



The Future of Special and Differential Treatment

The Twin Challenges of Preference Erosion and Developing Countries' Differentiation

POLICY BRIEF PAPER

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Unlike previous trade rounds, the Doha Development Agenda (DDA) relies on no clear and undisputed economic paradigm to govern the principle of “Special and Differential Treatment” (SDT) of developing countries (DCs) in the WTO. The gods of the past had already been buried when the DDA was launched in 2001: be it the 1960s’ “import substitution” policies, rooted in the contribution from Prebisch and Singer to the works of the United Nations Conference on Trade and Development (UNCTAD), or the systematic case for unilateral openness derived from the “Washington Consensus” inherited from the 80s. Economists now dispute over the sense and the robustness of statistical correlations linking openness to growth (Rodrik and Rodriguez, 1999). Some also question the contribution of the multilateral trading system to countries’ trade performances (Rose, 2002). The “trade not aid” mantra underpinning some old approaches of the GATT negotiations has utterly passed away with the Monterrey Consensus (2002). The need for technical assistance to address supply-side constraints and help poor countries benefit from trade rules is now widely acknowledged. The better integration of trade and aid strategies (i.e. “coherence” or “aid for trade”) has become the new frontier of development policies.

Their conceptual background being in such disarray, the Doha negotiations on SDT remain unsurprisingly stuck in a stalemate, contributing to hold back the prospects of a successful “development round”. Some innovative research has recently been undertaken regarding some of the key negotiating issues underpinning the SDT dimension of the DDA. This paper intends to take stock of the findings of this

emerging literature on trade and development to contribute to identify avenues for a way forward in the negotiations.

THE TRADE AND DEVELOPMENT NEXUS IN THE DDA

Since the inception of the multilateral trading system, optimally articulating international trade liberalization commitments with developing countries’ national economic strategies has been a central debate. In a nutshell, the SDT principle asserts the need to adapt international trade rules to the specific economic situation of developing countries. To that end, SDT was historically built upon two major layers.

On one hand, SDT measures allowed the DCs to resort to some discrimination through flexibilities, or exemptions, to the multilateral trade rules. The trading system has historically swung between both. The Tokyo Round (1973-1979) mainly used the exemption method: developing countries were given the possibility of opting out of the negotiated “codes” (antidumping, subsidies, non-tariff barriers). On the opposite, the Uruguay Round (1986-1994) was based on a “single undertaking” principle, implying that all the GATT/WTO members were to adopt the same rules: SDT consequently moved towards implementation flexibilities, particularly through longer transition periods and prospects of increased technical assistance for DCs.

On the other hand, developed nations have been encouraged to provide DCs with enhanced market opportunities, in particular through granting “non-

reciprocal trade concessions”: such “positive discrimination”, derogating from the GATT’s “most favoured nation” (MFN) principle is rooted in the Generalized System of Preferences (GSP) from 1971 and legally based on the “enabling clause” from the Tokyo Round (1979).

According to the “enabling clause”, a country acceding to the WTO (or the former GATT) can choose to self-declare its status of Developing Country. This status entitles it to the benefit of all the SDT measures. Countries classified as Least Developed in the UN criteria can also benefit from SDT measures that are specific to their category. As a result, SDT only acknowledges two categories of developing countries. Adding the developed countries’ group, the WTO apparently recognizes only three country categories.

Developing countries considered that the SDT provisions from the Uruguay Round had failed both to balance North-South trade concessions and to confront the increasing marginalization of poor countries from world trade. As a condition for launching the DDA negotiations, DCs thus obtained that the existing SDT measures be reviewed in order to strengthen their effectiveness and operability. The Doha Declaration mandated such a review of the SDT measures embedded in the existing agreements. It covers a spectrum of 145 SDT measures covering : improved market-access conditions for DCs; special considerations of developing countries’ interests in particular agreements; lower level of discipline commitments; transition periods for implementation; “best endeavours” provisions committing developed countries to care about DCs’ interests and provide them technical assistance. On their own, Least Developed Countries (LDCs) exclusively benefit from 22 other specific SDT measures. For future agreements, meant to be negotiated under the DDA, the negotiating mandate set SDT as a major objective, aiming at integrating developing countries’ needs and interests in the future trade commitments, both for market access and newly negotiated trade disciplines. The negotiating mandate was initially set to deliver the first DDA “early harvest” by July 2002, on the topics of SDT.

Entrenched North-South oppositions rapidly embodied in two conflicting approaches of the negotiating mandate. Developed Countries promoted a crosscutting conceptual approach of SDT objectives, whereas DCs tabled 88 specific proposals for re-consideration of the SDT provisions adopted during the Uruguay Round. Developed Countries refused agreeing to specific proposal prior to systemic clarification of the scope and objectives of SDT. DCs

refused giving up negotiating specifics against opening an open-ended horizontal discussion. In a classical WTO manner, procedural tricks were therefore invented to try to bridge the gap before the Cancun WTO Ministerial (2003). The 88 SDT requests were broke down into three “baskets”: one for proposals deemed likely to raise consensus (most of them of low development impact); another for measures deemed unlikely to obtain consensus ever; the last basket for measures needing further consideration within other appropriate DDA negotiating committees. Yet, this approach failed to deliver any result, both in Cancun (2003) and Geneva (2004).

Underlying this North-South confrontation on classical SDT approaches of rules and market access, two major challenges have loomed up and turned into major stumbling blocks: the fear of preference erosion on the side of developing countries; the developed countries’ claim for better DCs’ differentiation under WTO rules.

CONFRONTING THE CHALLENGES OF PREFERENCE EROSION: FROM “FIXING” TO “ELIMINATING” TRADE PREFERENCES

Vulnerable developing countries, particularly in Africa, immensely fear losing the benefit of the non-reciprocal tariff preferences underpinning some of their competitive advantages vis-à-vis emerging competitors. Since they aim at lowering the ceilings on MFN tariffs, WTO market access negotiations automatically induce some reduction of the margin of preferences currently enjoyed by the beneficiaries of GSP regimes. Such prospect of “preference erosion” is intrinsic to the dynamic of multilateral liberalization and had previously been accepted as such. The “enabling clause” itself asserts that preferences should not create any obstacle to the progress of MFN liberalization.

Thus, non-reciprocal preferences have long been ignored by quantitative analysis of international trade, before they started being granted major attention from economists during the course of the DDA. As noted by Inama (2005) part of this recent endeavour on measuring and assessing trade preferences has unfortunately been influenced by negotiating aims and tactics. The flaws of trade preferences have often been pointed out and their economic results minored in order to reduce their “negotiating value” by the partisans of a broad multilateral liberalization (especially in agriculture and textile trade). Conversely their development merits have been overstated by partisans of the current WTO *status quo*. Notwithstanding the tactical intentions, some mainstream common ground can be found over the

assertion that since their implementation in the late 1960s, trade preferences have had a limited development impact overall.

The main reason is that the original principles of the GSP (generality, non-discrimination, non-reciprocity) have seldom been implemented in practice. The GSP resembles more and more a patchwork of non-transparent, unpredictable arrangements based on “à la carte” conditionality for trade concessions (selective and discretionary tariff concessions, opaque and complex regulations, restrictive rules of origin). Up to a certain degree, the various and overlapping systems of preferences today tend to return to a pre-GATT 1947 situation: from then on, one may consider that a very constant objective of the multilateral trading system has been to try to discipline the colonial legacy of discretionary discrimination in North-South trade regimes.

Some other reasons to the underperformance of trade preferences are systemic (preferences would tend to inhibit the diversification of developing economies, create discriminations between developing countries, favour rent sharing between DCs’ exporters and developed countries importers, feed vested interests’ opposition to trade liberalization).

This is not to suggest that, as a matter of principle, non reciprocal preferences may not be useful *per se*. It has also been argued that preferences have generated selected success stories (such as Mauritius) and that some critics based on their underutilization may prove empirically groundless in the agriculture sector (Bureau 2005). Yet, since the political economy of the decision making on preferences remains mostly a “North-North” domestic issue, their conditions tend to be quite restrictive and of little economic benefits in practice. Furthermore, trade preferences bear an endogenous bias: preferential regimes prove the more important and efficient for development when and where the MFN protection is higher in developed economies.

Therefore, on average, the GSP remains far from being “general” since “in effect, only slightly more than one fourth of dutiable imports receive GSP treatment” (Inama 2005) from preference-giving countries. Most GSP schemes bear vast “sensitive products” exemptions, particularly in the agricultural sector (Guyomard 2005). Stringent rules of origins and related administrative procedures often contribute to substantial underutilization of preferences, especially in the textile sector. For instance different administrative procedures related to certificate of origin are one of the underlying reasons why exporters privilege the ACP (African Caribbean

Pacific countries) regime over the EU “Everything Arms” (EBA) GSP initiative for LDCs.

Whatever the overall picture of GSP performance, it has been now widely acknowledged that the problem of preference erosion is both real and important for selected vulnerable countries.

As exposed in Hoekman (2005) and Perrin (2005), a variety of methodologies has been tested to measure the value of preferences and the costs of their erosion through MFN liberalization. The evaluation of the preferential margins and their economic impact varies significantly according to the considered variables: choice of macro-indicators being considered (total preferential export value / generated welfare or real income); depth of MFN tariff reduction scenario; integration of the compliance costs of preferences (estimated between 1 and 5% of the value of covered exports); offsetting impact of the indirect benefits associated with multilateral trade liberalisation. An innovative work from Bouët, Fontagné and Jean (2005) distinguishes between “apparent preference margin” (the difference between preferential and MFN applied rates) and the “true preferential margin” (the difference between the preferential margin enjoyed by an individual country’s and the average world preference granted to competitors).

From the various sources measuring preference erosion, the cost is estimated in a range of 0,5 Billion US\$ - for African LDCs - to 1,7 Billion US\$ annually - for all preference-dependent countries-. Within this range the welfare losses incurred from the sole textiles quota rents elimination are estimated to 1,1 Billion US\$ annually. In addition, the following features are commonly found in various estimations of preference erosion. The bulk of losses from preference erosion are expected to fall on a quite narrow set of “highly preferred” countries, whose exports are concentrated in a handful of very protected sectors/products such as: banana, sugar, meat, vegetables and fruits, textiles and apparel. These “big losers” are mostly small islands – including some middle income economies such as Mauritius, St Lucia, St Kitts and Nevis, Belize, Guyana and Fiji –, most Sub-Saharan states and some Central-American countries. The erosion of European preferences would account for a significant proportion of the overall costs incurred. In the case of banana, reform of the EU regime induces a reallocation of market share amongst ACP countries, Cameroon and Ivory Coast benefiting from Caribbean losses. In the case of sugar, the redistribution may profit the LDCs countries eligible to the “Everything but Arms” scheme to the detriment of ACP countries (Guyomard 2005).

There is hardly consensus in the literature regarding the design of solutions to the problem of preference erosion and economic diversification. Two broad categories of policy options are available for designing credible strategies to solve the problem of preference erosion: either by “fixing” or “eliminating” non-reciprocal trade preference.

The first type of approach – i.e. “fixing” the problems of trade preferences - primarily builds on some of the positive arguments acknowledging partial successes of trade preferences. It is also derived from a realistic assessment of the world trading system, considering that, whatever the MFN liberalisation scenario in the DDA, trade preferences will stay and could function more efficiently. A first line of proposal aims at restoring the primacy of the original principles of GSP, to achieve better transparency, non discrimination, and predictability of the preferential regimes. A second axis for improving the existing preferential schemes suggests relaxing and harmonizing the rules of origin, based on the most favourable existing regime (G8 Evian Summit 2003, Commission for Africa 2005). A third line calls for the immediate generalization of LDCs duty and quota free regimes, based for instance on the model of the EU “EBA” initiative (Dodini 2005). From the Singapore WTO Ministerial to the UN Millennium Development Goals the international community has repeatedly called for such a global commitment in favour of LDCs. Beyond LDCs some advocate the extension of such benefits to the middle-income countries.

The second broad type of approach – i.e. “eliminating” the problem of trade preference – aims at stimulating ambitious progress of MFN liberalization: the non-reciprocal trade preferences would thus mechanically disappear to the benefit of a better, non discriminatory trading system. In 2004, the “Sutherland Report” on the future of WTO convincingly reasserted this very classical and orthodox vision of the world trading system as a sort of “global public good”. Yet, as pointed out by Inama (2005), Hoekman (2005) and Perrin (2005) the odds for such a bold MFN liberalization strategy highly depend upon designing a coherent and integrated supporting financial strategy.

First, political economy analysis suggests that the opposition to MFN liberalization can only be overcome through appropriate “losers’ compensation” strategy. Such compensation may basically take two forms: it may be either “trade-based and inside WTO” or “aid-based and outside WTO”. The design of “pure

trade compensation” to preference erosion could theoretically rely on offering alternative preferences to the losers – for instance in the area of GATS “Mode 4” commitments regarding movement of natural persons for servicing contracts-. But the implementation of such “compensatory preferences” would raise the opportunity cost, thus reduce the incentive for broad MFN liberalization. It is therefore considered that the design of a financial compensation package could offer a more efficient solution to the problem of preference erosion. However the design of such solution raises complex issues since it needs to integrate trade negotiations and the mobilisation of financial instrument from “outside” the WTO. Also, the nature and magnitude of “transitional” adjustment costs – which go beyond possible balance of payments shortfalls concerns - are not well assessed, and more detailed analysis should be carried out at the country-level. Eventually the final targets and vehicles of any financial compensation will need to be carefully determined. Any allocation of adjustment aid toward preference-dependent DCs should not happen at the expense of other low income countries that do not benefit from preferences.

Second, economic analysis suggests that the potentially positive development impact of MFN trade liberalisation will be partly dependent on the implementation of a substantial and appropriate “aid for trade package”, aiming at fostering DCs capacities. The proposal of an enhanced “Integrated Framework” for Trade Related Technical Assistance for LDCs may play a key role in the design of such initiative. This proposal raises many questions regarding the funding and overall governance of this coordinating mechanism between multilateral agencies and bilateral donors. The two financial requirements, for “aid” on one hand and “compensation” on the other, may also clash in practice: targeting compensation on trade preferences rent holders would be necessary to overcome their political opposition to MFN liberalization, but may not achieve a good allocation of scarce financial resources from a development priority perspective.

A pragmatic and realistic way of considering the way out of preference erosion could be based on combining the two approaches: the “fixing” strategy can certainly provide answers for a transitional period, while the “eliminating” agenda remains the best long-term hope for development.

IMPROVING SDT RULES: MORE DCs' DIFFERENTIATION WOULD BETTER SERVE DEVELOPMENT OBJECTIVES

DCs have long criticized the weaknesses of existing SDT measures, both in terms of implementation needs (lack of institutional and technical capacities) and for preserving the autonomy of their national development strategies ("policy space"). However, economists strongly disagree over the idea that full and automatic DCs' exemptions from multilateral trade rule of non-discrimination would end-up stimulating development dynamics. The mainstream literature even suggests that such an approach would prove globally damaging for world trade as well as locally inefficient for development strategies. Furthermore, developed countries show that they are politically not prepared to accept further concessions on SDT rules without matching them with a new and realistic update of DCs commitments, in line with their differentiated economic situation and capacities. A major North-South confrontation has thus developed upon the developed countries' call for a greater differentiation of developing countries in the WTO. The matter has turned into an unspeakable taboo contributing *de facto* to the freezing up of SDT negotiations.

Yet, numerous arguments from an emerging body of literature suggest that more and better DCs' differentiation may significantly help to deepen SDT measures and thus improve their effectiveness and impact on development.

According to Paugam and Novel (2005) there are strong legal and economic arguments pleading for more differentiation within the WTO. The differentiation principle appears not only legally grounded in the "enabling clause", but has also been recognized and interpreted by the Appellate Body of the Dispute Settlement Mechanism. Furthermore, the WTO rules already implement differentiation through acknowledging several subcategories of DCs eligible to selected SDT measures. From an economic perspective three arguments are commonly being used to justify increasing differentiation. First, as for other international organizations in charge of development, more DCs' differentiation within the WTO would allow a better targeting of SDT measures to DCs' specific needs. Second, it is considered that the more vulnerable countries often lack alternative to trade policy instruments for implementing an initial development strategy, by lack of sufficient capacities and resources: DCs differentiation would help reserving to them the strongest SDT exemptions from WTO disciplines. Third, differentiation would help concentrate the benefits of deepest SDT benefits on

the smallest and mostly vulnerable players, thus limiting the damaging negative externalities for other WTO members' trading opportunities (Page and Kleen 2005). The literature on SDT also shows that three broad types of options are theoretically available to achieve differentiation. New DCs classification (and graduation) mechanisms could theoretically result from "country-based" criteria, "rules-based" criteria, or a mixing of both.

Since the Uruguay Round, agriculture has been identified as one of the most promising, if not politically sensitive, field for improving the effectiveness of SDT measures through increased DCs differentiation. Major policy concerns over food security and rural poverty led to establishing the specific category of Net Food Importing Developing Countries (NFIDC). Since then several theoretical attempts have been made for better targeting the country in need of appropriate SDT measures for food security and rural poverty reasons. As argued in Matthews (2005) while no consensus is in reach yet on countries' classification, the focus should now turn on to "the nature of the deal that has to be made if greater differentiation is to become a reality in the agriculture agreement". To that end, the WTO 2004 Framework Agreement (or "July Package") already provides an useful basis for increasing differentiation of relevant SDT measures under the three negotiating pillars of the Agreement on Agriculture (market access, domestic support, and export subsidies), by framing in development concerns as "food security, livelihood security and rural development needs". Provided the political will was there, new DCs differentiation criteria could be empirically devised to meet these development objectives.

However, considering the political taboo, DCs differentiation is likely to stay locked into the quiet realm of economic literature. Paugam and Novel (2005) suggest that three prerequisites would be needed to help achieve some political move over the issue. First and foremost, WTO members should explicitly refer the issue of differentiation to the unique compass of its potentially positive development impact. Differentiation should not be presented nor interpreted as a new tool for balancing market access concession. Second, negotiators should narrow down the scope of any debate on differentiation to the relevant topics where improving SDT trade disciplines would really help development strategies. The main topics possibly justifying more horizontal differentiation are likely to be located in the field of intellectual property and domestic regulations, food security and rural poverty, industrial policies. Conversely, there is no *a priori* need to devise horizontal differentiation criteria in the fields

of market access commitments and Trade Related Technical Assistance. Here, differentiated commitments should merely be based on modulating individual members' commitments in the WTO. Third, it has to be recognized that the prospects for introducing the principle of DCs' differentiation in the SDT negotiation would heavily depend on possibilities of positively combining incentives from the SDT and the market access negotiations. Considering the mercantilist nature of the WTO negotiations, it is unlikely that the most advanced developing economies would be willing to engage negotiations that would possibly lead up to limiting their eligibility to some of SDT benefits without prospects of market access compensation; a point also found in Matthews (2005) and Safadi (2005).

The design of new procedural solutions is therefore needed to that end. One suggestion from Safadi (2005) would be to give up the current "two-track" negotiating process on SDT, compartmentalizing the review of past agreements and the negotiation of future ones. Trade negotiators should be given a chance to consider simultaneously the full SDT packages and implications of each set of propositions within the relevant sectoral negotiating fora. Another suggestion envisions agreeing on new negotiating "modalities" for SDT, as part of the concluding results of the DDA. The WTO members would then need incentives to expeditiously carry out the left-over of SDT negotiations. To maintain negotiating incentives, part of market access commitments' implementation could be conditionally suspended to the entry into force of a new SDT agreement.

TIME FOR A STRATEGIC OVERHAUL OF SDT

Forty years after being developed within UNCTAD the main concepts underlying the traditional approach of SDT in WTO seem largely exhausted. Based on the notions of "preference" and "non-reciprocity" of trade commitments, the SDT embodies a systemic contradiction within a world trading system built upon the basic principles of "non-discrimination" and "reciprocal commitments". The stalemate of SDT and market negotiations over the issues of DCs' differentiation and preference erosion suggest that the system may have reached the bottom of the contradiction and would now need a strategic overhaul. From such a perspective, the future of preference erosion and DCs' differentiation appear much intertwined. First, because differentiation is already implemented unilaterally by developed countries through the "graduation" mechanisms of their trade preferences schemes. Second, because deeper and more effective SDT provisions, possibly based on further differentiation in the WTO could be

an avenue for providing meaningful trade compensation to countries virtually losing from preference erosion. Third, because there is probably no credible incentive for developed countries to improve the existing preferences schemes ("fix the problem") without offering further differentiation of beneficiaries. Fourth, because confronting both challenges will partly rely on designing appropriate "aid for trade" packages and integrated strategies. Developed and developing countries would gain giving up old SDT agendas and really start overhauling SDT by confronting these strategic challenges.

Jean-Marie Paugam
Serge Perrin
Anne-Sophie Novel

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