in this regard. The table shows the particularly large contribution to foreign exchange earnings and GDP that can arise from the export of a single commodity.

An argument is often made that preferences hurt rather than help developing countries as they serve to lock in preference dependent industries in these countries, and result in a misallocation of resources towards activities that receive preferences, thus contributing to the lack of diversification and a failure to exploit comparative advantage in non-preference receiving industries. Additionally, given this dependence on preferential access and with the industry being a significant employer and export earner in the recipient country, considerable amounts of scarce resources are expended to maintain the preferences.

Table 1: Importance of banana and sugar exports and preference value from selected countries in 2000-2002

	Exports as a percentage of agricultural exports	Exports as a percentage of total merchandise exports	Exports as a percentage of GDP	Value of preferences as a percentage of GDP
Sugar				
Fiji	55	20	6.3	3.5
Guyana	41	20	14	9.3
Jamaica	26	4	0.9	0.7
Mauritius	74	6	5.7	4.6
Bananas				
St. Lucia	68	65	4.3	0.71
St. Vincent	50	38.6	4.6	0.94
Dominica	63	26	4.7	0.71

Source: FAO (2004).

Set against these arguments, the market access and the higher prices provided through preferences are identified as the reasons for the development that has been achieved, and that without these preferences, several of the small sugar and banana producing countries particularly, would not have achieved their current levels of human development. This suggests that many preference dependent countries suffer from major development inhibiting constraints and therefore need the preferential schemes. Several of these countries have small economies, which can reduce development and trade options in a variety of ways. For example, a small domestic market provides limited ability to exploit economies of scale and diversification opportunities. A small resource base with limitations in natural resources, skilled labour pools and domestic capital stock makes achieving and maintaining competitiveness difficult. The long term decline and volatility in commodity prices has only served to exacerbate this vulnerable position.

[5] See FAO Trade Policy Technical Notes 3 and 6 on Bananas and Sugar.

Further, it is suggested that preferences have been an important contributor to the diversification that has already taken place and they are essential to future potential diversification. Local and international investment has often occurred because it is associated with the existence of the industry receiving a preference. This investment comes either from outside the industry to exploit the preference opportunity or from earnings associated with the existing industry. In Mauritius, the development of both the textile industry and the fishing industry are examples of this. In the case of fisheries, Prince Tuna in Mauritius benefited from foreign direct investment by a United Kingdom firm that invested to take advantage of an ACP tariff of zero when most-favoured nation (MFN) tariffs were 24 percent. Similarly, rice preference opportunities undoubtedly contributed to the diversification into transportation services by many rice producers in Guyana (FAO, 2004). Preferences can therefore provide both opportunities and income to access both new preference and non-preference opportunities. Without the guaranteed market and higher prices these opportunities would not have been available to many of the current preference dependent countries.

- *Administration and utilization of preferences*

Preferential schemes might not be as beneficial as they could be, given the limitations in their product coverage, the costly requirements to participate in the programmes, and the lack of capacity of the preference receiving countries to exploit the opportunities. The issue with regard to product coverage is that preferential schemes have been historically biased toward importation of non-sensitive products (in the preference granting countries) and raw materials. Preferential opportunities are generally made available only on limited lines in important areas of real export opportunity by exporting countries. The proportion of possible exports that may be on the eligible preference list and receive preference margins that are effective, determines considerably the extent to which the preference scheme is useful. Given the exclusion or relatively unfavourable treatment of certain important exports it is claimed that preferences have resulted in less diversification and investment than may have been possible. The EU market, as the most important market for agricultural raw materials and food items from the developing world has been pointed to in this regard. However, more recently, through preferential programmes such as the Everything but Arms (EBA) initiative this may have improved for some exporting countries.

The areas most often cited as contributing to the high cost of participation are regulations related to technical and sanitary and phytosanitary requirements and rules of origin governing the imports. The former require investment in infrastructure and establishment of inspection systems that stretch the limited financial and human resources of the preference receiving countries. The latter often limits the sources of raw material that can be used for the production of the export, and as a result unit production and shipping costs remain high, as raw materials are sourced from higher cost exporters. The higher these costs, the less the benefit of any margin of preference, to the point where the additional costs may exceed the value of the preference margin. These factors reduce the number of products that might benefit from preferences.

The share of preferential imports is often relatively low in relation to total imports from countries accorded preferential treatment. One reason for this may be that the regulatory conditions referred to above are too restrictive, and countries opt to not use the preference opportunity to export their products. Nevertheless, under particular preferential programmes the utilization of preferences (the ratio of the value of imports that received preferences to the value of imports that were eligible for preferences) by the preference receiving country is high. Taken individually, the utilization rate of some preference schemes may seem relatively low. However, when the competition between preference schemes is recognized (commodities eligible under more than one scheme), the utilization rate is generally very high.

While imports under the Cotonou agreement represent only 13 percent of the EU's imports of agricultural and food products, and 26 percent of all EU imports enjoying preferential treatment in 2002, the utilization rate for the preferences granted is over 90 percent for both ACP LDCs and non-LDCs (OECD 2004). In both ACP LDCs and non-LDCs the utilization of preferences by country and product under Cotonou is concentrated. Three ACP LDCs account for over 50 percent and five ACP non-LDCs account for almost 60 percent of the imports from the respective groups enjoying preferential treatment. For ACP LDCs fish accounts for almost 60 percent of preferential imports and for non-LDCs five products account for over 60 percent of the preferential imports.

Table 2 reveals the extent to which ACP countries claim preferences for their trade into the EU market. Stevens and Keenan (2004) point out that of the 52 percent of the imports that entered on an MFN basis, 97 percent entered duty free. In the category where the regime is "not specified" it is found that 81 percent of the imports face a zero MFN tariff and the remainder are generally in the under 10 percent MFN range. Based on four case study countries, they conclude that more than 90 percent of the ACP exports to the EU were either accorded Cotonou preferential treatment or faced zero MFN rates.

Table 2 EU total imports from ACP by regime, 2002

Regime	Value (US$000)	Share of total (percent)
MFN	15 032 460	52
GSP	123 010	0.4
Other preferences (Cotonou)	8 056 223	28
Not Specified	5 445 234	19
Total	28 656 927	100

Source: Stevens and Keenan (2004).

In the United States, preferences tend to be offered on less sensitive products. Table 3 suggests that AGOA countries currently make use of preferences on only a limited number of the available lines. The Andean Trade Policy Assistance(ATPA) pact and CBERA make relatively more use of the opportunity. Further, whereas utilisation, as measured on this basis, is greatest in GSP countries, it is limited in LDC GSP countries.

Table 3: Beneficiaries from United States preference schemes

Beneficiaries	Number of eligible countries	Number of participating countries	Number of eligible tariff lines	Number of tariff lines with trade
AGOA countries	38	21	1 181	52
ATPA countries	4	4	1 199	284
CBERA countries	24	21	1 203	361
GSP only countries	70	48	551	407
GSP/LDC-only countries	17	7	1 154	17
All beneficiaries	152	101	1 204	648

Source: Wainio (2004).

Given that MFN rates on most export commodities on which preferences are granted are already so low and access under current preference schemes (especially for) so wide, it might be suggested that there is no need for the continuation of preferences that are questioned (EU/ACP Protocol products) by some countries.

Alternatively, given the country and product concentration, efforts related to improving administration and enhancing utilization of preferences could be directed at identifying important country/product pairs and organizing preference schemes on this basis.

- *Impact of non-reciprocal preferences on global trade and third countries*

Developing countries that benefit from preferential trade account for a very small proportion of global agricultural trade, and non-reciprocal trade is even smaller and very concentrated among even fewer countries and products. Table 4 shows that about 80 LDCs and Small Island Developing States (SIDS) account for less than two percent of the world's agricultural exports. Furthermore, their share has been declining over the past decade. The low and declining market share suggests that the preferences enjoyed by these countries do not contribute to a reduction of market opportunities for third countries in these product markets.

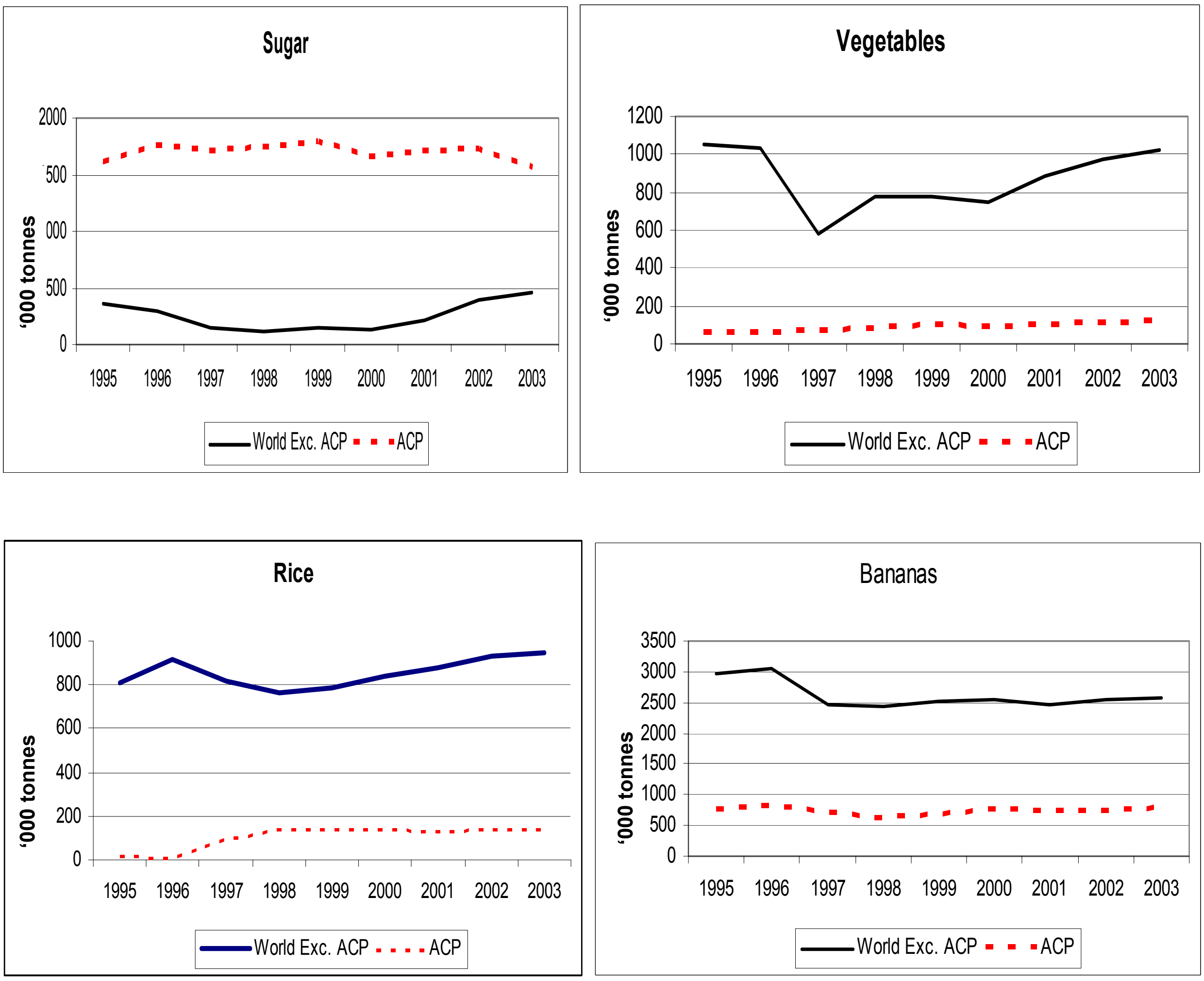
Table 4: Share in total world agricultural exports (percent)

Country groups	1990-1992	1992-1993	1994-1995	1996-1997	1998-1999	2000	2001	2002
SIDS	2	1	1	1	1	1	1	1
LDCs	1	1	1	1	1	1	1	1
All developing countries	26	26	28	29	29	28	29	29
Developed countries	73	73	71	70	70	71	70	70

Source: FAOSTAT (2004).

ACP countries benefiting from agricultural preferences into the EU market have been the major recipients of non-reciprocal agricultural trade. During the period 1995–2003, as shown in Figure 1, the non-ACP market share for several commodities in the EU market has been increasing, suggesting that their exports and market share are not unduly affected. This outcome does not address the situation where ACP preferences do not exist, and as a result the increased share of non-ACP countries may have been even greater.

Figure 1: Imports by the EU of selected products from ACP and non-ACP exporters



Source: Eurostat (2003).

- *The erosion of preferences*

There are two key dimensions to this issue, erosion and the related graduation issue.

Commitments to more liberalized trade and especially to lower tariff rates for agricultural products have contributed to the erosion of preferences. Table 5 shows that preference tariff margins for ACP countries granted by the EU have declined over time. It should be noted that the table reflects only *ad valorem* tariffs. Many tariff lines on which preferences are granted are however specified on a non *ad valorem* basis. A notable example is bananas, where a specific in-quota tariff of Euro 75 tonnes is currently used by the EU. Although there are a number of approaches for estimating the *ad valorem* equivalent (AVE) of a specific tariff, there is disagreement as to which is the most reliable approach (see FAO Trade Policy Technical Note 2). Such data for specific tariffs converted to AVEs were not available for several years and have not been included in the figures in the table. The data in Table 5 is therefore an underestimate of the extent of preference erosion.

Given this qualification, the lowering of MFN tariffs, the removal of non-tariff barriers by the EU on a multilateral basis, and the extension of its preferences beyond the ACP countries are the main factors that have accounted for ACP tariff preference erosion. The general tariff reduction being sought by countries in the multilateral round of trade negotiations therefore remains a double-edged sword for preference receiving countries. It produces benefits through improved access of their exports to world markets but also reduces benefits through an erosion of the existing preference margins in developed country markets. If the current trade liberalization process does not pay particular attention to the situation of the preference dependent countries, in most cases the resulting costs to them may be larger than the benefits. In this regard it is not surprising that in the ongoing WTO trade negotiations protecting preferences is an important goal of groups of countries such as the G-90 (a tripartite alliance of the ACP, the LDCs and the African Union) and the Small Island Developing States (SIDS).

Table 5: Tariff preference margins (EU/ACP)

HS-2 Commodities	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
01. Live animals	1	1	1	2	2	1	1	1	1	1
02. Meat and edible meat	6	6	7	7	7	6	5	5	5	5
03. Fish and crustaceans	11	12	12	11	11	10	10	10	10	10
04. Dairy produce; birds	2	2	3	4	4	3	4	3	3	2
05. Products of animal	1	1	1	1	1	0	0	0	0	0
06. Live trees and other	11	11	10	9	9	8	8	7	7	6
07. Edible vegetables	8	8	9	9	9	6	6	5	5	5
08. Edible fruit and nut (no bananas)	6	6	6	7	7	5	6	5	5	4
09. Coffee, tea, maté	8	8	8	4	4	4	4	3	3	3
10. Cereals	0	0	3	2	2	2	2	2	2	2
11. Products of the mill	0	0	3	2	2	2	2	2	2	2
12. Oilseeds and oleag.	2	2	2	2	2	2	2	1	1	1
13. Lac, gums, resins	2	2	3	3	3	2	2	2	2	1
14. Vegetable plaiting	0	0	0	0	0	0	0	0	0	0
15. Animal or vegetable	5	5	7	6	6	5	5	4	4	4
16. Preparations of meat	16	16	17	18	18	13	13	13	13	12
17. Sugars and sugar (excl. raw cane sugar)	4	4	2	3	3	0	4	1	1	3
18. Cocoa and cocoa prep.	17	17	13	12	12	12	11	9	9	7
19. Preparations of cereal	10	10	9	8	8	7	7	6	6	7
20. Preparations of vegetable	14	14	15	18	18	16	16	14	14	14
21. Miscellaneous edible	13	13	11	11	11	8	10	9	9	7
22. Beverages, spirits	4	4	5	3	3	3	3	3	3	1
23. Residues and waste	0	0	1	1	1	1	1	1	1	1
24. Tobacco and manufactured	39	52	39	45	45	38	38	31	31	31
41. Raw hides and skins	1	1	1	1	1	1	1	1	1	1
44. Wood and wood articles	4	4	3	3	3	2	2	2	2	2

Source: EUROSTAT.

Note: This table does not account for specific tariffs. It reports only the *ad valorem* tariff.

Bilateral and regional agreements that have extended lower-duty and duty-free arrangements to some groups of countries can also erode the benefits of preferences to countries that enjoyed certain preference levels before these changes. One example of this impact is in the Pacific Islands where members of the Pacific Forum were provided preferential access to the Australian and New Zealand markets through SPARTECA. However, as Australia and New Zealand lowered their MFN tariffs, products from Asia replaced imports from the Pacific. In Samoa for example, a coconut processing plant is reported to have been closed because it lost its export market.

The recent proposal from the EU to modify its internal agricultural arrangements on sugar is further evidence that the erosion of the benefits of preferences can take place without any direct changes in the preference regime itself. The ACP countries that are signatories to the Sugar Protocol hold the unanimous view that the July 14th 2004-proposed 33 percent decline in price by 2007 for imported sugar would make the preferential access meaningless as the price would not be remunerative.[6] In the case of Guyana, the loss in sugar export value, based on 2000-2002 exports is US$32 million.

With increasing and successive rounds of MFN tariff reductions, the value of current preferences will further decline, making it important to assess carefully how much "negotiating capital" should be invested to maintain levels of preferences that may not be very significant in the long run. From a preference receiving country standpoint, negotiating an outcome at least equal to the current situation and establishing clear, accepted and permanent allowances within the WTO framework is perhaps most critical in terms of the future worth of preferences.

Issues related to non-reciprocity of preferences and the stability of preferences may be crucial if the production structures in the beneficiary countries are to change and be sustainable. The promotion of a more liberal multilateral trade regime cannot be separated from the interests of some countries for preferences of specific products. There is also a fear that a lack of attention to this matter might cause these countries to lose interest in further MFN tariff reductions and could be a setback to the ongoing negotiations.

Another dimension of this issue is which countries should qualify for preferences and what the terms of graduation from particular preference schemes should be. Some countries argue that several middle income countries are receiving preferences and that others, now competitive on the world market, continue to receive preferences. With regard to the former, one response has been that these middle income countries lack the physical resources to diversify (they are small) and the nature of their production systems and geographic location (they are vulnerable) implies that the continued existence of an agricultural sector is dependent on some level of preferential market access. Thus, the argument might be made for some type of agreement to maintain a level of access for these countries while the more competitive exporters benefit over time from the expanding markets. This is related to the issue of graduation for which more objective criteria need to be agreed. In some preference schemes graduation is determined by the threshold level of per capita GNP and when a country exceeds "competitive needs limits". This latter criterion refers to the country in question passing its ceiling of allowable imports under the preference scheme, which could be a value amount or a percentage of the importer's market. When the level of export value or import percentage is achieved by the country its preferential eligibility would be evaluated.

In summary, even though countries do clearly use preference opportunities, it is suggested that preferences have lost their usefulness due to preference margin erosion, the proliferation of preference schemes (AGOA, EBA, GSP, Cotonou) which have devalued existing preferences, free trade agreements that make some preferences obsolete and declining terms of trade that cause them to lose their value.

Yet, it is still argued that preference-receiving countries will lose from multilateral liberalization and therefore need the maintenance of current preference regimes until adequate financial instruments and development programmes to assist them to adjust to the losses of preferences are put in place. Past financial instruments are considered to have lacked sufficient scale, concessionality, links to private sector development and enough flexible forward-looking investment incentives (Commonwealth Secretariat, 2004).

These issues form the context of the discussions in the negotiations and the focus of analysis related to preferences. The next section focuses on results of analyses and evaluation of preference schemes.

[6] ACP Press Release, October 6, 2004, www.acpsugar.org

5 Evidence on the effects of preferential trade agreements on the multilateral trading framework[7]

Although there are only a limited number of studies on non-reciprocal preferential agreements, particularly on the Cotonou agreement, there are numerous studies and reviews of regional and preferential trade agreements more generally, that have been undertaken in recent years. Some economists see preferential trade agreements as simply diverting trade and generally oppose them. Bhagwati and Panagariya (1996) argue that there are only two justifications for preferential trade agreements – (a) when they entail truly deep integration and (b) when there are no possibilities for multilateral trade negotiations. Others argue that to the extent that preferential trade agreements make a net positive contribution to freer trade and increased predictability for future market access, they contribute to the ultimate goal of global free trade (Ethier,1998). However, it is generally accepted that only through empirical analysis can the effects of a given preferential trade agreement be determined.

Historically, the effects of preferences on multilateral trade were considered positive if trade creation took place. More recently, analytical models reflecting "new trade theory" try to provide a more comprehensive understanding and assessment of the impacts by recognizing that countries join preferential trade agreements because increased market access enhances prospects for economic growth through the expanded opportunities for increased investment, enhanced productivity, and exploitation of scale economies, among other factors. However, most of the empirical analyses of preferential trade agreements do not capture these aspects and continue to analyse mainly trade creation, trade diversion and terms-of-trade effects.

OECD (2003) evaluate more than 40 empirical studies assessing the impact of preferential trade agreements. The models are categorized into three general types – gravity and other ex-post studies, partial equilibrium studies and computable general equilibrium studies.

The gravity models assess whether or not membership of preferential trade agreements has had an effect on the observed trade flows. In the simplest representation, trade between two countries is explained as a function of their GDP, populations and the distance between them. One of the drawbacks of the simple gravity models is that they are not able to capture reasons for participation in a preferential trade agreement or other historical ties, which may explain why a country may export different amounts to two countries with similar GDP, population and distance characteristics. This failure to capture reasons for participation in the preferential trade agreement leads to the estimation of coefficients that tend to be biased.

Partial equilibrium models (PE) consider only those product markets in which the policy changes are taking place and as such the feedback effects of all other markets, where quantities and prices may be changing, are not taken into consideration. The models generally assess whether beneficiaries are expanding their exports by taking advantage of the export opportunities provided by the preferential arrangement. However, there is no attention to adjustment costs that are needed after the trade regime changes. The PE approach is often defended on the basis that it allows much more detailed analysis. In several of the studies reviewed the level of detail is considerable, for example Wainio and Gibson (2003) utilize 8-digit HS level data. However there is a trade-off between the level of analysis and the availability of parameter estimates used in constructing the model as, for instance, elasticity estimates are not available at that level of detail. Equally, the models generally do not incorporate non-tariff barriers or a representation of domestic supply distortions.

Computable general equilibrium (CGE) models are economy-wide and seek to capture the linkages between all sectors of the economy. The models solve for prices, wages and real exchange rates that equilibrate product markets, factor markets and the balance of trade between countries. CGE models are therefore potentially useful in that they can evaluate trade diversion and creation at the sectoral level, determining the aggregate effect and linking changes in welfare to particular sectors. Generally the welfare effect is said to be positive if the cost to consumers of a bundle of goods is less as a result of the policy changes, in this instance, accession to a preferential trade agreement. However, questions have been raised as to the appropriateness of the model structure adopted. Most analysts using the Global Trade Analysis Project (GTAP) model for example, use it without modifying the model structure and generally assume perfect competition in all sectors. Where the model is modified it is mainly in its closure rules. Several of the GTAP applications have also used the accompanying database which did not reflect most existing preferential trade agreements. Some studies, for example Ianchovichina, Mattoo, and M. Olarreaga (2001) and Kerkela, Niemi and Vaittinen (2000) amended the database to reflect appropriate preference margins and preferential treatment of the Lomé and EBA schemes. However, these changes are generally

[7] This section draws on several of the recent studies and particularly on a comprehensive review prepared for the Organization for Economic Cooperation and Development (OECD) in 2003.

represented through tariffs, and the quantitative trade barriers that characterize the Lomé Protocol products are not accommodated. Additionally, most studies do not take account of preferential trade agreements other than the one they are studying. Table 6 provides a summary of some of the overall impact results. For comparative purposes results of reciprocal preference as well as non-reciprocal schemes are reported.

Table 6: Overall impacts of selected studies of preferential trade agreements (PTA)

Study – Method	PTA	Main Result
Wainio and Gibson (2003) - PE (Ex Ante)	US FTA	United States imports increase by 3.1 percent from beneficiaries of non–reciprocal arrangements
Hoekman, Ng and Olarreaga (2002) – PE (Ex Ante)	Removal of Tariff Peaks facing EBA beneficiaries	Beneficiary country exports expected to increase only minimally.
Rutherford, Rutstrom and (1997) – GE (Ex Ante)	EU-Morocco FTA	Benefits to Morocco of 1.5 to 2.5 percent of GDP
Lewis, Robinson and Thierfelder (2001) – CGE (Ex Ante)	EU and South Africa	1.7 percent increase in welfare for South Africa and 0.03 percent for the EU.
Ogueldo and MacPhee (1994) – Gravity (Ex Post)	US GSP	Increased trade flows between the United States and its beneficiaries
Nilsson (2002) – Gravity (Ex Post)	EU/ACP	Historic ties to France, Belgium and the United Kingdom are important factors explaining EU imports from ACP countries
Wolf (2000) - CGE	EU-UEMOA FTA	Both sides gain but EU gains more
McDonald and Walmsley (2003) - CGE	EU and South Africa FTA	EU stands to gain substantially. South Africa will if EU agri-trade liberalized

Source: Prepared on the basis of studies reviewed

Despite the difficulty of comparing quantitative results from so many different studies focused on different preferential agreements and characterized by different methodologies, different data sets and different assumptions, the OECD (2003) review draws what it refers to as the careful conclusion that:

> "...the overall impact of preferential trade arrangements on welfare and trade is non-negligible and generally positive, but also relatively small".

For example, the overall impact results from the gravity and ex-post models are found to be consistent with the PE and CGE results in the context of CBERA preferences. Beneficiaries increased their shares of preferential exports to total exports over time, but the share remained low. Two explanations offered are that the gains are small because the beneficiary countries already enjoy low tariffs, and that the gains from trade liberalization are spread over a long period of time.

The results of the review in terms of impacts on participating countries reveals different results in the context of non-reciprocal and reciprocal preferences. For non-reciprocal arrangements, there are small welfare gains for the beneficiaries and almost no change or slight declines in welfare for the preference-giving country. One study (Hoekman, Ng and Olarreaga, 2002) shows that the increases in total imports are minimal and the adjustment costs for Quad (United States, Japan, Canada, EU) domestic import-competing industries are negligible.

For reciprocal arrangements, where there were high levels of protection before the free trade agreement in the developing country, there are considerable gains to be had by the *developed* country. This obviously has important implications for the ongoing EU/ACP negotiations that are expected to be concluded by 2007. Wolf (2000) finds that creating a free trade area between UEMOA and the EU increases trade in all directions but the increase would be much more pronounced for the EU, reflecting the fact that UEMOA tariffs are initially much higher for agricultural products than are the EU tariffs. The same applies for South Africa and the EU, and more so if the EU does not liberalize its agri-food trade, as the EU will gain substantially even if agri-food trade is excluded from the agreement.

These results seem to suggest that until developing countries have the supply response capacity to benefit more from increased market access in developed country markets, they stand to lose from preferential arrangements that are reciprocal. This may provide an argument for maintenance of non-reciprocal preferences.

The results indicate that there will be some trade diversion impact on third countries, but generally this would be a relatively small effect given the magnitude of the affected countries' exports. Hoekman, Ng and Olarreaga (2002) find that non-LDC ACP countries would suffer from some trade diversion. The small impact is also reflective of the small size of LDC exports. Most studies concluded that the trade creation resulting from preferential trade agreements outweighs the adverse trade diversion effects (e.g. Lewis, Robinson and Thierfelder, 2001).

The benefits of preferential arrangements are greatly affected by whether sensitive products are included (or not) in the schemes. For instance, in the FTAA if the United States excludes oil seeds, dairy products and sugar, the gains for Mercosur countries are greatly reduced because it is in these products that these countries have a comparative advantage. The same applies to an EU agreement with Mercosur if rice, cereal grains, bovine meat products, dairy products and sugar are excluded.

Another important result relates to the loss of tariff revenue in the context of reciprocal trade agreements. In Wolf's CGE model, the results indicate a loss in real GDP that is explained by a decline in demand arising from lower government spending and transfers. The latter decline is a result of lower tariff revenues raised by the government.

Reducing supply side constraints, strengthening institutions, improving infrastructure, diversifying production and export structures are all factors which the studies show will increase the welfare gains and enhance growth performance in preference receiving countries. The diversification of export structures in terms of commodities and destinations is also important to reducing the detrimental impacts of erosion of preferences.

6 Advancing negotiations on the future of agricultural preferences

There is a general acceptance that some small countries (Belize, Mauritius, St. Lucia) may lose and some large countries (Brazil, China, India) may gain as trade is further liberalized and preferences are eroded. However to achieve consensus within the WTO, there is a need to find mechanisms whereby the impact of the losses is reduced and the possibility of gains is realized.

The key dimensions of these mechanisms are associated with aspects of specificity and coherency:

- *Specificity* refers to the existence of a relatively small number of country/product pairs. These would need to be identified by analysis of products at a very disaggregated level, and analysis within countries that focuses on target groups, and pays attention to both structure of production and distribution of gains is important.
- *Coherency* refers to the need to recognize the linkages between policy frameworks and different sources and types of adjustment assistance. National policy frameworks need to adopt a much more integrated and balanced approach that stresses, among other areas, supply side issues, macroeconomic policies and trade measures. At the international level there needs to be greater cooperation across agencies recognizing the areas of specialization and ensuring consistency of policy thrust and recommendations.

There are, nevertheless, areas where there is some agreement upon which to build related to the issues of country coverage and to adjustment assistance. These are listed below:

- Emphasis on "deep" preferences that provide significant market access concessions for a limited number of countries that need preferences, as opposed to "shallow" (less) preferences for all developing countries. The difficult issue here is reaching agreement on the criteria determining how these countries are identified and what the preference concession should be.
- Modification of the currently accepted definition of LDCs to cover additional situations that can be argued to require similar preferences to LDCs. The direction in which these discussions have been going would suggest an emphasis on both poverty and vulnerability. This remains a difficult issue because the poverty target groups and the preference dependent countries do not overlap sufficiently.
- Provision of adjustment assistance. This is generally considered from two standpoints. Firstly, assistance that results in increased productivity and competitiveness in current production activities, and assistance that results in diversification and implementation of an exit strategy from the uncompetitive preference dependent industry. Secondly, and where there is much less agreement on assistance, is if its scope and form appears as some type of compensation for loss of market opportunities and preference erosion. While compensatory action for injury in the international trading framework is a part of WTO practice, the sense in which preference erosion and loss of markets can be said to result from any single country's policies is at best very controversial. Injury in another sense is related to the Uruguay Round decision on Net Food Importing Developing Countries (NFIDCs) where it is implied that if these countries were hurt by increasing food prices as a result of agricultural reforms there would be some special consideration granted. No effective measures have been developed around this earlier agreement.
- Attention to the many submissions by developing countries calling for enforceable mechanisms at the end of the Doha Round related to special and differential treatment. In this regard, there may be a possibility of refinement of the Trade Integration Mechanism (TIM) (IMF, 2004) on preference erosion giving it more of a development twist and linking it to Development Bank activity in addition to stabilization support. The establishment of financial arrangements in the context of the

proposed Special Fund for Diversification linked to preference erosion (Commonwealth Secretariat, 2004) may also be considered. Further, progress on adjustment assistance might be approached in addition to, not in place of, the design of an improved preferential regime for specific countries. In other words, adjustment assistance may not in all cases be a substitute for preferences.

- Consideration of policies that promote stability of access. These concessions would be open only to preference dependent countries and tied to facilitating their transition to a situation of less dependence. The binding of the preferences agreed on, their definition in terms of preference margins, the expansion of tariff rate quotas, simpler rules of origin that allow increased use of tariff preferences are all areas that need consideration as the redefining of preference schemes is addressed.

Finally, the negotiations need to be informed by more analytical work to understand the impact of different rules of origin, the limitations of domestic supply constraints to trade expansion and preference utilization, the effects of trade, especially trade under preferences, on poverty and income distribution, and critically, how preferences have contributed to development of several countries that now enjoy medium/high levels of human development and how this might be affected as preference schemes are either eroded or discontinued.

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