Economic Policy Responses to Preference Erosion: From Trade as Aid to Aid for Trade[1]

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Introduction

Developed countries have long granted non-reciprocal (unilateral) trade preferences 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) proposed a "Generalized System of Preferences" (GSP) under which industrial countries would grant non-reciprocal trade preferences to all developing countries, not just to former colonies. Since then, the member countries of the Organization for Economic Cooperation and Development (OECD) have adopted a range of non-reciprocal preferential access schemes, in addition to an ever-expanding set of bilateral and regional (non-reciprocal) trade liberalization arrangements. Such schemes include:

- national GSP programs,
- GSP+ programs for the least developed countries (LDCs)—such as the European Union (EU) Everything but Arms (EBA) initiative; and
- special arrangements for subsets of developing countries such as the U.S. African Growth and Opportunity Act (AGOA).

Trade preferences are a central issue in ongoing efforts to negotiate further multilateral trade liberalization under the Doha Round of negotiations. Middle-income countries are increasingly concerned about the discrimination they confront in OECD markets as a result of

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the better access granted in these markets, both to other industrial 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-favored-nation (MFN)-based liberalization of trade and the removal of trade-distorting policies in agriculture by OECD countries will erode the value of their current preferential access.

Such erosion has in fact been going on for decades as a result of unilateral and multilateral reforms in preference-granting countries and the spread of regional trade agreements. As a result, the attention given to the preference erosion has waxed and waned depending on the impacts of, and changes to, specific programs. The most recent preference erosion shock was the implementation, under the auspices of the Uruguay Round, of the Agreement on Textiles and Clothing (ATC) on January 1, 2005. This agreement, which removed quantitative restrictions on exports, confronted all countries with the prospect of far greater competition from the lowest-cost suppliers of textiles and apparel—especially in China.[2] While the shock was not attributable to the removal of a program explicitly aimed at granting preferential access—rather, the aim was to restrain the most competitive suppliers—the effect was to give less competitive producers an advantage in 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 as well as assessments of the monetary value of potential preference erosion associated with further WTO-based, nondiscriminatory tariff reductions. Preferences are designed to help promote trade and, more important, export diversification. By encouraging trade in sectors where rents are earned, preferences induce specialization in those sectors. And by raising returns, they imply a financial transfer—an improvement in beneficiary countries' terms of trade. While both dimensions are important, we believe that induced specialization 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.[3]

We underscore the need to distinguish the likely impact effects of erosion from the net overall effects once policy responses by recipient countries and actions by the rest of the

[2] 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.
[3] Although aid may not be (have been) politically feasible. Political considerations do affect policy choices, including the use of preferences. In this paper, we focus on the economics of the issue.

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 effects of erosion. In assessing the magnitude of the effects of erosion, much will depend not only on the depth of OECD liberalization—for example, the extent to which such sectors as sugar, beef, or rice are opened up—but also on what other countries do. Much also depends on whether developing countries benefiting from preferential access take actions to improve the competitiveness and productivity of their firms and farmers. Here, development assistance can play an important role.

As economists often point out, many kinds of negative shocks impose adjustment costs on countries, both trade- and non-trade-related. Focusing on just one of these while ignoring others is in principle difficult to justify. While we certainly recognize that adverse shocks occur all the time, there are three main arguments for addressing preference erosion losses: First, given that the stated objective of preference-granting countries is to encourage exports from beneficiary countries, another instrument needs to be put in place to offset the removal or reduced effectiveness of the initial instrument that was used (that is, preferences). Second, insofar as preference programs have induced investments in activities in which countries do not have a comparative advantage, and adjustment to a situation where they do not have guaranteed preferential access to markets is costly, there is a strong equity argument for donors to assist these countries in the required restructuring. Third, we are of the view that a non-discriminatory trade regime and MFN-based liberalization by WTO members is a global public good. Multilateral, MFN-based trade liberalization will benefit the world as a whole, and assisting the countries that stand to lose will help achieve this global public benefit. It may help do so by helping to reduce incentives for preference receiving countries to try to block a Doha deal. Much more important in our view is that an explicit focus on addressing erosion concerns will help remove an instrument that is costly to the trading system as a whole. Preferences distort trade and have been a factor generating the spread of regional trade agreements as excluded (less-preferred) countries are motivated to negotiate equivalent access on a reciprocal basis with major preference-granting countries. For the future, lack of progress on the Doha Round and continued deepening of preferential trade arrangements in the interim - notably the EU's Economic Partnership Agreements – is potentially deepening the "status quo bias" even further – suggesting that that erosion concerns may become even more of a constraint in concluding a multilateral trade round.

In this paper, we begin by reviewing briefly the effects of preference programs and summarize some of the recent estimates of the value of current programs. We then turn to potential policy responses and 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 irrelevant that developing countries may benefit as well from their own liberalization or that of other developing countries, or that such potential benefits may be substantial. But 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 help poor countries implement such measures. We then argue that assistance for preference erosion should be part of a broader effort by OECD countries to make the trading system more supportive of economic development. This is partly because erosion is, and will continue to be, an ongoing process, with or without a Doha Round. More important, many developing countries have benefited little from preferences. This suggests that the focus should be on identifying actions and policy measures to improve the ability of developing countries to use trade for development.

The Mechanics of Preferences

As discussed in the Introduction to this volume, trade preferences involve a mix of benefits for preferential exporters, costs imposed on third-country exporters, and potential losses for the importing country. Only if the (more) preferred country is 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 which continue to confront the same price.[4]

Preference erosion involves a redistribution of benefits from those with the best preferences to those that were confronting higher tariffs. The latter countries will gain in exporter surplus, while the preferential suppliers experience a fall in demand for their exports

[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, that is, 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.

that results in a partial, though generally not full, loss of the benefits from the original preference scheme. The loss is not complete because 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.

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 favoring 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.

General equilibrium effects must be considered, especially the impact of changes in policies in other countries, both those that do and 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 or create opportunities for exports that did not exist before.

Compliance costs (e.g., paperwork, red tape, and documenting origin) can be significant. The empirical literature estimates, on average, that the documentary requirements impose costs of some 3-5 percent of the value of goods (Brenton and Manchin 2003, Brenton and Ikezuki 2005, Anson and others 2005). This substantially reduces the actual benefits of trade preferences for developing countries as it requires MFN tariffs to exceed an average of 4 percent for preferential access to be meaningful. Given that the average MFN tariff in the OECD is only about 4 percent, preferences can only matter where there are tariff peaks.

To the extent that either importers and distributors (Francois and Wooton 2008) or the transport and logistics sector (Francois and Wooton 2001) have market power, 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 yield high rents for those able to export free of trade barriers. But buyers will be aware of the existence of these rents and if they are able to set prices (have market power), the rents may be captured mainly by distributors or other intermediaries (Tangermann 2002). The African Growth Opportunity Act (AGOA) preference scheme provides evidence 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 about 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 13 percent in Malawi to 53 percent in Mauritius.[5] In terms of market power, the result is a simple redistribution of the benefits of preferences, with rents transferred to importers. In terms 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 the capacity to export the products enjoying preferential access. 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 lacking productive facilities or the ability to compete even with the price advantage conferred by the preference, owing to internal transactions and operating costs. Preferences were conceived as instruments to assist countries that have the requisite supply capacity to diversify and expand their exports. They have little value for countries without such capacity.

Estimates of the Impact of Erosion

Research suggests that the erosion of all preferences--both GSP and such deeper more recent preferences as EBA and AGOA--would have a substantial impact on some countries, especially those with high concentration of exports in heavily protected commodities. Relatively larger impacts are concentrated in small island economies and in a number of LDCs dependent on sugar, bananas, and, to a lesser extent, garment exports (Subramanian 2003, Stevens and Kennan 2004). These are the commodities subject to high preference margins. Among the LDCs, Cape Verde, Haiti, Malawi, Mauritania, and São Tomé and Príncipe are the most vulnerable to preference erosion. Alexandraki and Lankes (2006) conclude that six middle-income countries—Belize, Fiji, Guyana, Mauritius, St. Kitts and Nevis, and St. Lucia—would also be significantly affected, with predicted export losses ranging from7.8 percent for Fiji to 11.5 percent for Mauritius. Amiti and Romalis (2007) come to similar conclusions. The

[5] See Ozden and Sharma (2006) for a similar analysis of the U.S. Compliance and Business Integrity (CBI) program. Francois and Wooton (2008) obtain similar, size-dependent results in an analysis of the incidence of mark-ups along the distribution chain.

limited number and small size of most of the economies concerned argues for closely targeting measures to help mitigate the impact of preference erosion at these countries.[6]

The costs of preference erosion need to be set against gains from MFN liberalization–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 the erosion of bilateral preference margins. Thus, preference erosion will be offset by the compensatory effect of broad-based multilateral liberalization, including by emerging market economies and by beneficiary countries themselves. But 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).

Finally, implementation and transition periods also matter, as do the depth and scope of the reforms. Total erosion is unlikely to occur quickly and any MFN reforms will be implemented gradually over several years. Some recent studies quantify the potential income effects of preference erosion.[7] Francois, Hoekman, and Manchin (2006) conclude that complete preference erosion owing 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.[8] This assumes away compliance costs. Limão and Olarreaga (2006) also assess the welfare effects on LDCs of complete preference erosion. They calculate what the income transfer to LDCs would need to be to correspond to the transfer implied by existing preference programs. They conclude that 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 Limão and Olarreaga's results in line with those of Francois,

[6] 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.

[7] Much of the literature focuses on trade effects—see, for example, Subramanian (2003), Alexandraki and Lankes (2006) and chapters 7 and 8 by Low and others. Our interest here is in the magnitude of the implied financial transfers as this provides the most straightforward measure of the value of preferences. This does not imply a view that such transfers were the primary objective of preference programs. We return to the implications of this objective for policy responses to erosion below.

[8] Their conclusion derives from 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).

Hoekman, and Manchin (2006), 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 (chapter 9 of this volume) 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 much of the benefits. In contrast, Francois, Hoekman and Manchin include the erosion of ATC quota rents in the baseline scenario Francois and others note that the ATC abolition imposes erosion costs on negatively affected developing countries that are some 10 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 a loss of quota rents. To a significant extent this erosion has already been incurred, as liberalization of quotas started at the end of the Uruguay Round and was completed in 2005.[9]

If the analysis centers on preference erosion in the broader context of potential tariff reduction by all OECD member countries—or all WTO members, including developing countries—the magnitude of the total erosion loss is generally reduced. This is because the EU has been the most aggressive in using preferences as a tool for development assistance and also 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 U.S. GSP programs). Thus, the gains associated with MFN tariff reductions by non-EU OECD countries will partially offset the losses attributable to EU liberalization. In the case of sub-Saharan Africa, Francois, Hoekman, and Manchin (2006) conclude that overall losses will be reduced by a factor of four—to $110 million--while low-income countries in Asia stand to gain.

[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.

If compliance costs are also considered, the incidence and magnitude of preference erosion changes further, as such costs vary across commodities. Bangladesh, for example, specializes in such high-tariff categories as clothing that are subject to restrictive rules of origin. Including compliance costs thus substantially reduces the magnitude of potential erosion. In Madagascar, potential losses become potential gains. For countries specialized in agriculture – such as Malawi and Zambia– the effects of accounting for compliance costs are much smaller given that such costs are not as big for agricultural exports (Stevens and Kennan 2004).

Ignoring compliance costs and the distribution of rents, estimates of total preference erosion losses for low-income countries range between $500 million and $1.7 billion, with much depending on whether the ATC is included.[10] The magnitude of the estimates of preference erosion from even an ambitious Doha Round tend to be less than the erosion associated with the elimination of textile and clothing quotas on developing country exports. For example, Francois, Spinanger, and Woertz (2005) find that the removal of textile restrictions hurts sub-Saharan Africa, although the impact is smaller than for such Asian countries as India and Vietnam. The ATC-induced negative impact on Africa, however, is smaller than the estimated the potential degree of Doha Round preference erosion found by Francois, Hoekman, and Manchin (2006) 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 ATC quotas were equivalent to tariffs well above any realistic threshold value of compliance costs.

The importance of the quantitative impacts of the ATC illustrate that a range of policy- and non-policy-induced shocks will affect countries almost continuously—reflecting, for example, the global business cycle, changes in consumer tastes, the development of new technologies, and natural disasters. 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 than those generated by other forces. They will also be realized gradually, since trade

[10] Figures are higher if the focus extends to middle income countries, some of which—such as Mexico—stand to suffer potentially substantial losses as preferential access to the United States and Canada is eroded. This paper focuses mainly on low-income, weak and vulnerable economies.

reforms are generally implemented over a number of years. These considerations have implications for the design of a policy response to erosion.

Possible Policy Responses

Based on the literature to date, we conclude that the aggregate magnitude of erosion will be limited. This takes 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. But the stand-alone impact of the lost 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 policy question of whether to focus on the overall economic net effects taking into account feasible policy responses, or on the losses incurred in those markets where preferences matter, ignoring any possible offsetting effects.

Both perspectives are relevant. The overall economic effect is clearly the appropriate focal point from a development perspective. It is critical to identify what governments can do to attenuate any negative effects of global MFN liberalization. Indeed, part of the policy response by preference-granting donors should be to help recipient country governments adopt measures to better enable firms and farmers in poor countries to exploit trade opportunities and compete with imports. Economic effects are also the focal point of the WTO process, as negotiations involve give and take, with the goal of each member to maximize net economic gains.

The second focal point, the losses incurred in markets where preferences matter, corresponds to the erosion of benefits stemming from the removal of a specific policy put in place by OECD countries. From this perspective the existence of other sources of offsetting market access and/or terms of trade gains— whether from liberalization by other developing countries or own liberalization—is irrelevant. What matters is the impact of removing the non-reciprocal access to specific protected markets. 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). This assumes away any positive externalities from expanded export production—that is, the focus is only on the terms-of-trade effect. Insofar as countries could or did not benefit (have exports), this measure will show no loss. This is an important dimension of the preference-erosion question to which we return below.

We are not arguing 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* WTO member countries. 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 involving additional financial assistance (determined by a quantification of the direct bilateral erosion losses current recipients of preferences will incur), and allocating funding towards measures that will reduce the negative economic effects of this erosion.[11]

Various approaches can be employed in responding to preference erosion losses. One is to seek compensation within the trade negotiating agenda—that is, take actions to improve market access and the terms of trade of the targeted countries. This can involve the non-liberalization of products that are of greatest value from a preference point of view. It could even entail raising tariffs on products to the degree that they are not bound under the WTO, although raising trade barriers to increase the value of preferential access would reduce global welfare. 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 imposes a substantial opportunity cost from a global efficiency perspective.

It is difficult to identify trade-based solutions consistent with the MFN principle while appropriately targeting those countries 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 Limão and Olarreaga (2006) argue, 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 superior in welfare terms to trade preferences. Indeed, it would constitute a Pareto improvement, making all WTO members better off by allowing deeper MFN liberalization to

[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.

occur. This solution assumes, however, 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 harmonization toward the most liberal common denominator (Commission for Africa 2005)--and to provide discriminatory access in other areas (e.g., increased opportunities for the temporary movement of service suppliers under the General Agreement on Trade in Services). 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 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 and creates incentives to impede MFN liberalization (Limão, 2006; Karacaovali and Limão, 2008).

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 in which developing countries have a comparative advantage. Another is to ensure that MFN liberalization proceeds gradually to allow adjustment to occur over a number of years. Yet another would be to rewrite the rules so to increase the benefits for poor countries, even at the expense of rich country interests. Much of what is discussed in the WTO under the heading "special and differential treatment" and implementation of negotiated commitments is based on perceptions that the existing rules do not fully support development prospects. A willingness to address these concerns could help offset preference erosion losses. Indeed, pro-active policies can help address market failures that result in weak trade capacity. Trade policies are unlikely to be effective or appropriate, but some may be subject to WTO rules or the subject of proposed disciplines (e.g., subsidies of various kinds). These may provide a rationale for greater "flexibility" in applying 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]

We now turn to the second broad approach for responding to preference erosion losses by developing countries: development assistance. We discuss this option because

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

the research summarized above finds that the main negative monetary impact of erosion flows from the removal of specific trade barriers in specific OECD countries. That is, erosion is primarily a bilateral issue that should be resolved bilaterally, in that those imposing the costs should bear the burden of offsetting them. Although preferences are a WTO concern, as the system of bilateral preferences has multilateral consequences, in practice we do not see feasible WTO-based solutions that are not distortionary. As the pursuit of bilateralism in allocating assistance would be inefficient, a multilateral approach that builds on existing instruments is preferable. Moreover, given the objective of preferences—that is, export development—arguably the focus should also be on attaining that goal.

Existing Mechanisms for International Adjustment Financing

In recent years, a number of initiatives have sought to help countries better exploit trade opportunities and deal with adjustment pressures. These include the multi-agency, multi-donor Integrated Framework for Trade-Related Assistance (IF) and the IMF's Trade-Integration Mechanism (TIM) (discussed below). 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, the institutions sponsoring them do not provide earmarked funding for trade adjustment purposes.

The IMF's Trade Integration Mechanism (TIM) illustrates 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 liberalization (IMF 2004). The TIM is intended to address not only preference erosion but also such situations as balance of payments shortfalls resulting from 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 such specific shocks as preference erosion is considered 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 must 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 17 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 national 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 prioritized trade-related capacity building and assistance needs that are linked to the country's overall development strategy.

The philosophy behind the IF mechanism largely mirrors what is now known as the "new aid framework." The goal of this framework is to improve harmonization between the providers of trade assistance (both bilateral and multilateral) and place trade in the context of a country's overall development strategy (Prowse 2002). Most LDCs (more than 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 prioritized trade-capacity-building plans are presented within the context of consultative group meetings and round tables in which donors (both multilateral and bilateral) are asked to make pledges. This allows bilateral and multilateral donors to respond to each country's identified needs systematically and coherently, according to comparative advantage and preference. Bilateral donors can also continue to contribute bilaterally, or provide resources through multilateral organizations. Either way reduces the duplication and proliferation of vertical initiatives. However, given an "aid-resource-constrained environment," prioritized trade action plans have had to compete, justifiably, with other priority sectors (namely, health and education). To date, implementation on the ground in prioritized trade areas has been limited.

A Stand-Alone Compensation Fund?

Neither the TIM nor the IF directly addresses the concerns of developing countries about preference erosion. The TIM involves loans, and thus implies 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, the TIM does not "offset" the losses incurred; rather, it ignores the bilateral nature of the problem. 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 the IF does not earmark funds or specific allocations for countries.

The most direct and simplest solution would be for donor countries to agree to compensate developing countries directly for preference erosion attributable to MFN trade reforms (Page 2004, Page and Kleen 2004). This would help both 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, the associated compensation should not be seen 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 (e.g., 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 to beneficiary countries without conditions according to the estimated preference losses. The fund would need to be secure, leading Page and Kleen to argue that voluntary commitments should be made 'legally irrevocable.'

Grynberg and Silva (2004) offer a similar proposal. They suggest establishing a Special Fund for Diversification (SFfD) to mitigate the impact of preference erosion owing to MFN liberalization. This proposal would have financing (from pooled donor funds) "commensurate with preference losses" provided for private-sector-led export diversification investments. A share of SFfD funds would be set aside for a private-sector window to facilitate expanded investment start-ups 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 toward 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.

The UN Millennium Taskforce on Trade (2004) has suggested another option in which one element of a solution could involve income-support programs for farmers and producers of goods that have enjoyed high rates of protection. While such programs are targeted at the *domestic* producers of preference-granting countries and are intended to facilitate a shift away from production support, negatively affected producers in developing countries that benefited from preferential access could also be assisted by being included in the support program. Elements of this approach will reportedly 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. Such programs have an obvious political economy rationale. Moreover, extending support to affected producers in developing countries would also acknowledge the arguments made by groups in OECD countries that continued preferences (and, thus, market price support) are needed to help producers in developing countries. However, 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 among the higher income groups, 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, the adjustment costs arising from preference erosion must clearly be addressed. But establishing a separate fund targeted at one specific structural adjustment need and at a specific set of countries runs counter to a more harmonized approach to development assistance. Adjustment to MFN liberalization will also affect many that have not benefited from preferences but that are, for example, located in highly protected domestic industries and sectors. 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 many countries, especially those with narrow export bases.

Imbs and Wacziarg (2003) suggest that countries at early stages of development experience a positive relationship between export (production) diversification and growth. But the experience with schemes aimed at promoting export diversification is mixed, with many programs that do no more than entrench already inefficient industrial and production patterns. While there is certainly a case for government intervention to address market failures and for "policy flexibility" (e.g., Rodriguez-Clare 2004, Rodrik 2004, Pack and Saggi 2006, and

Hoekman 2005) we believe that funding must be provided in the context of an overall country development program and a broad macroeconomic policy framework to realize the dynamic gains associated with MFN liberalization.[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 more convincingly 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 that organization.

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

As noted earlier, export diversification and development were the main rationales for preferences. Many countries have benefited from preferential access and have graduated from bilateral programs, and others continue to benefit. But many of the poorest countries have been unable to use preferences to diversify and expand their 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 from preferential "trade as aid" toward more efficient and effective instruments to support poor countries could both improve development outcomes and help strengthen the multilateral trading system (Hoekman 2007). Tariffs are just one of several variables constraining developing country exports. Other variables include transport and transactions costs, which 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 have been the primary limitation on the ability of many African countries to benefit from preferences.[14] This underscores the need to improve trade capacity and facilitate diversification. This can be pursued partly by shifting to more (and more effective) development assistance that targets domestic supply constraints, as well as measures to reduce the costs of entering foreign markets.

[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.

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

The case for trade support extends beyond preference erosion

A Doha reform package can be expected to generate sizable gains for both developed and developing countries. The size of these gains is 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—for example, through expanded income support. But even under the most conservative estimates, the aggregate global gains will be substantial. In absolute terms, developed countries will gain more than developing countries, providing them the means to step up support and development assistance. Such support is needed as the consequent trade liberalization will require adjustment and the pursuit of policy reforms and public investments to bolster trade capacity. What is important is that developed countries recognize the need for additional resources for trade adjustment and integration as the cost of the potential global benefits arising from further multilateral liberalization—a global public good.

In undertaking trade reform and in order to participate effectively in the global trading system, poorer countries must confront with many economic and political concerns. On the economic side, adjustment costs will arise before offsetting investments are realized in other (new) sectors. Preference erosion is just one element of these costs. Some countries (e.g., some net food importers) may experience deterioration in their terms of trade. Countries where tariff revenues constitute a significant proportion of total fiscal resources will need to undertake tax reform. Adjustment costs are a function of policy changes; as noted earlier, those associated with preference erosion will be gradual and tariffs are just one element of the cost function facing exports. A fundamental problem is that many of the poorest developing countries are ill- equipped to take full advantage of (new) trade opportunities because of supply- side, administrative capacity, and institutional constraints. Improved market access without the ability to supply export markets competitively is of little use. Gains from trade liberalization require an environment with mobile labor and capital, and that facilitates investment in new sectors of activity—requiring, for example, an efficient financial system and good transportation and logistics services. Inevitably, for most poor countries, this requires complementary reforms undertaken 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 redistributive dimensions of trade integration must be taken into account to assure the political viability of the process. Providing sizable assistance has historically been critical in persuading countries of the benefits of integration. It played a key role in building support for the liberalization measures adopted as part of the creation of the European Economic Community and common market. The post-war Marshall Plan was conceived in large measure to neutralize the forces moving Western Europe away from multilateral trade and to thereby facilitate global economic recovery.

Recognizing 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 the most to promote development. Trade reform undertaken together with "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 and World Bank and IMF 2005). But it should be complemented by actions to redirect some of the global gains to helping advance trade and growth in the poorest countries and to give this greater priority in aid programs. This, in turn, would help achieve 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 and assistance mechanisms that target priority areas defined in national development plans and strategies. When developing countries opt to incorporate trade into their development strategies, donors should help enable these countries respond to the opportunities offered by trade liberalization and integration. As Prowse (2006) discusses at greater length, options for trade support should be considered within the emerging "new aid framework," under which aid management and implementation practices are aligned with country policies and programs and bilateral and multilateral efforts are coordinated and harmonized.

Two issues are particularly pertinent with respect to trade support. First, no one multilateral agency has the effective authority to respond to all a country's needs for trade adjustment and integration; therefore, a system must be designed to better harmonize existing processes with a country's development plans. Second, 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 program. 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, the program's ability to better integrate a country into the global trading system is questionable. Thus, more resources are needed to identify, prepare, and implement a coherent trade, investment, and growth strategy in-country in the context of the country's development process, and to address trade adjustment costs and capacity-building needs.

This need has been recognized. Progress has been made, with greater attention now being given to trade policy and trade-related capacity building by developing countries and international agencies. The IF has been strengthened through the creation of a dedicated trust fund and secretariat, with pledges on the order of $200 million at the time of writing. There are numerous operational questions that will need to be resolved in terms of how additional funding and technical support is best managed and delivered. While the increased attention for trade capacity building and assistance is an important positive development, the focus is very much on trade competitiveness. This is of course very important as it is critical to enable firms and workers to benefit more from trade opportunities. he prospect of preference erosion has not been a significant factor underpinning increased trade assistance.

This may be short-sighted. Given that the overall magnitude of potential erosion is limited and that the absence of a credible mechanism to offset losses may impede progress in multilateral negotiations once the major market access agenda items have been resolved, there is a case for seeking a binding commitment 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, the commitments for each beneficiary country should ideally be disbursed through the existing processes and mechanisms through which aid is allocated, on

[15] This will require tariff line level analysis of the type undertaken in the other chapters of this volume.

the basis of the framework described above that places trade needs within a country's overall development program. 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 equal to the bilateral "partial equilibrium" value of preferences received. That is, the quantification exercise – which should 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 toward preference erosion is both narrow and potentially difficult to implement. Recall the earlier discussion of the studies attempting to estimate the value of preferences and potential losses. Much depended on whether the ATC was included or not. Should the effects of the ATC be ignored? Some might argue they should be—that this is "water under the bridge" as it was negotiated as part of an overall Uruguay Round agreement. Moreover, in the case of the ATC, policy was not intended to benefit some countries but to restrict some exporters (protect import-competing firms).

Trying to agree on a methodology for quantifying potential erosion losses clearly risks lengthy negotiations and disagreements concerning the scope of the analysis. In addition to the ATC, one can consider, for example, the conclusion of free trade agreements (FTAs) or the effects of unilateral liberalization. Should these also be covered? Whatever one's views on whether the Uruguay Round was a balanced package and on the desirability of FTAs, the fact is that industries and households around the developing world currently confront adjustment costs stemming from past policy decisions and will continue to do so. Moreover, as noted earlier, countries must regularly deal with many other shocks that are more substantial than erosion.

If the focus is on preference erosion, we would argue it should be restricted to *future* losses caused by MFN liberalization as a result of the Doha Round.[16] Although any outcome will be negotiated and countries will have other ways 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. This benefits all WTO members and is 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,

[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.

such a constraint should be imposed in the case of preference erosion since the magnitudes of the associated losses vary substantially across countries. However, if this is done, funding must be disbursed in the context of an overall development program of policy and support.

Of course, this will do little for those countries that have been unable 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 an ambitious Doha Round or current official development assistance (ODA) (currently totaling about $100 billion). Account should also be taken of the commitment by OECD countries in the Monterrey Consensus to double ODA spending and attain the 0.7 percent of GDP target.

Concluding Remarks

Far-reaching multilateral liberalization will give rise to preference erosion. Erosion will also be a consequence of reciprocal trade liberalization (free trade agreements) by major trading nations. The analyses included in this volume and the extant literature concludes that preference erosion is a major economic issue for a number of countries, although clearly much depends on the extent of multilateral liberalization commitments to emerge from the Doha Round.

There are three main arguments for addressing preference erosion losses: First, given that the stated objective of preference-granting countries is to encourage exports from beneficiary countries, another instrument needs to be put in place to offset the removal or reduced effectiveness of the initial instrument that was used (that is, preferences). Second, global trade liberalization will benefit the world as a whole. Assisting the countries that stand to lose will help achieve this global public benefit by reducing the incentives of preference-dependent countries to attempt to block global liberalization. Lack of progress on the Doha Development Agenda and continued deepening of reciprocal PTAs – notably the EU’s Economic Partnership Agreements EPAs – is potentially deepening the "status quo bias" as regards preferences, suggesting for the future that erosion concerns may become more of a constraint in concluding a multilateral round than it was during 2001-2008. Third, insofar as preference programs have induced investments in activities in which countries do not have a comparative advantage, and adjustment to a situation where they do not have guaranteed preferential access to markets is costly, there is a strong equity argument for donors to assist these countries in the required restructuring.

Given that preferences are bilateral in nature, the countries and trading blocs that reduce the value of past preferential access commitments should address the problem by offering other transfers to former beneficiaries. We have argued that compensation for losses should take place outside the WTO to minimize distortions to the world trading system. Avoiding additional new preferences and distortions in the trading system is a key reason to address preference erosion explicitly. This will not imply the end of discrimination—many low-income countries will require continued assistance to achieve their export development and diversification goals. Accordingly, this paper has focused on reducing the use of distorting trade policy instruments and emphasizing other mechanisms, including financial assistance targeted at the variables that limit 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 for quantifying prospective losses generated by MFN liberalization on a bilateral basis, estimating 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 run counter to 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. The ultimate uses of the funds should be determined by the governments concerned, based on a policy agenda for trade and growth consistent with a country's development strategy. Domestic 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 to help countries bolster their capacity to exploit trade opportunities. In the process, the negative effects of preference erosion will be attenuated, and those countries unable to benefit from existing or past programs could be helped to achieve the original goal of trade preference programs—export development and diversification.

Solutions to preference erosion should be multilateral in the sense that the required financial transfers are best allocated through existing multilateral aid mechanisms as opposed to bilateral ones. A number of arguments support this view, 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 preference erosion—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.

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 weak, those domestic policies that may be most appropriate and effective may not be obvious, suggesting the need for further experimentation and learning (Rodrik 2004). This suggests 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 those policies that would be most effective and efficient in helping attain specific government-set goals, and by increasing the transparency of policies and their outcomes through multilateral monitoring (Hoekman 2005).

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