Is preference erosion a significant problem? – Brussels, 3 April 2006

Trade preferences are central in the on-going negotiations for further multilateral trade liberalization within the framework of the Doha Development Agenda (DDA). Many least developed countries (LDCs) and developing countries feel that the liberalization of trade and removal of trade-distorting policies in agriculture will not be in their interests as this would reduce the benefits they reap from their preferential access to developed countries' markets (preference erosion). At the same time, and for the same reasons, advanced developing countries feel discriminated against.

It is in the nature of multilateral trade liberalisation that as most favoured nation (MFN) tariffs are reduced, preferential access will be eroded. This is an on-going and continuous phenomenon. Moreover, preferences are also affected by other policy changes - unilateral EU decisions to change its agricultural policy, the signing of new free trade agreements or the deepening of its preferences under existing arrangements.

The effects of preference erosion are complex to evaluate, inter alia because not all developing country exports are dependent on preferences.

- Much trade is already liberalised and so a large share of developing country exports, at least to the EU, come in at MFN zero (57% in 2004).

- Preference utilisation rates matter. If a given product is imported from a preference beneficiary at the MFN rate as well as at the preferential rate, the reduction of the MFN rate will benefit those exporters subject to the MFN rate and will counteract the losses incurred by those exporting at the preferential rate.[1]

- But preference utilisation rates may be negatively affected by MFN liberalization as the benefits may no longer outweigh the compliance costs of the preferences (administrative routines, rules of origin etc) estimated at up to 4-5% of the value of goods.

- The benefits or 'rents' of preferences do not accrue fully to the exporting country; they are often shared between the importer and the exporter.

- New firms may appear in the market following liberalization and increase competition.

Estimated effects depend on whether models take into account the positive impacts of broader liberalisation. Numerous studies have analysed the effects of preference erosion. Most use either general equilibrium (CGE) models or work in partial equilibrium. So called CGE models estimate the welfare and production effects of trade liberalisation.[2] Such models contain a network of linkages between industries and countries and take into account that a change in one part of the (world) economic system will affect other parts. Losses in a country's export sector may thus be compensated by gains in other sectors of the domestic economy or in other countries/regions under study. Partial equilibrium studies are easier to undertake, but they

[1] Different exporters of the same product may face different costs in actually utilizing a preference. Producers use different technologies and it may be convenient for some to use the preference and satisfy the necessary requirements, while the origin rules or other issue may make it less convenient for others.

[2] Welfare is a summary of the change in utility for a particular household and is expressed as the difference between nominal household income and an expenditure price index for the household.

ignore such links. Consequently, the former studies generally show both the impact of preference erosion and the overall positive effects of trade liberalisation, while the latter focus on the negative effects of trade liberalisation related to preference erosion.

Regardless of the methodology used, research indicates that fears of preference erosion are exaggerated. Table 1 in annex summarises the potential effects of preference erosion from a number of relatively recent and thorough studies on the issue. The results emanate from a variety of underlying assumptions and different methodologies focussing on different countries/regions. It is therefore difficult to compare the results. Nevertheless, the overall impression from these studies is that:

- the vast majority of developing countries have much more to gain from multilateral liberalisation than they lose from preference erosion;

- preference erosion is likely to affect only limited number of countries and impacts will be fairly small in aggregate;

- nevertheless a small number of countries will be negatively affected. These tend to be small and/or poor countries, often heavily dependent on a market which has been heavily distorted, like sugar or textiles.

The first three columns display the result of CGE models. Francois et al (2005) assume that preferences are fully eroded which leads to a loss for African and Asian least developed countries (LDCs) which amounts to about $200 million, while the group ‘Other Low Income countries’ gains about ten times as much. The IMF (2005) assume various cuts by both developed and developing countries (but not by LDCs) in the agricultural and non-agricultural sectors and finds that developing countries as a group would gain $16 billion or 0.16% of their real income. The only region/sub-region to lose is ‘Rest of SSA’, whose loss is estimated at $100 million or 0.02% of real income. Finally, the OECD (2005) conclude that a simultaneous 50% cut in ad-valorem equivalent measures of protection by the QUAD (EU, US, Canada and Japan) and Australia would lead to losses for only six developing countries plus the region/sub-region of ‘Rest of SSA’, while everybody else gains.

Multilateral liberalisation is key to ensuring that preference erosion is offset. Several studies show that if only the EU undertakes MFN liberalisation, quite a few developing countries lose. However, these losses are in most cases cancelled out and indeed transformed into gains when (i) liberalisation by other industrialised countries are brought into the picture, and (ii) liberalisation by developing countries themselves are included in the scenarios.

Even those studies that do not take the broader impacts of liberalisation into account show limited impacts. The partial equilibrium studies find that only a handful of countries risk losing more than 5% of their exports due to preference erosion. WTO (2005) is the only study that takes into account the fact that competitors of the main preference beneficiaries normally do not export under MFN duties but rather under another preference schemes or free trade agreements. This study concludes that the loss for LDCs would amount to 0.8% of the preference value, while the corresponding effect on developing countries as a whole would be a gain of 0.2%.[3]

[3] Based on tariff reductions using the Swiss formula with a coefficient equal to ten in non-agricultural sectors.

For the EU market, preference erosion is a rather limited problem. An initial analysis by the Trade Analysis Unit on the impact of erosion of preferences on the EU market indicates that the number of WTO developing country members for whom preferential exports to the EU are significant is rather low and that preference erosion is only an issue for these countries in the following sectors: sugar, bananas, vegetables, clothing, cut flowers and fish.

For those countries that will be hit, aid and technical assistance should be forthcoming. Although the overall impact of preference erosion will be limited, the countries/regions that will lose out will need special measures to ensure that, in the medium term, their economies develop and are re-oriented to sectors in which their comparative advantages lie. This will enable them to exploit the new opportunities which the Doha Development Agenda will offer and ensure that they too gain from trade expansion.

Annex

Table 1: Summary of study estimates on the potential effects of preference erosion for developing countries

Methodology	General equilibrium			Partial equilibrium		
Study	Francois et. al (2005)[a]	IMF (2005)[b]	OECD (2005)[c]	WTO (2003)	Alexandraki and Lankes (2004)†	WTO (2005) ††
Country	**Change in real income ($ million)**	**Change in real income ($ billion / %)**	**Change in per capita welfare (%) ***	**Change in total exports of goods (%) / ($ million)****		**Change in preference value (%)**
Bahrain						1.1
Bangladesh	- 138.2					
Belize					- 9.1 / 18	
Botswana	16.4					
Cape Verde				- 6.3 / 0.9		
Dominica					- 5.5 / 2	
El Salvador						- 5.2
Fiji					- 7.8 / 41	
Guatemala						- 4.2
Guyana					- 7.9 / 41	
Haiti				- 6.4 / 3.9		- 6.1
Honduras						- 4.6
India	275.8					
Lesotho						- 7.4
Madagascar	9.8					
Malawi	- 7.0		0.62	- 11.5 / 48.6		
Malaysia						

Maldives						1.1
Mauritania				- 8.8 / 40.4		
Mauritius					- 11.5 / 201	
Mongolia						3.0
Morocco			-0.09			
Mexico			-0.13			
Mozambique	- 14.3		-0.22			
Nepal						1.3
Sao Tome and Principe				- 5.2 / 1.1		
Sri Lanka			0.87			1.6
St. Kitts and Nevis					- 8.9 / 3	
St. Lucia					- 9.8 / 4	
Tanzania	1.5		-0.08			
Tunisia						
Uganda	- 4.3		-0.11			
Vietnam	1774.8		0.97			
Zambia	- 21.3		-0.15			
Sub-Saharan Africa		0.4 / 0.10				
South Africa		0.4 / 0.25				
Other Southern Africa***		0.1 / 0.19				
Rest of SSA		- 0.1 / 0.02	-0.05			
African LDCs	- 110.5					
Asia/Other LDCs	- 87.4					
Other Low Income	2050.5					
Developing countries		16.1 / 0.16				0.2
LDCs						-0.8
Rest of SACU			1.65			
Rest of Oceania			0.47			

Source: See list of references.

Note:

[a] Income effects of full preference erosion.

[b] In agriculture, the United States cuts its actual domestic support by 28 percent, Norway by 18 percent, the EU by 16 percent, and Australia by 10 percent. The average applied agricultural tariff is cut by 44 percent for developed countries as a group and by 21 percent for developing countries. Agricultural export subsidies are eliminated completely. Non-agricultural tariff bindings are cut by 50 percent in high-income countries, 33 percent in developing countries, and zero in the least developed countries.

[c] Welfare implications of simultaneous 50% cut in ad-valorem equivalent measures of protection by the QUAD and Australia.

* Welfare implications of simultaneous 50% cut in ad-valorem equivalent measures of protection by the QUAD and Australia. All developing countries experiencing negative effects are include as are the five countries gaining the most in improved welfare.

** Only losses greater than 5 per cent of exports have been included.

*** Botswana, Madagascar, Malawi, Mozambique, Tanzania, Uganda, Zambia, and Zimbabwe.

† Results based of an export elasticity of 0.

†† Impact of NAMA MFN tariff reduction on preference value and scope for future preferences, 2003 (Swiss formula cut with the coefficient=10 applied on 2003 MFN applied rates). The five most negative and positively affected countries are included. Based on adjusted preference margins.