Economic Policy Responses to Preference Erosion: From Trade as Aid to Aid for Trade*

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Abstract: Trade preferences are a central issue in ongoing efforts to negotiate further multilateral trade liberalization. "Less preferred" countries are increasingly concerned about the discrimination they confront, while "more preferred" developing countries worry that WTO-based liberalization of trade will erode the value of current preferential access regimes. This tension suggests there is a political economy case for preference-granting countries to explicitly address erosion fears. We argue that the appropriate instrument for this is development assistance. The alternative of addressing erosion concerns through the trading system will generate additional discrimination and trade distortions, rather than moving the WTO towards a more liberal, non-discriminatory regime. We argue that prospective losses generated by MFN liberalization should be quantified on a bilateral basis, using methods that estimate what the associated transfer *should have been* and ignoring the various factors that reduce their value in practice (such as compliance costs or the fact that part of the rents created by preference programs accrue to importers in OECD countries). Given that many poor countries have not been able to benefit much from preference programs, a case is also made that preference erosion should be considered as part of a broader response by OECD countries to calls to make the trading system more supportive of economic development. The focus should be on identifying actions and policy measures that will improve the ability of developing countries to use trade for development.

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Introduction

Non-reciprocal trade preferences have been long granted by developed countries to various developing countries. Historically, the pattern of these preferences reflected past colonial trade ties. In 1968, the UN Conference on Trade and Development (UNCTAD) recommended the creation of a 'Generalized System of Preferences' (GSP) under which industrialized countries would grant trade preferences to all developing countries on a non-reciprocal basis, not just to former colonies. Since then a plethora of non-reciprocal preferential access schemes have been put in place by OECD countries, in addition to an ever-expanding set of reciprocal bilateral and regional trade liberalization arrangements. Non-reciprocal schemes include national GSP programs, GSP+ programs for the Least Developed Countries (LDCs) such as the EU Everything but Arms (EBA) initiative, and special arrangements for subsets of developing countries such as the Cotonou convention between the European Union (EU) and the African, Caribbean and Pacific (ACP) countries, the US African Growth and Opportunity Act (AGOA), the US Caribbean Basin Initiative, etc. In practice, non-reciprocity is a bit of a misnomer as the preferential access is often conditional on non-trade-related actions or behaviour by the recipient countries.

Trade preferences are a central issue in ongoing efforts to negotiate further multilateral trade liberalization. Middle-income countries are increasingly concerned about the discrimination they confront in OECD markets as a result of the better access granted in these markets to other industrialized countries—because of free trade agreements—and to poorer or "more preferred" developing countries. Conversely, LDCs and non-LDC ACP countries worry that general, most-favoured-nation (MFN)-based liberalization of trade and removal of trade-distorting policies in agriculture by OECD countries will erode the value of current preferential access regimes. Such erosion has been ongoing for decades as a result of unilateral and multilateral reforms in preference-granting countries and the pursuit of regional trade agreements, with the attention given to the issue waxing or waning depending on the impacts of and changes to specific programs. The most recent example of a significant preference erosion shock was the implementation of the Agreement on Textiles and Clothing (ATC) on January 1, 2005, which confronted all countries with the prospect of much greater competition from the lowest-cost suppliers of textiles and apparel—especially China—as quantitative restrictions on exports were removed.[1] While this was not due to the removal of a program that was explicitly aimed at granting preferential access—instead, the aim was to restrain the most competitive suppliers—the effect was to give less competitive producers an advantage in contesting a highly restricted market.

Determining the economic relevance of trade preferences in the context of WTO-based multilateral liberalization—the ongoing Doha Round of trade negotiations—requires both econometric assessments of the extent to which preference schemes are actually used (*de facto* as opposed to *de jure* preferences) as well as a numerical assessment of the monetary value of potential preference erosion associated with further WTO-based, nondiscriminatory tariff reductions. Preferences are designed to be an instrument to promote trade, both traditional and, more important, export diversification. By encouraging trade in sectors where there are rents, preferences induce specialization in those sectors. In addition, by raising returns, they also imply a financial transfer—an improvement in beneficiary countries' terms of trade. While both dimensions are important, in our view the former predominates from an economic development perspective—after all, if the objective had been to transfer resources, it would have been more efficient to do so directly through aid.[2]

We argue that a key issue is to separate out the likely impact effects from erosion from the net overall effects that will result once policy responses by recipient countries and actions by the rest of the world are taken into account. Trade reforms by recipient countries and emerging market economies that do not grant preferential access have the potential to substantially attenuate the negative impact effects of erosion. In assessing the magnitude of the effects of erosion much will depend not only on the depth of OECD liberalization—e.g., the extent to which sectors such as sugar, beef or rice are opened up—but also on what other countries do. Much depends as well on whether developing countries benefiting from preferential access take actions to improve the competitiveness and productivity of national firms and farmers. Here development assistance can play an important supporting role.

[1] Preference receiving countries are also concerned about the potential negative terms of trade effects of multilateral liberalization insofar as this raises the price of their imports, especially of goods that currently benefit from subsidies and protection in OECD markets, by more than the price/quantity of their exports.
[2] Although aid may not be (have been) politically feasible. Political factors do affect policy choices, including the use of preferences. In this paper we focus on the economics of the issue.

As is often pointed out by economists, there are many sources of negative shocks that impose adjustment costs on countries, both trade and non-trade-related. Focusing on just one of these while ignoring others is generally difficult to justify. A premise of the paper is that a non-discriminatory trade regime and MFN-based liberalization by WTO members is a global public good, and that this justifies taking action to address this specific issue. This is not to deny preferences are not legitimate or to say that they do not benefit recipients—although our view is that they are less beneficial than is often held to be the case. However, they are distortionary and help generate increasing preferential trade in the world trading system as excluded (less-preferred) countries confront incentives to negotiate reciprocal free trade agreements (FTAs) with major donor countries.

The plan of the paper is as follows. We start in Section 1 with a brief review of the mechanics of preference programs. In Section 2 we summarize some of the recent estimates of the value of current programs. Section 3 turns to potential policy responses. We argue that from a “mercantilist” perspective of quantifying the magnitude of potential preference erosion what matters is to assess the loss of benefits stemming from the removal of a specific policy that has been put in place by OECD countries. From this perspective it is not relevant that developing countries might benefit as well from their own liberalization or that of other developing countries, or that such potential benefits may be quite substantial. However, from a *development* perspective identifying actions that would generate such benefits is critical, as is determining what the rest of the world—especially richer countries—can do to assist governments in poor countries to implement such measures. Section 4 presents a case that assistance for preference erosion should be considered as part of a broader response by OECD countries to calls to make the trading system more supportive of economic development. One reason for this suggestion is that erosion has been and will continue to be an ongoing process, with or without a Doha Round; more important is that many developing countries have not been able to benefit much from preferences. This suggests the focus should be on identifying actions and policy measures that will improve the ability of developing countries to use trade for development. Section 5 concludes.

1. The mechanics of erosion

It is helpful to start with a brief discussion of the basic mechanics of preferences and preference erosion.[3] Figure 1 represents an archetype OECD country importing varieties of good X from two suppliers, an LDC (S_{LDC}) and a non-LDC ($S_{non\text{-}LDC}$). Trade preferences imply a reduction in the tariff applied to imports from the LDC. This increases LDC exports from $X_{LDC,0}$ to $X_{LDC,1}$, with associated benefits for the LDC exporter represented by area A. There is also a concomitant shift in demand away from imports from the non-preferential supplier, resulting in a loss in exporter surplus equal to area B. The magnitude of the costs and benefits depend on supply and demand responsiveness to price changes, as well as the degree of substitution between preferential and non-preferential suppliers. The impact on the country granting the preferences depends on a mix of effects – terms of trade, trade creation, and trade diversion. For a beneficiary country preferences change the relative returns of producing a product – thus either promoting diversification or impeding it (as in the case of sugar or bananas). They also affect the overall terms of trade of the country, thus implying the equivalent of a net financial transfer.

Trade preferences therefore involve a mix of benefits for preferential exporters, costs imposed on third-country exporters, and potential losses for the importer as well. Only if the (more) preferred country (countries) is (are) small in the sense of not at all affecting the internal price in the importing nation will there be no detrimental effect on third country competitors. If so, the preference only creates trade (expands imports), to the detriment of local suppliers in the preference granting country, but not to other foreign suppliers, as they continue to confront the same price.[4] Preference erosion involves the elimination of tariffs on the non-preferential supplier. This is shown in the bottom half of Figure 1. Elimination of the tariff on remaining third-country suppliers, given the duty free access already for preferential suppliers, means that third-country exporters see their exports increase from $X_{non\text{-}LDC,1}$ to $X_{non\text{-}LDC,2}$. There is a gain in exporter surplus of area E, which may be greater

[3] What follows draws on Francois, Hoekman and Manchin (2005).
[4] See Baldwin and Murray (1977) for an early discussion. Most empirical studies conclude however that preference programs are associated with negative terms of trade effects for excluded (less preferred) countries, i.e., there is trade diversion as well as trade creation. Much depends on having good estimates of the elasticities of substitution between foreign and domestic goods and between foreign products of different origin. Early studies assumed these elasticities were identical. General equilibrium studies by contrast tend to use Armington elasticities. For more discussion, see Brown (1987), Langhammer and Sapir (1987) and the references cited there.

or less than the original loss of exporter surplus resulting from the preferences, area B in the top part of Figure 1. The preferential supplier experiences a fall in demand for its exports from $D_{LDC,1}$ to $D_{LDC,2}$. This results in a partial, though generally not full, loss of the benefits from the original preference scheme. This is represented by area C, which is shown as being less than area A in the top half of Figure 1. The reason the loss is not complete is that preferences include, in part, the benefits relative to the original tariff-ridden equilibrium from a non-discriminatory tariff reduction by the importer. Preference erosion therefore generally yields a partial, not full, loss of the original benefits of the preference scheme. At the same time, third-countries recover some of the costs originally imposed by the preference scheme.

The foregoing ignores numerous important dimensions of reality.[5] First, preferences can only have an impact if there is a non-zero tariff in the importing market. Two-thirds of the major items Africa exports to Canada, for example, faced zero MFN tariffs even before the 2003 initiative in favour of LDCs. Similarly, 69 percent of EU imports from Africa (by value) in 2000 were in items facing zero MFN duties (Stevens and Kennan, 2004)—again, before EBA was introduced in 2001.

Second, there are general equilibrium effects to consider, especially the impact of changes in policies in other countries, both those that do and those that do not grant preferences. Such changes may affect demand and supply and thus world prices of the product concerned. Changes in overall (global) trade policies may also affect the relative returns of trading different products, create opportunities for exports that did not exist before, and so forth.

Third, compliance costs (paperwork, red tape, documenting origin, etc.) can be significant. The average estimate in the empirical literature is that documentary requirements imply costs of some 3-5 percent of the value of goods (Brenton and Manchin, 2003; Brenton and Ikezuki, 2004; Anson et al. 2003; Candau et al. 2004; Carrère and de Melo, 2004). This substantially reduces the actual benefits of trade preferences for developing countries as it requires MFN tariffs to exceed 4 percent on average for preferential access to be meaningful. Given that the average MFN tariff in OECD is only 4 percent or so, preferences can only matter where there are tariff peaks.

[5] See for example the survey by Hoekman and Ozden (2005).

Fourth, to the extent there is market power on the part of either importers/distributors (Francois and Wooton, 2005) or the transport and logistics sector (Francois and Wooton, 2001), the terms of trade benefits of preferential tariff reductions will be captured at least in part by those intermediaries with market power rather than the exporters (although any diversification benefits will remain). If preferences apply to highly protected sectors in donor countries, they will result in high rents for those able to export free of trade barriers. However, buyers will know the existence of these rents, and if they have the ability to set prices (have market power), the rents may predominantly be captured by distributors or other intermediaries (Tangermann, 2002). There is evidence, based on the AGOA preference scheme, that the pass through of preference margins is indeed partial at best. Olarreaga and Özden (2005) find that the average export price increase for products benefiting from preferences under AGOA was about 6 percent, whereas the average MFN tariff for these products was some 20 percent. Thus, on average exporters received around one-third of the tariff rent. Moreover, poorer and smaller countries tended to obtain lower shares—with estimates of the share of the loss ranging from a low of 13 percent in Malawi to a high of 53 percent in Mauritius.[6] In the case of market power, the result is a simple redistribution of the benefits of preferences: rents are transferred to importers. In the case of administration costs, however, the result is not redistribution but a deadweight loss (waste).

Finally, for preferences to have value, the beneficiary countries need to have an export capacity in the products for which preferential access is granted. In practice, GSP programs may exclude products in which developing countries have a strong comparative advantage. Many low-income countries simply do not have the capacity to exploit preferences, either not having productive facilities at all or not being able to compete even with the price advantage offered by the preference due to internal transactions and operating costs. Preferences were conceived as instruments to assist countries with supply capacity to diversify and expand their exports. They have little value for countries that do not have such capacity yet.

[6] See Ozden and Sharma (2004) for a similar analysis of the US CBI program. Francois and Wooton (2005) obtain similar size-dependent results in an analysis of the incidence of markups along the distribution chain.

2. Estimates of the Impact of Erosion

The available research suggests that erosion of all preferences, both GSP and the deeper more recent preferences such as EBA and AGOA, would have a substantial impact on some countries, especially those with high concentration of exports in heavily protected commodities. Relatively bigger impacts are concentrated in small island economies and a number of LDCs dependent on sugar, bananas and to a lesser extent garment exports (IMF, 2003; Stevens and Kennan, 2004). These are the commodities where protection and therefore preference margins are high. Of the LDCs, Cape Verde, Haiti, Malawi, Mauritania, and São Tomé and Príncipe are found to be the most vulnerable to preference erosion. Alexandraki and Lankes (2004) conclude that six middle-income countries—Belize, Fiji, Guyana, Mauritius, St. Kitts and Nevis, St. Lucia—would also be significantly affected, with predicted export declines ranging from 11.5 percent for Mauritius to 7.8 percent for Fiji. The limited number and small size of most of the economies concerned imply that measures to help mitigate the impact of preference erosion need to be closely targeted at the countries at risk.[7]

The costs of preference erosion need to be set against gains from MFN liberalisation–both for the recipient country and other developing and least developed countries. While LDCs do stand to lose from tariff reductions in sectors or products where preferences matter, they also stand to benefit from improved access to global markets. This at least partially, and often substantially, offsets the more direct losses from erosion of bilateral preference margins. Thus, preference erosion will be offset by the compensatory effect of broad-based multilateral liberalisation, including by emerging market economies and by beneficiary countries themselves. However, research suggests that what matters most in terms of own reform by LDCs is the pursuit of complementary reforms and public investments that enhance the productivity of firms and farmers. Additional trade reforms on their own will not generate significant benefits in terms of poverty reduction (World Bank and IMF, 2005).

[7] The only large country expected to suffer from preference erosion is Bangladesh, which has benefited significantly from the textile quota restrictions imposed on other large competitive developing countries such as China, and which were removed at the end of 2004 under the WTO Agreement on Textiles and Clothing. However, as discussed below, these costs are already “sunk” in that the shock has already occurred.

Finally, implementation and transition periods also matter, as does the depth and scope of the reforms. Total erosion is unlikely to happen in a short span—and any MFN reforms will be implemented gradually over several years. What follows briefly discusses some recent studies that quantify the potential income effects of preference erosion.[8] Focusing on the LDCs and using a global general equilibrium model and the latest version of the Global Trade Analysis Project (GTAP) database that incorporates data on the major OECD preference programs (Bouet et al. 2004), Francois, Hoekman and Manchin (2005) conclude that complete preference erosion due to MFN reforms in the EU—including in agriculture—would impose a welfare (real income) loss of some $460 million on African LDCs and an additional $100 million on Bangladesh. This assumes away compliance costs. Limão and Olarreaga (2005) also undertake an analysis of the welfare effects of complete preference erosion. They calculate what the income transfer to LDCs would need to be so as to be equivalent to the transfer implied by existing preference programs. They conclude that for LDCs the figure is $266 million. This is a one-year, short-run effect—all else equal the net present value will be several times higher. This brings their results in line with those of Francois, Hoekman and Manchin (2005), although the results are not strictly comparable given that Limão and Olarreaga use partial equilibrium methods.

Using a variety of techniques, Grynberg and Silva (2004) estimate the losses in income transfers to producers in trade-preference-dependent economies at $1.7 billion annually. They argue that producers will require 14 to 20 years to adjust, implying a total net present value of losses ranging from $6 billion to $13.8 billion. An important feature of this analysis is that it includes the impacts of abolishing quotas on exports of textiles and clothing. This accounts for $1.1 billion of the total of $1.7 billion loss estimate. Van der Mensbrugghe (2005) concludes that existing preferences generate an additional $1.6 billion in income for low-income developing countries, as compared to a counterfactual MFN-only regime. Here also the inclusion of ATC quota rents accounts for a major portion of the benefits. In contrast, the erosion of ATC quota rents is included in the baseline scenario in Francois, Hoekman

[8] Much of the literature focuses on trade effects—see e.g., IMF (2003) and Alexandraki and Lankes (2004). Our interest here is on the magnitude of the implied financial transfers as that provides the most straightforward measure of the value of preferences. This is not to argue that such transfers were the primary objective of preference programs. We return to the implications of this objective for policy responses to erosion in section 4 below.

and Manchin (2005). Francois et al. note that the ATC abolition imposes erosion costs on negatively affected developing countries that are some ten times larger than the potential overall erosion of remaining preferences under a Doha Round. The estimated losses reflect a combination of greater competition from China and loss of quota rents. To some extent this erosion has already been incurred, as liberalization of quotas started at the end of the Uruguay Round.[9]

If the analysis centres on preference erosion in the broader context of potential tariff reduction by all OECD—or all WTO members, including developing countries—the magnitude of the total erosion loss is generally reduced. This reflects the fact that the EU has been the most aggressive in using preferences as a tool for development assistance and that it is also the entity that has the most extensive trade-distorting policies in a key sector for poor countries: agriculture. Preference programs in other OECD countries have tended to be subject to greater exceptions (an example is the non-inclusion of apparel in US GSP programs). Thus, the gains associated with MFN tariff reductions by non-EU OECD countries will partially offset losses due to EU liberalization. In the case of Sub-Saharan Africa, Francois, Hoekman and Manchin (2005) conclude that overall losses will be reduced by a factor of four—to $110 million, while low-income countries in Asia stand to gain.

If compliance costs are also considered in the analysis, the incidence and magnitude of preference erosion changes further, as such costs vary across commodities. For Bangladesh, which is specialized in high tariff categories like clothing that are subject to restrictive rules of origin, including compliance costs substantially reduces the magnitude of potential erosion. For Madagascar, potential losses turn into potential gains. For countries specialized in agriculture – Malawi and Zambia for example – the effects of accounting for compliance costs are much smaller given the finding in the literature (e.g., Stevens and Kennan, 2004; Candau et al. 2004) that such costs are not a big issue.

Ignoring compliance costs and the distribution of rents, estimates of total preference erosion losses for low-income countries are in the range of $500-$1.7

[9] ATC restrictions implicitly favoured smaller, higher-cost developing country suppliers at the expense of exports from China. While implementation of the ATC was staged, the major importing countries heavily back loaded implementation, resulting in a much greater than necessary adjustment shock at the end of the 10-year transition period than was necessary.

billion, with much depending on whether the ATC is included in the analysis or not.[10] The magnitude of estimates of preference erosion from even an ambitious Doha round tend to be less than the erosion that is associated with elimination of textile and clothing quotas on developing country exports. For example, Francois, Spinanger and Woertz (2005) find that the removal of textile restrictions is detrimental for sub-Saharan Africa, although the impact is smaller than for Asian countries such as India and Vietnam. However, the ATC-induced negative impact on Africa is smaller than the estimates of the potential magnitude of Doha Round preference erosion found by Francois, Hoekman and Manchin (2005) if no account is taken of compliance costs. If such costs are considered—which they estimate to average 4 percent—the potential Doha trade preference losses are smaller than those associated with lifting of ATC textile and clothing quotas. One reason is that the rents associated with the latter were equivalent to tariffs well above any realistic threshold value of compliance costs.

The importance of the quantitative impacts of the ATC illustrate the point that a variety of policy and non-policy-induced shocks will impact on countries almost continuously—reflecting the global business cycle, changes in consumer tastes, the development of new technologies, natural disasters, etc. These call for social safety nets and government policies to help firms and households adjust and benefit from new opportunities. The types of shocks and adjustment pressures generated by changes in global trade policies will often be smaller in magnitude than those generated by other forces. They also will be realized gradually, given that trade reforms are generally implemented over a number of years. These considerations have implications for the design of a policy response to erosion.

3. Possible Policy Responses

The bottom line we take from the extant literature is that taking into account supply capacity constraints, the costs of satisfying documentary requirements, the fact that rents will be shared with intermediaries in the importing country, and the potential offsetting effects of own reform and that of other developing countries, the aggregate magnitude of erosion will be limited. However, the stand-alone impact of the removal

[10] Figures are higher if the focus extends to middle income countries, some of which—e.g., Mexico—stand to suffer potentially substantial losses as preferential access to the US and Canada is eroded. The focus in this paper is primarily on low-income, weak and vulnerable economies.

of preferential access to the most distorted markets (those in the EU) will be significant for a relatively small number of countries for which a small number of tariff lines are important. This then raises the question from a policy perspective whether the focus should be on the overall economic net effects taking into account possible (feasible) policy responses, or whether the focus should be on the loss incurred in those markets where preferences matter, ignoring any possible offsetting effects.

Both perspectives are relevant. The first focal point is the appropriate one from a development perspective—clearly it is very important to identify what governments can do to attenuate any negative effects of global MFN liberalization. Indeed, part of the policy response by donors (those who granted the preferences) should be to assist recipient country governments put into place measures that will enhance the ability of firms and farmers in poor countries to exploit trade opportunities and compete with imports. It is also the focal point of the WTO process, as negotiations involve give and take, the objective of each member being to maximize a net overall gain.

The second focal point is a metric of the magnitude of erosion of benefits that stem from removal of a specific policy put in place by OECD countries. From this perspective it is not relevant that there are other sources of offsetting market access and/or terms of trade gains—be it from liberalization by other developing countries or own liberalization. What matters is the impact effect of removal of the non-reciprocal access to specific protected markets. In terms of Figure 1, for a given product (tariff line), the value of this transfer can be represented by area C. The value of total erosion is then the sum over all the products for which the country has been granted preferential access. (If MFN reforms are partial, the loss will be smaller). Note that this assumes away any positive externalities from expanded export production—i.e., the focus is only on the terms of trade effect. Insofar as countries could/did not benefit (have exports), there will be no loss on this measure. This is an important dimension of the preference erosion question to which we return below.

This is not to imply that offsetting actions should not be encouraged, as this is in the interest of the developing countries directly affected by MFN liberalization in the OECD. Indirectly, such actions are in the interest of *all* countries (all WTO members). Global liberalization and a shift away from discriminatory trade policies will bolster the trading system and help generate welfare improvements for the world as a whole. These considerations suggest a two-pronged approach that involves additional financial assistance, determined by a quantification of the direct, bilateral erosion losses current recipients of preferences will incur (the sum of all areas C in Figure 1), with funding allocated towards measures that will reduce the negative economic effects of this erosion.[11]

Various approaches can be identified in responding to preference erosion losses. One is to seek compensation within the trade negotiating agenda—i.e., take actions that will improve market access and the terms of trade of the targeted countries. This can involve non-liberalization of products that are of greatest value from a preference point of view. It could even entail raising tariffs on products insofar as these are not bound under the WTO, although raising trade barriers in order to increase the value of preferential access would be globally welfare reducing. More common is the argument used by vested interests in the OECD that preferred developing countries should not lose any more preferential access to their (highly distorted) markets and that further MFN reform should be avoided. The result is the potential for status quo bias reflecting a "bootlegger-Baptist" coalition between these protectionist interests and developing country governments. This would impose a significant opportunity cost from a global efficiency perspective.

It is not easy to identify trade-based solutions that are consistent with the MFN principle while appropriately targeting those countries that are most affected by the erosion of preferences. A recent proposal to address the erosion issue by converting bilateral preferences into equivalent bilateral import subsidies comes close. As argued by Limão and Olarreaga (2005), this would preserve both the trade-based nature of the assistance and its bilateral (discriminatory) nature, while still implying a multilateral solution. They show that an import subsidy scheme would be welfare superior to trade preferences—indeed, it would be a Pareto improvement, making all WTO members better off, as it would allow deeper MFN liberalization to occur. However, this solution is premised on continued acceptance by WTO members of exceptions to MFN—i.e., it implies continued discrimination across trading partners.

Other options "within" the trading system are to expand preferential access to major emerging markets, to reduce the costs of rules of origin—through

[11] Another question is whether any assistance should be temporary or longer-term. From an adjustment viewpoint the former is appropriate; from a development perspective a case can be made that the duration of assistance should be conditional on development of competitive export capacity.

harmonization towards the most liberal common denominator (Commission for Africa, 2005), and to provide discriminatory access in other areas—e.g., better access for mode 4 under the GATS. The latter is already occurring on a bilateral basis, outside the WTO, as reflected in special arrangements or relationships between OECD members and specific developing countries. In our view efforts to move down such discriminatory paths in the WTO are not desirable. Indeed, we would argue that a major objective or rationale for seeking to shift away from using preferential trade as a form of aid is that it undermines the fundamental principle of non-discrimination as well as create incentives to impede MFN liberalization (Limão, 2005).

Of course, non-discriminatory solutions could also be pursued within the trading system. An example would be to target MFN liberalization on goods and services developing countries have a comparative advantage in. Another is to ensure that MFN liberalization proceeds gradually to allow for adjustment to occur of a number of years. Yet another would be to rewrite rules so that that they benefit poor countries more, even if it comes at the expense of rich country interests. Much of what is discussed in the WTO under the heading of "special and differential treatment" and implementation of negotiated commitments revolves around perceptions that the existing rules are not fully supportive of development prospects. A willingness to address these concerns could help to offset preference erosion losses. Indeed, there is a case for pro-active policies to address market failures that help result in weak trade capacity. Trade policies are unlikely to be effective or appropriate, but some of these policies may be subject to WTO rules or be the subject of proposed disciplines (e.g., subsidies of various kinds). These may provide a rationale for greater "flexibility" in the application of disciplines—in particular greater acceptance of a process that relies on monitoring and transparency of policy more than on rigid enforcement of common rules.[12]

In what follows, we limit attention to the second broad approach that can be taken to respond to preference erosion losses incurred by developing countries: through development assistance. In our view a major reason for pursuing this avenue is that the research summarized above finds that in monetary terms the primary negative impact of erosion follows from the removal of specific trade barriers

[12] See Hoekman (2005) for some suggestions in this regard.

in specific OECD countries. That is, the erosion problem is primarily a bilateral issue that should be resolved on a bilateral basis, in the sense that those imposing the costs should bear the burden of offsetting them. This is not to deny that preferences are a WTO concern—the system of bilateral preferences has multilateral consequences. This is another reason to pursue a solution outside the trading system—in practice we do not see feasible WTO-based solutions that are not distortionary. Any solution should therefore have a multilateral component. As the pursuit of bilateralism in the allocation of assistance would be inefficient, a multilateral approach that builds on existing instruments is desirable. Moreover, given the objective of preferences—export development—arguably the focus should also be on the attainment of that goal.

Existing Mechanisms for International Adjustment Financing

A number of initiatives have been taken in recent years to assist countries better exploit trade opportunities and deal with adjustment pressures. These include the *Integrated Framework for Trade-Related Assistance* (IF) and the IMF's *Trade-Integration Mechanism* (TIM). In addition to these trade-specific initiatives, multilateral development banks support trade-related investments and provide technical assistance when requested by client governments. While such assistance has been expanding in both absolute and relative terms—see World Bank and IMF (2005)—these institutions do not provide earmarked funding for trade adjustment purposes.

The IMF's Trade Integration Mechanism (TIM) is an example of one possible approach to addressing preference erosion costs. It was developed to help countries expecting short-tem balance of payments difficulties in coping with the effects of multilateral liberalisation (IMF, 2004). The TIM is intended to address not only preference erosion but also covers instances such as balance of payments shortfalls as a result of ATC quota integration and the possible impact on net food importing developing countries of higher food import prices. The TIM is not a new facility but operates through existing IMF instruments. This ensures that the impact of possible adjustment costs resulting from specific shocks such as preference erosion is considered and placed in the context of a country's overall macroeconomic policy framework. The usual IMF policy conditionality and terms and costs of lending apply. Therefore the impact of assistance on a country's external debt burden would need to be taken into account.

The Integrated Framework for Trade-Related Assistance focuses much more on the "structural" agenda as opposed to dealing with short-term macroeconomic impacts of external shocks. The IF brings together the key six multilateral agencies working on trade development issues—the IMF, the International Trade Centre, UNCTAD, the UN Development Programme, WTO and the World Bank—and seventeen bilateral donors (including Canada, the EU, Japan and the USA). The basic purpose is to embed a trade agenda into a country's overall development strategy, usually the Poverty Reduction Strategy paper (PRSP). The process starts with a diagnostic analysis. This assessment looks at a number of issues, including the complementary policy agenda necessary to support successful trade reform, and generates a proposed action matrix of prioritised trade-related capacity building and assistance needs that are linked to the country's overall development strategy.

To a large extent the philosophy behind the IF mechanism mirrors the intentions of what is now known as the "new aid framework" to improve harmonisation between the providers of trade assistance (both bilateral and multilateral) and place trade within the context of a country's overall development strategy (Prowse, 2002). The majority of LDCs (over forty) have applied for assistance under the scheme. A small trust fund finances the trade assessments and small scale technical assistance arising from the action matrices. The larger identified and prioritised trade capacity building plans are presented within the context of Consultative Group meetings and Round Tables associated with the PRSP process where donors (both multilateral and bilateral) are asked to make pledges. This allows bilateral and multilateral donors to respond to each country's identified needs in a systematic and coherent manner, according to comparative advantage and preference. In addition bilateral donors can continue to contribute bilaterally, or choose to provide resources through multilateral organisations. Either way it reduces the duplication and proliferation of vertical initiatives. However given an "aid resource constrained environment," prioritised trade action plans have had to compete, justifiably, with other priority sectors (namely health, education). To date, implementation on the ground in prioritised trade areas has been limited.

A Stand-Alone Compensation Fund?

Neither of these existing mechanisms directly addresses the concerns of developing countries regarding preference erosion. The TIM involves loans, and implies therefore that the costs of adjustment to erosion will be borne by the countries that lose preferential access to markets. Moreover, the focus is on the short term, macroeconomic effects—that is the *net* effects taking into account all policy changes and responses, not just the removal of preferential access. Thus, there is no element of “offsetting” the losses incurred—the bilateral nature of the problem is ignored. The IF focuses purely on the national trade-related agenda of LDCs. While funding of priorities will have a large grant component—in contrast to the TIM—there is no guarantee that trade projects will be financed, as there is no earmarking of funds or specific allocations for countries.

The most direct and simplest solution would be for donor countries to agree to directly compensate developing countries for preference erosion incurred as a result of MFN trade reforms (Page, 2004; Page and Kleen, 2004). This would both help realize the potential global efficiency and welfare gains associated with an ambitious Doha Round outcome, and directly offset associated impact losses for developing countries. Page and Kleen (2004) argue that as global liberalization is a public good, it would be incorrect to consider the associated compensation as aid. They therefore propose that a compensation fund be housed at the WTO. How donor countries would provide resources would be a matter of “choice”, although the level of contributions would be determined by various criteria (for example share of trade, income, past commitments and use of preferences). Given that the funds would be regarded as compensation for the removal of a prior benefit, funding would be allocated without conditions to beneficiary countries according to the estimation of loss of preferences. The fund would need to be secure, leading Page and Kleen to argue that voluntary commitments need to be made ‘legally irrevocable’.

Grynberg and Silva (2004) have made a similar proposal. They suggest the establishment of a Special Fund for Diversification (SFfD) to mitigate the impact of the erosion of preferences due to MFN liberalisation. A distinct feature of this proposal is that financing (from pooled donor funds) “commensurate with preference losses” would be provided for private sector-led export diversification investments. A share of SFfD funds would be set aside for a private sector window to facilitate investment start-up expansion by small and medium-sized enterprises (SMEs), restructuring or rehabilitation in non-traditional sectors. Remaining funds would be provided for a public sector window for enabling infrastructure investments, as well as for optional technical assistance and social safety net windows. The emphasis on the private sector as a recipient of preference loss compensation funds would go some way to addressing a specific aspect of preference programs—that they directly benefit exporters. Under the Commonwealth Secretariat proposal this constituency would have the prospect of some direct compensation.

Another option has been suggested by the UN Millennium Taskforce on Trade (2004), which argues that one element of a solution could involve income support programs for farmers and producers of specific goods that have benefited from high rates of protection. While such programs are targeted at the *domestic* producers of preference granting countries and are intended to be a vehicle to facilitate a shift away from production support, negatively affected producers in developing countries that benefited from preferential access could also be assisted by including them in the support program. Elements of this approach reportedly will be pursued in the new EU sugar regime. It could be extended to other highly distorted markets where preferences matter and where producers will confront adjustment costs as market price supports are lowered. There is an obvious political economy rationale for such programs, and extending support to affected producers in developing countries would also take seriously the arguments made by groups in OECD countries that continued preferences (and thus market price support) are needed to assist producers in developing countries. However, it should be recognized that support for affected firms may not benefit the country insofar as the firms are foreign and/or do not diversify or invest in the country concerned.

All of these types of programs and mechanisms raise equity concerns in that those who have benefited the most from preferences are not necessarily the poorest or most vulnerable. Indeed, by definition the assistance will be granted to those who have been most able to benefit from preferences. Within recipient countries, some of these beneficiaries will be located among the higher income groups in society, raising equity considerations. The suggestions for a preference erosion fund of some kind go against the emerging wisdom on improving aid effectiveness and enhancing international policy coherence (IMF and World Bank, 2004). Leaving aside the issues of quantification of losses, there is no doubt that the adjustment costs arising from preference erosion must be addressed. However, establishing a separate fund targeted at one specific structural adjustment need and a specific set of countries runs counter to a more harmonised approach to development assistance. Adjustment to MFN liberalisation will also affect many that have not benefited from preferences but are located in highly protected domestic industries and sectors, for example. They will also require assistance to adjust. In general, the shocks that regularly confront countries can be expected to exceed those associated with preference erosion for most countries. The need to diversify is not unique to economies that have benefited from preferences but is common to numerous countries, notably those with a narrow export base.

Evidence by Imbs and Wacziarg (2003) suggests that countries at very early stages of development experience a positive relationship between export (production) diversification and growth. However, the experience with schemes aimed at promoting export diversification is mixed, with numerous examples of programs that do no more than entrench already inefficient industrial and production patterns. While this is not to deny the case for government support to address market failures or the case for "policy flexibility"—see e.g., Rodriguez-Clare (2004), Rodrik (2004), Pack and Saggi (2005), Hoekman (2005)—in our view funding must be provided within the context of an overall country development programme and a broad macroeconomic policy framework to realise the dynamic gains associated with MFN liberalisation.[13] As a development tool stand-alone specific funds and associated mechanisms are unlikely to find widespread support among donors and recipient countries insofar as they are not integrated into national poverty reduction and development strategies. This applies a fortiori to suggestions to place a compensation fund in the WTO, which is neither a development nor financial agency. Placing a funding mechanism for trade adjustment associated with preference erosion in the WTO would change the role of the organisation.

4. Addressing Erosion Costs as Part of the Case for Aid for Trade

As noted, export diversification and development was the primary motivation for preferences. Many countries in the past have benefited from preferential access and have graduated from bilateral programs, and others continue to benefit. But many of the poorest countries have not managed to use preferences to diversify and expand exports. Given the systemic downsides, limited benefits, and historical inability of many poor countries in Africa and elsewhere to use preferences, a decision to shift away from preferential "trade as aid" toward more efficient and effective instruments

[13] This is an aid policy perspective. As noted below, trade negotiators are likely to have a different view, suggesting a case for temporary earmarking of funding.

to support poor countries could both improve development outcomes and help strengthen the multilateral trading system (Hoekman, 2004). Tariffs are just a part of the overall set of factors constraining developing country exports—other variables include transport and transactions costs that are often much higher per unit of output than in more developed countries. With or without preferences, more effective integration of the poorest countries into the trading system requires instruments aimed at improving the productivity and competitiveness of firms and farmers in these countries. Supply constraints are the primary factors that have constrained the ability of many African countries to benefit from preferences.[14] This suggests that the main need is to improve trade capacity and facilitate diversification. In part this can be pursued through a shift to more (and more effective) development assistance that targets domestic supply constraints as well as measures to reduce the costs of entering foreign markets.

The case for trade support extends beyond preference erosion

A Doha reform package can be expected to generate sizeable gains to both developed and developing countries. The overall magnitudes of such gains are difficult to assess accurately—much depends on what is agreed and how it is implemented, and how much of the gains are transferred to compensate domestic losers—through expanded income support, for example. However, even under the most conservative estimates, the aggregate global gains will be significant. In absolute terms developed countries will gain more than developing countries, providing the means to engage in increased support and development assistance. Such support is needed as the consequent trade liberalization will require adjustment and the pursuit of concomitant policy reforms and public investments to bolster trade capacity. What is important is recognition of need (additional resources for trade adjustment and integration) against the potential global benefits arising from further multilateral liberalisation—a global public good.

In undertaking trade reform and to participate effectively in the global trading system, poorer countries are faced with a gamut of economic and political concerns. On the economic side, there are adjustment costs that will arise before offsetting investments are realized in other (new) sectors. Preference erosion is just one

[14] See, e.g., Commission for Africa (2005), Page (2004), and Stevens and Kennan (2004).

element of these costs. Some countries may confront deterioration in their terms of trade (e.g., some net food importers). Countries where tariff revenues make up a significant proportion of total fiscal resources will need to undertake tax reform. Adjustment costs are a function of policy changes—as mentioned previously, those associated with preference erosion will be gradual and tariffs are just a part of the cost function facing exports. A fundamental issue is that many of the poorest developing countries are ill equipped to take full advantage of (new) trade opportunities due to supply side, administrative capacity and institutional constraints. Improved market access without the ability to supply export markets competitively is not much use. Gains from trade liberalisation are conditional on an environment that allows the mobility of labour and capital to occur, that facilitates investment in new sectors of activity—requiring, among other factors, an efficient financial system, good transportation/logistics services, etc. Inevitably for most poor countries this requires complementary reforms prior to and in conjunction with the trade reforms.

On the political side, even accepting that trade is likely to generate global gains, the distributive and re-distributive dimensions of trade integration need to be taken into account if the political viability of the process is to be assured. Providing sizeable assistance has historically been of considerable importance in helping persuade countries of the benefits of integration. It played a significant role in building support the liberalisation measures undertaken as part of the creation of the European Economic Community and common market. The post-war Marshall Plan was instigated in large measure to neutralise the forces moving Western Europe away from multilateral trade and to thereby facilitate global economic recovery.

Recognising the importance of complementary policy actions and the need for support for adjustment and integration to achieve successful trade reform in low-income economies does not imply that the Doha Round should be any less ambitious or deliberately slowed. The reverse is true. Moving ahead multilaterally on a non-discriminatory basis will do most to help development. Trade reform undertaken in conjunction with concomitant “behind the border” policy measures and investments has significant potential to generate additional trade opportunities that would help lift a large number of people out of poverty (UN, 2004; World Bank and IMF, 2005). But it should be complemented by actions to redistribute some of the global gains to help address to trade and growth agenda in the poorest countries and make this more of a priority in aid programs—in the process helping to attain the original objective motivating preferential access regimes.

Integrating preference erosion into a broader "aid for trade" initiative

Supporting trade adjustment and integration requires a shift towards more efficient transfer/assistance mechanisms that target priority areas defined in national development plans and strategies. When developing countries choose to make trade a part of their development strategies, donors should ensure that support is provided to enable developing countries to respond to the opportunities which trade liberalisation and integration can bring. As discussed at greater length in Prowse (2005), arguably options for trade support need to be considered within the emerging "new aid framework" under which aid management and implementation practices are aligned with country policies and programmes and bilateral and multilateral efforts are coordinated/harmonized.

With respect to trade support, two issues are particularly pertinent. Firstly no one agency has effective authority to respond to all the needs for trade adjustment and integration, and therefore a system needs to be designed to harmonise more carefully existing processes around a country's development plans. Secondly, providing resources for adjustment and integration to benefit from a multilateral trade round requires greater coherence between the development needs of countries and the requirements of the WTO rules based system.

The Integrated Framework has become an established mechanism that provides a programmatic approach to assistance for trade adjustment and integration within the context of a country's development programme. To date it has relied on the consultative group and round table pledging sessions to finance adjustment needs and capacity building. As already noted, given that consideration of trade and investment activities within the PRSPs must compete with other sectors, the trade dimension has been relatively limited. Without additional assistance, one can question the efficacy of the programme to provide a more enabling process of integration into the global trading system. Thus, more resources are needed to provide a sustained effort to identify, prepare and implement a coherent trade, investment and growth strategy in-country within the context of a country's development process, and to address identified trade adjustment costs and capacity building needs.

There are numerous operational questions that will need to be resolved in terms of how additional funding might be managed through a mechanism that builds on the IF framework—these are discussed in Prowse (2005). The key is to mobilize such additional funding, the magnitude of which will affect the design of any allocation mechanism. The prospect of preference erosion provides one compelling rationale for increased assistance to offset the associated losses, as well as an avenue through which to increase available funding for trade priorities.

Specifically, a binding commitment could be sought through which preference giving countries/trading blocs accept to transfer the assessed value of current preference programs in the form of financial aid. This implies that assistance would be specific for each beneficiary country.[15] If such an approach is pursued, rather than establishing a separate fund and a parallel institutional structure, ideally the commitments for each beneficiary country should be disbursed through the consultative group and round table processes through which aid is allocated, on the basis of the framework described above that places trade needs within a country's overall development programme. In terms of quantifying the value of preferences, in principle, as argued above, there is a (political economy) case that the transfer would need to be the equivalent of the bilateral "partial equilibrium" value of preferences received. That is, the quantification exercise – which will need to be performed through an independent arbitration type exercise – would ignore the general equilibrium effects of changes in other countries policies or the country's own policy stance**.**

While apparently attractive, it is important to recognize that in practice such an approach towards preference erosion is both narrow and potentially difficult to implement. Recall the earlier discussion of the studies attempting to estimate the value of preferences/potential losses. Much depended on whether the ATC was included or not. Should the effects of the ATC be ignored? Some might argue it should be—that this is "water under the bridge" as it was negotiated as part of an overall Uruguay Round agreement. Moreover, there is of course a major difference in that in the case of the ATC the focus of policy was not to benefit some countries but to restrict some exporters (protect import-competing firms).

[15] This will require tariff line level analysis of the type undertaken by Inama (2005), Candau and Jean (2005), Kowalski (2005) and Lippoldt (2005).

Seeking to agree on a methodology to quantify potential erosion losses clearly embodies the danger of lengthy negotiations and disagreements on the question of what the domain of the analysis should be. In addition to the ATC one can consider the conclusion of FTAs, the effects of unilateral liberalization, etc. Should these also be covered? Whatever one's views on whether the Uruguay Round was a balanced package and the desirability of FTAs, the fact is that industries and households around the developing world confront adjustment costs as a result of past policy decisions and will continue to do so. Moreover, as noted previously, countries regularly confront numerous other shocks that are/will be of greater magnitude than erosion.

If a specific focus is maintained on preference erosion, we would argue this should be restricted to *future* losses caused by MFN liberalization as a result of the Doha Round.[16] Although it must be recognized that any outcome will be negotiated and that there will be other areas through which countries will seek to improve the overall outcome, the political economy rationale for this is that it will help support a more ambitious outcome in terms of MFN liberalization, which is beneficial for all WTO members and an important systemic reason for addressing preference erosion concerns. There is then also a case to earmark funds on a country basis. Although earmarking is generally not regarded as good aid policy, there is a compelling reason to impose this constraint in the case of preference erosion as the magnitudes of the associated losses vary significantly across countries. However, if this is done it is important that funding be disbursed in the context of an overall development programme of policy and support.

Of course, this will do little for those countries that have not been able to benefit from preferences. The assistance needs of these countries in the trade area clearly are much greater than any estimate of the value of current preferences. Although the proposed methodology for quantifying the required transfers from donors will result in "upper bound" estimates of the value of preference programs—which is arguably appropriate from a political economy standpoint—the overall numbers involved will be relatively small in comparison to the trade-related capacity needs of low-income countries. The available research suggests that the transfers needed to offset lost preferences are not large relative to either the overall gains of

[16] This is not to deny that ongoing erosion-related adjustment pressures can be significant. Such costs need to be addressed through the existing framework for trade-related assistance.

an ambitious Doha Round or current official development assistance—presently in the $70 billion range. Account should also be taken of the commitment by OECD countries in Monterrey to double official development assistance spending and attain the 0.7 percent of GDP target.

5. Concluding Remarks

Preference erosion is a significant economic issue for a number of countries. It is also a bilateral issue, suggesting that the countries and trading blocs that reduce the value of past preferential access commitments should offer transfers to the affected countries. We have argued in this paper that compensation for losses should take place outside the WTO so as to make the trading system less distorted. Avoiding additional new preferences and distortions in the trading system is a key reason to address preference erosion explicitly and separately. This will not imply the end of discrimination—many low-income countries will benefit from continued assistance to achieve export development and diversification objectives. Thus, the focus of this paper on reducing the use of distorting trade policy instruments and placing the emphasis on other mechanisms, including financial assistance to target more directly the factors that constrain trade capacity. The associated resources should be allocated through the multilateral channels that have been established to provide funds for trade-related priorities identified by developing countries.

Specifically, there is a political economy case that prospective losses generated by MFN liberalization should be quantified on a bilateral basis, using methods that estimate what the associated transfer *should have been* and ignoring the potential impact of offsetting measures. A bilateral analysis generates the best measure of the value that should be attached to preference programs for “compensation” purposes. That is, even though compliance costs and the incidence of rents are important determinants of the value of preferences, they should be ignored as they substantially reduce the real value of the programs and thus go against the purported objectives that motivate them.

Binding commitments could be sought—as part of a Doha Round agreement—to undertake such assessments and to transfer equivalent financial resources to the affected countries. If so, these funds should be earmarked for the relevant recipient developing countries, and delivered through existing aid channels, with the ultimate uses of the funds determined by the governments concerned, based on a policy agenda for trade and growth that is consistent with a country's development strategy. Own trade reforms and complementary investments and measures to reduce transactions costs, improve the investment climate, and enhance productivity and competitiveness of farmers and firms are needed to deal with the adjustment costs associated with erosion losses. But such costs go far beyond the erosion of preferences. More assistance is needed more generally to bolster the capacity to exploit trade opportunities. In the process, the negative effects of preference erosion will be attenuated, and, as important, those countries that have proven unable to benefit from existing or past programs could be assisted in attaining the original objective of trade preference programs—export development and diversification.

Solutions to preference erosion should be multilateral in the sense that the financial transfers that are called for are best allocated through existing multilateral aid mechanisms as opposed to bilateral ones. There are a number of arguments for this, including aid effectiveness and the fact that preference erosion is just one of many potential shocks and opportunities that will confront developing countries. Rather than seek to create a stand-alone fund to compensate for erosion of preferences—whether inside or outside the WTO—it is more efficient and effective to integrate funding to offset preference erosion into the broader "aid for trade" effort—arguably the more important need (Prowse 2005).

A broader "aid for trade" effort would also allow the objectives of preferences to be pursued more effectively and across a broader group of countries—by recognizing that market access is not the most important variable constraining export growth in many developing economies. Dealing with the supply side constraints will require funds (investments), but also the adoption of policies that address specific government and market failures that prevent a supply response from emerging. As argued in the recent literature, although the case for trade policies in this context is very weak, what types of domestic policies might be most appropriate and effective may not be obvious, suggesting that experimentation and learning should be encouraged (Rodrik, 2004). This suggests there is a link between the aid for trade agenda and the issues of "policy flexibility" and "special and differential treatment" in the WTO (and regional) trade agreements. Given the presumption that trade policy cannot do much to address the sources of market and government failure that impede supply responses, international cooperation (trade agreements) can help by creating institutional mechanisms to help identify what policies would be effective and efficient in attaining specific goals set by governments, and by increasing the transparency of policies and their effects (outcomes) through multilateral monitoring (Hoekman, 2005).

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Figure 1: The mechanics of preference erosion