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Matthew McQueen*

Are EU Non-Reciprocal Trade Preferences Passé?

A substantial body of opinion argues that, at best, trade preferences for developing countries have had little or no trade stimulating effect. This paper argues that this view fails to distinguish between the effects of EU and US preferences and, in the case of EU preferences, can be rejected on the basis of recent empirical evidence. The implications of the Appellate Body ruling on EU special preferences and the Commission's proposals for the reform of the rules of origin are then examined. The paper concludes with an examination of proposals to increase the effectiveness of the GSP+.

Trade preferences have been a fundamental element in the EU's strategy for integrating the developing countries more fully into the global economy. A substantial body of influential opinion has argued, however, that preferences, especially unilateral preferences, have had little or no trade stimulating effect and have been detrimental to the interests of the developing countries. The reasons given for this are the limitations and uncertainties of the schemes, the creation of a "false" comparative advantage, and the undermining of incentives to engage in unilateral and multilateral trade liberalisation.

This article examines the theoretical, empirical and institutional basis for these views. While the limitations of the EU's preferences are fully acknowledged, it is argued that they have been significantly less that those of the US scheme and the failure to distinguish between the effects of the two sets of schemes and a reliance on outdated empirical evidence has led to an underestimation of the positive effects of EU preferences. The security of the GSP within the WTO is then evaluated in the light of the Appellate Body ruling on the EU's regime of special preferences. The paper concludes with an assessment of ways in which the GSP could be improved, both in terms of the Commission's proposals for radical changes to the rules of origin, and ways in which the GSP+ could be widened and deepened to make it more effective.

The Theory of Unilateral Preferences Revisited

Standard microeconomic theory envisages trade preferences as producing a "once-and-for-all" terms of trade gain for producers in the developing country. If we assume that imports from beneficiaries (DC) do not affect the donors' (EU) domestic price of the product, then producers in DC obtain a higher price for their exports (equivalent to the pre-GSP price plus the tariff). Exports of DC will rise both because the higher price of exports will increase the production of these goods, and because the rise in the export price will increase the domestic price of the product in DC and therefore decrease domestic consumption in DC (releasing more goods for export). If we drop the small country assumption and assume that the increase in imports from beneficiaries decreases prices in EU, then DC's terms of trade gains are reduced and consumers in EU gain an increased supply of the product at a lower price. Non-beneficiaries lose because they obtain a lower price for a reduced volume of exports. Further modifications to the analysis to take account of conditions of imperfect competition would envisage the economic rents to producers in DC being further reduced along the supply chain including importers, wholesalers and retailers in EU, and therefore reducing the supply response of producers and exporters in DC. From this analysis it could be concluded that this is a costly, inefficient and discriminatory way of producing a small degree of assistance to developing countries compared to direct transfers of aid.

Useful as this analysis is in identifying the static effects of preferences, it does not consider the dynamic effects of preferences within the context of contemporary theories of the relationship between trade and growth. The latter suggests that access to the large markets of donor countries (EU) enables DCs to obtain increasing benefits from preferences as a result of being able to achieve scale economies at the plant and industry level, and learning effects from competing with established producers in EU. Comparative advantage is therefore acquired through preferential access to a large competitive market which would not be possible through production for a very much smaller "protected" domestic market. Further dynamic benefits to DC are likely to arise from inter-industry linkages between the export sector and the rest of the economy.

* Senior Lecturer in Economics, University of Reading, UK.

Learning-by-doing externalities have been explored in recent work comparing the effects at the margin of a shift from donor country grants to tariff preferences.[1] In the static model, additional aid has the "Dutch disease" effect of raising the price of non-traded goods (this effect may be even greater if the aid is focused on poverty reduction programmes) and the real exchange rate, reducing export competitiveness. Tariff preferences, in contrast, draw resources out of non-traded goods into exportables and this results in a smaller appreciation of the real exchange rate and higher exports than under an equivalent grant. In the dynamic model, the substitution at the margin of trade preferences in place of aid acts like an export subsidy and, as a result of the productivity spillover effects of higher exports, leads to a higher level of welfare than an equivalent amount of grants.

It is important to note that preferences can never be a sufficient condition for the growth and diversification of exports and can only potentially operate as a catalyst for economic development if there is a supportive economic environment for the private sector in the developing countries. The provision of this enabling environment must largely be the responsibility of governments in the beneficiary countries, but preference donors can assist in overcoming market failures in the provision of knowledge and technology which will be necessary for producers in DC to acquire in order to utilise market opportunities offered by preferences.

Two important issues arise from this analysis. First, beneficiaries with a large, competitive, domestic market could be expected to be able to achieve the minimum size necessary to export to the developed countries by first producing for the domestic market, and it is no surprise that such beneficiaries account for a substantial share of GSP receiving imports. For such countries, the GSP can be expected to be largely in the nature of a "windfall gain" for exports that would largely have occurred in any case. The majority of developing countries, however, have a very small size of domestic market. For example, the total GDP of sub-Saharan Africa, excluding South Africa, is less than that of Belgium and the corresponding measure for Latin America and the Caribbean, excluding Argentina, Brazil and Mexico, is about the same size as the Netherlands. The growth and diversification of production and exports of these small developing economies is likely to be constrained by the small size of the domestic market, with a correspondingly greater probability that preferential access to the much larger markets of the developed countries could generate dynamic gains from trade. This provides the economic rationale for EU preferences discriminating between beneficiaries on the grounds of being "poorly diversified". It is worth noting that this is not necessarily the same category as poor or low income countries and if raising the incomes of poor people is the sole objective of the donor country, then aid will be a much more efficient policy instrument than preferences.

Second, unlike the case for infant industry protection in developing countries, trade preferences by the industrialised countries provide a margin of effective protection for producers in the developing countries which depends on the structure of border protection in the developed, importing, country and the precise characteristics (product coverage and depth of preferences) of the offer of preferences. The combination of these elements may give rise to price signals which create a "false" comparative advantage for beneficiaries in the sense that producers may be able to compete successfully against producers in the importing country (EU) but not against third countries (non-preferred countries) once preferences are removed (either because the beneficiary is no longer deemed to require preferences or as a result of trade liberalisation by the developed country). Preferences are therefore a second-best policy instrument compared to a uniform system of subsidies to exporters in the developing country and the case for preferences must therefore rest on the latter's being unacceptable on grounds of political economy. This appears to be the case as export subsidies given by governments in the developing country would be very difficult to finance and would probably be actionable under the WTO Agreement on Subsidies and Countervailing Measures (unless it is a least developed country, or has a per capita GNP of less than $1,000 measured at 1990 dollars over a three year period), while a general subsidy granted by the developed country to imports from the developing countries would probably be politically unacceptable in the donor country.

The theoretical case in favour of preferences is therefore conditional on the terms and conditions of the offer (since these determine the margin of preferences), the domestic conditions facing exporters in the beneficiary countries, and the absence of significant resource misallocation arising from the incentive effects generated by the structure of preferences.

[1] Christopher S. Adam, Stephen A. O'Connell: Aid Versus Trade Revisited: Donor and Recipient Policies in the Presence of Learning-By-Doing, in: The Economic Journal, Vol. 114, January 2004, pp. 150-173.

The Structure of the Generalised System of Preferences of the EU and the USA

The EU scheme was introduced in 1971 and has been continuously renewed at ten-year intervals, with a number of important modifications, since that date. Most industrial products have been covered and the number of agricultural products steadily increased. Substantial changes occurred in 1995 when tariff quotas were replaced by four levels of "tariff modulation" (where the margin of preference depended on the "sensitivity" of the product), offering a larger margin of preferences for products where the quota had previously been binding. Criteria for country-sector graduation (removal) from the scheme, which had been in operation since 1986, were also revised and came into force in 1998, and in the same year special incentives were introduced for countries complying with several ILO Conventions and for countries adhering to international standards for the sustainable management of tropical forests. Special arrangements were also made for eleven Latin America countries (subsequently extended to Pakistan) which cooperated with measures to combat drugs trafficking. Successive improvements to the GSP offer have been made in favour of the least developed countries, culminating in the "Everything But Arms" (EBA) offer in 2001.[2]

The current GSP regulations (the guidelines for which apply for the period 2006-2015) apply for the period up to the end of 2008.[3] The scheme consists of three components; a general scheme available to all developing countries, special preferences available to "vulnerable developing countries", and the EBA. The general scheme covers 7,200 of the 9,000 dutiable tariff lines, divided into 3,300 non-sensitive products which enter duty-free and 3,900 sensitive products which obtain a 3.5 per cent absolute reduction on the appropriate tariff (except textiles and clothing where there is a 20 per cent proportional reduction in the tariff, for example 11 per cent reduced to 8.8 percent). Specific duties are reduced by 30 per cent where this is the only tariff applied, but where there is a combination of ad valorem and specific duties, only the ad valorem duty is reduced. The second component is the GSP+ which grants duty free entry for all 7,200 products to "vulnerable countries" (a "vulnerable country" is one that is not classified by the World Bank as a high income country during three consecutive years, whose five largest sections of its GSP-covered imports to the Community represent more than 75% in value of its total GSP-covered imports and whose GSP-covered imports to the Community represent less than 1% in value of total GSP-covered imports to the Community). These key statistics are averaged over 3 consecutive years. To obtain these special preferences, beneficiaries must effectively implement sixteen international conventions on human and labour rights, seven conventions on the environment, and three conventions on drugs. Country-product "graduation" from the GSP applies when GSP imports of a product from the beneficiary exceed 15% of EU-GSP imports of that product over three consecutive years (currently applies to imports of particular products from Brazil, China, Algeria, India, Malaysia, Thailand and the Russian Federation). The third component of the GSP is EBA, granting free entry for all imports (except arms) from the least developed countries (rice and sugar from 2009). To obtain preferences, beneficiaries must comply with the EU's preferential rules of origin.

The US scheme came into effect in 1976 and is, in some respects, simpler and more transparent than that of the EU. Products either receive duty-free entry or are not eligible for the GSP; rules of origin require a minimum of 35 per cent value added to non-originating imported intermediate products and this can be "cumulated" across recognised regional groupings (currently five) of developing countries; documentation is kept to a minimum. Product coverage is significantly more limited than the EU scheme, country eligibility has been subject to greater discretionary powers exercised by the US President, and the renewal of the scheme has been subject to greater uncertainty, especially in the 1990s. A general review of the scheme in 1985 to 1987 led to numerous changes in product eligibility and the current scheme excludes most textiles and clothing, watches, footwear, handbags, luggage, flat goods, leather wearing apparel and "import sensitive" goods (covering steel, glass and electronic articles).[4] Limited preferences are offered for agricultural products. If imports of a product exceed half or more of total US imports of that product, or exceed a certain $ value in any year, then that country-product combination is deemed not to have a "competitive need" of the GSP and is excluded. Imports can also be considered to be "sufficiently competitive" at the 25% threshold level of 40% of a competitive need $ value. Country-product combinations subject to these rules can be permanently removed (graduated) from preferences under certain broad criteria.

[2] See Matthew McQueen: EU Preferential Market Access Conditions for Least Developed Countries, in: INTERECONOMICS, Vol. 37, No. 2, 2002, pp. 101-115.

[3] Council Regulation (EC) No. 980/2005.

[4] Generalised System of Preferences. Handbook on the scheme of the United States of America, UNCTAD/ITCD/TSB/Misc. 58/Rev. 1, United Nations, New York and Geneva 2003.

Country eligibility has also been subject to a significant degree of political control. Until the first half of the 1990s communist countries were excluded, as are OPEC countries. The Trade and Tariff Act of 1984 and subsequent reviews of the scheme enable US officials to wholly or partially remove a GSP beneficiary from the scheme if they do not protect US intellectual property rights, protect workers' rights, discriminate against imports of US goods, or fail to resolve investment disputes.

Renewal of the US scheme has, since mid 1993, "been tenuous".[5] The main reason for this appears to be the introduction of new budget rules in 1990 which required any increase in government expenditure or decrease in revenue (in the case of the GSP, tariff revenue forgone) to be offset by other spending cuts or tax increases, making it more politically difficult to renew the GSP.

A wider range of eligible products was introduced in 1997 into the US scheme in favour of the least developed countries (LDCs) and this was followed in 2000 by the African Growth and Opportunities Act (AGOA). AGOA provides duty-free treatment until 2015 to all GSP products (including products only available to the LDCs) and extends coverage to a further list of manufactured products previously excluded from the GSP (although in the case of textiles and clothing, exporters must qualify under one of a number of criteria, including the use of US yarns and fabrics, and certain categories of products are subject to tariff quotas). Rules of origin have been relaxed to allow imports of intermediate products from the USA up to a value of 15% of the value of the product and these count towards the 35% minimum value added criterion. Also, beneficiaries can "cumulate" origin in producing the final good for export although beneficiaries have to demonstrate that they have implemented an effective "visa" system to prevent trade deflection. In addition, until the end of September 2007, lesser-developed beneficiaries may use non-US fabric and yarn for clothing wholly assembled in their country. Despite its title, AGOA only applies to sub-Saharan Africa (SSA) and to be eligible, these countries must demonstrate to the US government a commitment to a wide range of requirements additional to the normal GSP requirements, such as establishing an open rules-based trading system with minimal government intervention in the economy, a commitment to maintaining the rule of law, and having systems to combat corruption and bribery. Currently 47 of the 48 SSA countries are eligible for the GSP and 37 of these are eligible for AGOA.

In addition, the USA offers special preferences under the Caribbean Basin Trade Partnership Act (CBTPA) and the Andean Trade Promotion and Drug Eradication Act (ATPDEA).

What Does the Empirical Evidence Tell Us?

One-fifth of all developing country exports now go to the EU, while the EU accounts for 63% of the non-oil exports of the least developed countries (LDCs) and 70% of their agricultural exports. EU imports under the GSP are just over three times those of the USA (€50 billion compared to €16 billion in 2003) and the general trend has been for GSP imports to grow more rapidly than total imports from GSP-receiving countries (in the case of Brazil, India and Thailand, twice as fast).[6]

Both the breadth of coverage of dutiable products and the depth of preferences are higher in the EU scheme than in the USA. Just under 60% of dutiable products imported from non-LDC beneficiaries are covered by the EU scheme compared to around 30% for the US scheme (the maximum level reached was 60% in 1997), although covered imports receiving preferences (utilisation rate) are a little higher for the USA (65%) than the EU (56%). Almost all EU imports from the least developed countries (LDC) are covered under the EBA compared to 44% (4% for non-oil imports) for the USA, although utilisation rates for the US scheme have increased from a low of 29% in 1997 to around 96%. Utilisation rates for the EBA are around 56%, probably reflecting both the wider product coverage of EBA and more stringent EU rules of origin.

Another important factor affecting the utilisation of the US scheme compared to that of the EU has been confidence in the continuation of the GSP. The EU scheme has been renewed at regular ten-year intervals since its inception, but the US scheme has been subject to breaks, notably in 1996/97 (when it was renewed thirteen months after it expired), but also in 1993, 1994 and 2001/2 (a gap of eleven months).

Despite these important differences between the EU and US preferences, there is very little empirical evidence comparing the effects of the two schemes. A recent survey article on unilateral trade preferences by Ozden and Reinhardt, for example, states that "numerous empirical studies have concluded that GSP has radically underperformed, yielding at best a mod-

[5] European Commission, Directorate General for Trade: Opening the Door to Development. Developing Country Access to EU Markets 1999-2003.

[6] Stefano Inama: Trade Preferences for LDCs: A quantitative analysis of their utilisation and suggestions to improve it, available at: GTAP. agecon purdue.edu/resources.

est increase in imports from beneficiary states".[7] However, of the five articles cited to support this conclusion only one specifically estimated the impact of the EU scheme (and found that trade creation was larger than trade diversion) and three of the studies concentrated on the US scheme. The estimated effects were also based on data for the 1970s or 1980s. Since then the schemes of the USA and particularly the EU have undergone significant changes (see above), multilateral trade negotiations have reduced the margin of tariff and non-tariff preferences (for example the abolition of the MFA) and the enlargement of the EU has presented developing countries with both increased market opportunities in the new member states (trade creation) and increased competition in their traditional EU markets (trade diversion). EU preferences under the GSP must also be assessed in the context of the EU's hierarchy of preferences, where unilateral preferences under the Lomé Convention and the Cotonou Agreement, and preferences under the bilateral Mediterranean Agreements (steadily replaced by free trade agreements from 1998 onwards), have offered higher levels of preferences (product coverage, depth of preferences and conditions for preferential market entry) than under the GSP.

Two recent studies using the latest gravity model techniques provide evidence that the trade effects of the EU and the US preferences are significantly different, with the greater breadth and depth of EU preferences generating higher levels of exports, particularly for low income countries.

The first study by Persson and Wilhelmsson examines the effects of all of the EU's (15) preferential schemes over the period 1960-2002 for a sample of 109 developed countries (excluding Bulgaria, Romania, Turkey and major oil exporters).[8] The use of time series allows for the control of country-pair specific factors which may vary over time (e.g. competitiveness) and allows for changes in a beneficiary's membership of the EU's evolving schemes of preferences. The results indicate a hierarchy of effects, with beneficiaries under the Yaoundé and Lomé Conventions (especially least developed ACP countries) experiencing the greatest gross trade creation effect (28% to 32% increases in exports), followed by the GSP-only least developed (21%), the Mediterranean countries (14%) and GSP-only non-least developed (4%). A further interesting result was that the new member states of the EU reduced their imports from developing countries as a result of significant trade diversion. This may also indicate that the developing countries failed to offset this effect by taking advantage of improved access to these new markets.

The second recent study by Nilsson compares the effects of EU (15) and US trade policies on developing country exports for the period 2001 to 2003, allowing for former colonial ties.[9] The results show that EU trade policy towards developing countries as a whole over this time-period produced a gross trade creation effect 35% higher than US trade policy, and 50% more for low income countries (i.e. compared to the US-GSP and AGOA).

Recent research has also produced evidence on the factors which may determine the utilisation of preferences. One obvious factor is that obtaining preference involves compliance costs, notably in fulfilling the requirements of rules of origin. The compliance costs will consist of any additional costs incurred in adapting structures of production to fulfil the rules of origin (including possibly sourcing intermediate products from higher cost "originating" countries) and proving that the process and value added criteria are fulfilled. If the margin of preference is less than the costs of obtaining preferences then there is clearly no incentive to request preferences.

One approach in quantifying the effects of these costs is to examine the relationship between the preference margin and the utilisation rate and recent research by Candau, Fontagne and Jean indicates that although the utilisation tends to be lower for margins below 3% (and to a lesser extent between 3% and 6%) it still remains substantial (above 63%).[10] This result is surprising since it has always been assumed that compliance costs were significant and led to low utilisation rates for low margins of preference. One difficulty with a direct comparison of the preference margin and utilisation rate is that the decision to utilise preferences depends upon a number of factors other than simply the margin of preference, such as the traders' knowledge of the scheme (under-utilisa-

[7] Caglar Ozden and Eric Reinhardt: Unilateral Preference Programs: The Evidence, in: Simon J. Evenett and Bernard M. Hoekman (eds.): Economic Development and Multilateral Trade Cooperation, Basingstoke 2006, The World Bank and Palgrave Macmillan, p. 199.

[8] Maria Persson and Fredrik Wilhelmsson: Assessing the Effects of EU Trade Preferences for Developing Countries, in: Y. Bourdet, J. Gullstrand, K. Olofsdotter (eds.): The European Union and Developing Countries: Trade, Aid and Growth in an Integrating World, Cheltenham 2007, Edward Elgar, pp. 29-48.

[9] Lars Nilsson: Comparative Effects of EU and US Trade Policies on Developing Country Exports, in: Y. Bourdet et al., op. cit., pp. 49-70.

[10] Fabian Candau, Lionel Fontagne, Sebastien Jean: The Utilisation Rate of Preferences in the EU, 7th Global Economic Analysis Conference, Washington DC, 17-19 June 2004.

tion if they are not aware of the preferences, over-utilisation if they underestimate compliance costs) as well as factors determining the costs and revenues from exporting to a particular market. It is therefore preferable to control for these factors and allow the threshold value of the preferential margin to be determined endogenously (rather than exogenously selecting values as in the previous study). Using this approach for non-LDC countries covered by Cotonou preferences in 2001, Manchin found a threshold value (defined as the difference between the MFN and preferential tariff) of 4.5%, with an average utilisation rate of 16% for values below the threshold and 43% for values above the threshold. Once the decision had been made to request preferences, the magnitude of the preference margin does not appear to have a significant effect on utilisation.[11] This threshold is a little higher than was previously thought to be the case, based on the old EFTA scheme and, as the author points out, may be due to higher compliance costs for exporters in the ACP countries (or perhaps in most developing countries). It suggests that the 3.5% preferences margin (and the 20% proportional reduction in the MFN rate for textiles and clothing) in the EU-GSP may have been set too low for all but the most competitive developing countries.

A new area of research has been to examine whether non-reciprocal preferences not only have little trade-stimulating effect, but are actually detrimental to the growth of developing countries because they reduce the incentive for beneficiary countries to engage in trade liberalisation. One reason for this could be that preferences remove the incentive for exporters in the beneficiary country to lobby for a reduction in their own country's trade barriers (which are essentially a tax on the production of exportables). To test whether there is a causal relationship between preferences and a more protectionist trade stance, Ozden and Reinhardt compared the trade stance of countries removed from the US GSP to the trade stance of those countries prior to removal and all countries never removed from the US GSP.[12] The results indicated that the greater the reliance on the GSP the greater the country's resistance to liberalisation. Conversely, removal from the scheme accelerated trade liberalisation. Since trade liberalisation may be considered to be associated with higher growth rates (although most observers would consider this to be a highly conditional relationship), the conclusion is that unilateral preferences are detrimental to the growth of recipients. As the authors acknowledge, this result is surprising since, as we have discussed, most exports to the USA by GSP beneficiaries do not qualify for the GSP while, as we have noted, the same authors have claimed that the GSP has at best produced only a modest increase in the exports of beneficiaries. We would therefore expect preferential access to the US market to be, at best, a minor determinant of the trade policies of GSP beneficiaries. Clearly before accepting such a relationship we need to be able to overcome the well-known problems in producing a reliable indicator of the trade policy stance of a country and in devising a model which identifies the factors determining trade policy. For the present, this result may be regarded as providing an interesting hypothesis for further research.

The Benefits and Costs of Preferences: A Case Study of Mauritius

Models of trade flows seek to control for general factors which may influence trade flows so that we can estimate whether preferences have stimulated a higher level of exports than would have been the case without preferences. This still leaves a number of unanswered questions based on the rationale for preferences. For example, have preferences assisted the development of infant industries, and the creation of new industries? Have they fostered the creation of external economies of scale, learning effects, intra and inter-industry linkages and the development of "value-chains", and diversified exports in forms which lead to a higher growth and greater stability in export earnings?

In this respect, the debate over preferences resembles the inconclusive debate on the effects of trade liberalisation and growth, and further advances in knowledge and understanding are more likely to come from models which identify the structural relationships through which preferences affect exports and the development of the economy. In the absence of such models, case studies can provide useful insights and in this context, the experience of Mauritius is instructive.[13]

When Mauritius gained independence in 1968 it was a poor country wholly dependent on sugar exports and famously described by James Meade as a "case study in Malthusian economics". Today it is a prosper-

[11] M. Manchin: Preference Utilisation and Tariff Reduction in European Union Imports from Africa, Caribbean and Pacific Countries, in: The World Economy, Vol. 29, No. 9, 2006, pp. 1243-1266.

[12] Caglar Ozden, Eric Reinhardt: The Perversity of Preferences: GSP and developing country trade policies, 1976-2000, in: Journal of Development Economics, Vol. 78, 2005, pp. 1-21.

[13] Matthew McQueen: ACP Export Diversification: The Case of Mauritius, Overseas Development Institute Working Paper 41, London 1990.

ous upper middle income country with a per capita GNI of US $4,640 (purchasing power parity $11,950), achieved despite an 85% increase in the population since 1960 (650,000 to 1.2 million).

Preferences have played a large part in this successful development but it is worth noting that despite obtaining preferential access to its main export markets in the UK and France since independence (under Commonwealth Preferences and the Yaoundé Convention), the beneficial effects of preferences only became significant in the early 1980s. In the ten years after independence policies emphasised protection and import substitution while, as a result of a rapidly increasing budget deficit, inflation and unemployment rapidly increased and the balance of payments moved into an unmanageable deficit. This situation was reversed as a result of IMF stabilisation policies' being implemented during the 1980s, followed by large inflows of bilateral and multilateral aid, both to support the balance of payments and to modernise the infrastructure.

These changes in economic policy, together with political stability (Mauritius is a multiparty parliamentary democracy) set the necessary conditions for preferences to become effective. Significant inflows of foreign direct investment, initially from Hong Kong and then from a wide range of other countries, established an EPZ based very largely on clothing. A substantial proportion of investment in the EPZ came, however, from Mauritian nationals, stimulated to a significant extent by profits from the preferential export of sugar to the EU (largely the UK) where they benefited from CAP related prices (averaging around three times the work price). As a result, almost two-thirds of production in the EPZ was Mauritian controlled. Joint ventures and long-term contracts with fashion houses and large clothing chains in the EU crucially provided both access to a protected market and the transfer of knowledge and technology. As the clothing industry grew so the complexity of operations of the larger enterprises increased, initially from simple CMT operations, but developing into the production of high quality clothing in the larger establishments. As the size of the industry grew so linkages were developed into spinning, weaving and dyeing operations and into a whole range of specialist services such as quality control, design, marketing and distribution. Value added in the EPZ increased from 10 per cent of gross output in the early years of the industry to 37 per cent for clothing and 27 per cent for the spinning, weaving and finishing of textiles in 2000. Profits from the EPZ in turn have been invested in the prosperous tourism industry and in the nascent financial sector.

The erosion of preferences in sugar (resulting from EU trade liberalisation and decreases in the CAP price of sugar) and particularly in textiles and clothing (with the phasing-out of the MFA) raises, however, the important question of whether preferences created a false comparative advantage which has now left the economy vulnerable to global competition. This is probably the case for sugar (which cannot compete with world competition) but in the case of clothing a substantial part of the industry has moved up market and should be able to compete in terms of quality. The costs of preference erosion are, nevertheless, substantial and considered to be of the order of 8 per cent of GDP.

The lessons from Mauritius are that preferences can fulfil their theoretical potential for a small (and vulnerable) economy of developing infant industries and an infant economy. The dynamic, growth enhancing, gains have been substantially greater than could be predicted from a comparative static model which concentrated simply on the price advantage conveyed by the margin of preference. At the same time, the experience of Mauritius shows (and the modern theory of selective intervention indicates) that the advantages gained from preferences must be used to move the economy away from a dependence on preferences as rapidly as possible. In this respect, Mauritius has been a little slow to move from an export-led growth economy to an outward-orientated economy based on knowledge and skill intensive activities, thought it is difficult to assess the extent to which this may have been due to preferences.

How Secure are Non-Reciprocal Preferences?

Critics of unilateral preferences emphasise the uncertainty of treatment which is attached to such preferences. Both the EU and the USA exclude high income countries (defined by the World Bank) from their schemes. The EU also temporarily excludes countries which are guilty of "serious and systematic violations of the principles laid down" in a list of international conventions, an example of which would be the current exclusion of Myanmar on the grounds of human rights abuse. The US scheme gives the President wider powers both to exclude countries (see above) and also to waive exclusions in the national interest. Both countries have "competitive need" exclusions by country/product combination. The US scheme operates an annual data update and this leads to imports of particular products from certain countries being excluded or included in the scheme at frequent intervals. Exclusions under the EU scheme are based on data over three consecutive years "to increase pre-

dictability and fairness of graduation by eliminating the effect of large and exceptional variations in import statistics". The EU scheme has also been subject to regular and continuous renewal since its inception and although the EU could, in theory, withdraw its offer it is clear that this would not be acceptable to the member states. The US scheme, as we have noted, has to be renewed annually and this is not only a politically difficult process but has been, on a number of occasions, subject to substantial delays. The combination of these different characteristics of the two schemes means that the EU scheme has a greater potential to produce the necessary degree of confidence which traders and investors require if preferences are to assist the economic development of recipients, rather than simply produce windfall gains.

Critics of unilateral preferences also tend to emphasise that the GSP may be subject to greater challenge under the disputes settlement procedures of the WTO than bilateral preferences covered under Article XXIV of GATT 1994.

The GSP was first introduced under a GATT waiver to Article I in 1971 and this was given permanent legal effect in 1979 by the so-called "Enabling Clause" (the correct title is "Differential and More Favourable Treatment Reciprocity and Fuller Participation of Developing Countries") as part of the Tokyo Round of multilateral trade negotiations. This permitted "generalised, non-reciprocal and non-discriminatory preferences beneficial to the developing countries" (as agreed in 1971), "not withstanding the provisions of Article I of the Agreement". It is significant to note that the Enabling Clause was enacted eight years after the EU scheme and three years after the US scheme had been in operation and therefore agreed in the full knowledge of the extent to which these schemes fell short of the general objectives of the GSP as stated in 1971. The GSP schemes of all of the developed countries were not challenged until 2002, despite the fact that the restricted country and product coverage of the schemes might be challenged as failing the tests of "generalised" and "non-discriminating", while making preferences conditional on meeting requirements set by the donors might be challenged as failing the test of being "non-reciprocal". The absence of challenge, while not indicating conformity with the GATT or the Enabling Clause, could presumably be explained by an acceptance by all parties that such limitations and conditions were the political price that had to be paid to enable each donor to overcome the objections of pressure groups within their own countries which were hostile to preferences.

The challenge of India in 2002 was triggered by the inclusion of Pakistan in the EU's special preferences for particular countries for combating drug production and trafficking, and for the protection of labour rights and the environment. India claimed that this created "undue difficulties" for India's exports to the EU and nullified or impaired the benefits it obtained under Article I.1 of GATT 1994 and paragraphs 2(a), 3(a) and 3(c) of the Enabling Clause. The disputes settlement Panel found that the EU's scheme was inconsistent with Article I.1 and paragraph 2(a) of the Enabling Clause, since the special preferences were not offered to all developing countries. The EU appealed and the Appellate Body (AB) modified the Panel's findings with respect to the relationship between Article I.1 and the Enabling Clause and stated that the complaining party had not only to claim inconsistency with Article I.1 but had also "to identify those provisions of the Enabling Clause with which the scheme is allegedly inconsistent, without bearing the burden of establishing the facts necessary to support such inconsistency. That burden … remains on the responding party invoking the Ending Clause as a defence" (par. 115).[14] Most importantly, the AB also rejected the Panel's finding that the phrase "non-discriminatory" meant that the GSP had to apply equally to all developing countries. In drawing this conclusion the AB emphasised that paragraph 3(c) of the Enabling Clause states that preferences "shall … be designed and, if necessary, modified to respond positively to the development, financial and trade needs of developing countries". They concluded that the absence of an explicit requirement to respond to the needs of "all" developing countries suggests that the provision imposed no obligation to respond to the needs of developing countries collectively. Furthermore, 3(c) states that preferences may need to be "modified" in order "to respond positively" to the needs of developing countries. Also, the purpose of special and differential treatment is to foster the economic development of developing countries and "it is simply unrealistic to assume that such development will be in lockstep for all developing countries at once, now and for the future" (paragraph 160). In reaching these conclusions, particularly regarding the importance of the absence of "all" developing countries in 3(c), it seems likely that the AB regarded this omission in 1979 as deliberate since the schemes already differentiated between developing countries both explicitly (competitive need criteria, and level of

[14] Report of the Appellate Body: European Communities - Conditions for the Granting of Tariff Preferences to Developing Countries, Geneva 2004, WTO.

per capita GDP) and implicitly (in product coverage). The AB, however, was also clear that the purpose of the Enabling Clause was to avoid a return to special preferences favouring selected developing countries and that "the existence of a 'development, financial [or] trade need' must be assessed to an objective standard" (paragraph 163). Also, that "paragraph 3(a) requires that any positive response of a preference-granting country to the varying needs of developing countries not impose unjustifiable burdens on other Members" (the actual phraseology of 3(a) of the Enabling Clause is "not raise barriers to or create undue difficulties for the trade of other contracting parties"). The AB found that the EU failed to prove that the Drug Arrangements were available to all GSP beneficiaries that were similarly affected by the drug problem and that there was no mechanism under which additional beneficiaries could be added to the list of beneficiaries, in contrast to the arrangements for the protection of labour rights and the environment. The AB report and the modified Panel reports were accepted by the WTO member states in 2004 and the EU amended its Special Incentive Arrangements and specified general qualifying criteria which could apply to any "vulnerable" developing country.

The AB ruling represents a substantial strengthening and clarification of the legal bases of the GSP. It also provides a good illustration of how the WTO operates as a "rules-based" and "member-driven" (i.e. political) organisation. In rejecting the Panel's neutral interpretation of "discrimination" as "making a distinction", in favour of a narrower negative meaning of "being unjust", the AB reflected the political reality of how preferences have operated since their inception, while at the same time making it clear that a return to preferences for a particular group of countries selected by the donor (such as Lomé/Cotonou) would be unacceptable. This still leaves open the possibility of challenge on a range of other issues such as what constitutes "development, financial and trade needs of developing countries" and whether donors should be free to unilaterally determine the criteria for this; whether donors can freely select additional qualifying conditions for countries qualifying under the criteria of "need"; whether donors should be free to select the "graduation" criteria (i.e. removal of preferences) for countries and country/product combinations. It is worth repeating that the challenge from India has been the one and only challenge on the GSP scheme of any country, and may well have reflected its general political relations with Pakistan rather than any specific issues concerning the GSP. On the other hand large developing countries such as India, China and Brazil have become much more active in pursuing their trade interests in the WTO and it is precisely these countries against which the EU's preferences (both unilateral and bilateral under FTAs) largely discriminate. It therefore seems increasingly important to increase confidence in the schemes by bringing them more closely within the institutional arrangements of the WTO, for example under arrangements similar to the scrutiny arrangements for free trade areas and customs unions covered by Article XXIV; but with more effective procedures, such as those available to the Disputes Settlement Board.

Changes to the Rules of Origin

One of the most important reasons given in the literature for the underutilisation of EU preferences are the rules of origin, since they impose the additional costs of demonstrating compliance with the rules of origin and any additional costs associated with changes to the sourcing of inputs, production processes and investment decisions. Rules of origin are fundamental to any system of preferences to ensure that beneficiaries, rather than non-beneficiaries, obtain preferential access (trade deflection). The EU's rules of origin are based on changes of tariff heading, domestic value added (mostly 60%) to imports of non-originating intermediate products, specific process requirements, the use of wholly obtained inputs into production, and frequently a combination of these requirements.[15] Since the inception of EU preferences, they have been criticised as requiring unrealistically high levels of working or processing in most beneficiaries, particularly in developing countries lacking vertically integrated structures of production. They have also become increasingly outdated in a world of globalised production and generate significant transactions costs of compliance for exporters. Evidence has also been produced that the rules of origin are most restrictive on "sensitive" goods, precisely the ones in which developing countries, particularly low income countries, have a comparative advantage.[16]

In a major change of policy, the Commission has proposed a radical strategy to simplify the rules of origin and to reform fundamentally the basic conditions for qualifying production processes so that they correspond "to the real production and export capacity of the beneficiary countries, in particular for the least

[15] Matthew McQueen: EU Preferential Market ... , op. cit., pp.107-108.

[16] Matthew McQueen: Lomé and the Protective Effect of Rules of Origin, in: Journal of World Trade Law, Vol. 16, No. 2, 1982, pp. 119-132.

developed and smallest countries".[17] To meet these objectives the Commission proposes replacing the current complex criteria with a minimum (or threshold) level of value added in the beneficiary country (or region, in cases where the EU recognises a coherent regional group or zone) expressed as a percentage of the net production cost of the final product. To avoid trade deflection in sectors such as agriculture, fisheries or textiles, the Commission envisages the possible need to supplement the value added criterion with "additional conditions or criteria supporting actual development".[18] It is also proposed to revise the "nationality" criteria for fishing vessels to one based on "the flag, registration and simplified yet adequate conditions regarding property, the crew conditions being removed" (the latter refers to the condition that at least half the crew are nationals of the EU or the beneficiary country).[19] It is envisaged that the revised rules of origin would be first applied to the GSP, then to the Economic Partnership Agreements (EPAs) which are scheduled to commence with six regional groups of ACP countries on 1 January 2008, and progressively extended to existing FTAs.

Establishing a threshold level, or levels, of value added which meet the development objectives of the reforms but also prevent trade deflection will not be easy. In addition, it should be recalled that the EU has, in the past, defended the high implicit or explicit value added in the existing rules of origin on the grounds that it encouraged deeper levels of industrial development. These issues are explored in a recent report by the Overseas Development Institute (ODI) which provides benchmarks against which the Commission's future proposals may be assessed.[20] The study concentrated on narrow manufactured and processed primary products, since 95% of these items are exported by low or lower middle income countries. Eighty products (defined at the HS4 digit level) were exported to the EU by at least two low income countries with a value of at least €5 million. This list of products were then matched to the ISIC Rev.3 industrial classification system to produce data on the share of output contributed by labour and operating surplus for 29 countries at different levels of development (corresponding to the Commission's proposal to calculate value added as a percentage of the net production costs of the final product). Value added varied by sector as expected, but the variation between countries for any given sector was much greater (ranging from 27% to 76%). This clearly creates difficulties for the establishment of a threshold level of value added. These difficulties are compounded by the fact that these variations in levels of value added are not well correlated with levels of per capita GNI. As a result, different threshold levels cannot be established for different levels of economic development without setting them unnecessarily low for some countries and too high for others. This applies not only to low income countries compared to low-middle income countries, but also to the least developed countries, where the study concludes "that there is no evidence from the data available of any distinguishing characteristic of LDCs that sets them apart from other countries".[21] Interestingly, the data indicates that although harmonising EU rules with those of the USA would decrease transactions costs for exporters, a threshold value added of 35% is probably too high for most industrial sectors in low and low-middle income countries. It would therefore appear that the new EU rules would need to be set at 20% to 30% for roughly half the product groups and 31% to 40% for the remainder, with lower levels for small (in terms of GDP) low income countries and for a small number of product groups. Setting a value added rule in place of the normal change of (four digit) tariff heading (CTH) or process criteria of the current rules would also potentially create significant uncertainty since we do not know, for any given sector, what equivalent value added is implied in the existing rules.

A change to a value added criterion may remove constraints on exporting to the EU in some, and perhaps most, sectors but create them in others. Again, this is an argument for setting the criteria at the minimum level required to avoid trade deflection, rather than at a higher level which seeks to stimulate higher levels of domestic value added in beneficiaries as a development objective.

This conclusion is reinforced by the second part of the study which demonstrates that any move from non-constraining to constraining rules of origin would decrease total output in every country and for every sector since the increase in the production of intermediary products would be more than offset by the fall in the output of final goods.[22] The decline in total output

[17] Commission of the European Communities: Communication from the Commission to the Council, the European Parliament and the European Economic and Social Committee. The Rules of Origin in Preferential Trade Arrangements: orientations for the future, Com (2005) 100 final. Brussels, 16.3.2005.

[18] Ibid., p. 9.

[19] Ibid.

[20] Christopher Stevens, Michael Gasiorek, Jedrzej Chwiejczak, Jane Kennan: Creating Development Friendly Rules of Origin in the EU, London 2006, Overseas Development Institute.

[21] Ibid., p. 27.

[22] Ibid., p. 8.

would be greater if exporters in the developing country fulfil constraining rules of origin by sourcing intermediate products from the EU (under the "donor country content" rule) rather than from domestic firms. Using the rules of origin to force firms to obtain intermediate products from a source from which they would not otherwise purchase them also undermines the fundamental objective of preferences which, as previously emphasised, is to enable infant industries to expand output and enter world markets, where costs of production and the quality of the product must be at least comparable to that of competitors.

The restrictive effect of rules of origin may be reduced by allowing countries to import intermediate products from another country and to allow these inputs to count as "originating" (i.e. rather than "non-originating") products. This rule is known as "cumulation" of origin. As we have noted, most preferential schemes allow beneficiaries to count imports from the donor country (in this case the EU) as originating products (bilateral, or donor country, cumulation) but if the developing country would not otherwise have sourced its imports from the donor country, then this is simply trade diversion, raising costs of production in the developing country. The EU also allows regional cumulation of origin between members of recognised regional arrangements and in the case of unilateral preferences this currently applies to the ACP, ASEAN, SAARC and the merged Andean Community and Central American Common Market. It is important, however, to distinguish between "diagonal cumulation" (which applies in the EU's GSP) where imports from a regional partner have to qualify as originating products, and "full cumulation" (which applies in the Cotonou Agreement since the ACP countries are legally designated as one territory) where originating status can be accumulated on a regional basis. Since the latter does not require sufficient working or processing in each of the regional partners, it clearly has a greater potential for encouraging the regional integration of production. There is, however, little evidence that cumulation of origin is significant in reducing the restrictive effect of rules of origin and by introducing an artificial constraint on the sourcing of intermediate products it is just as likely to result in trade diversion costs, if it has any effect at all. The primary objective of preferences is to assist developing countries, particularly small developing countries, to diversify their economies, become less vulnerable to exogenous shocks, and to participate more fully in world trade and production. To achieve these objectives it is essential that they have the maximum flexibility, compatible with avoiding trade deflection, in sourcing inputs so that they can develop sectors of production which are competitive in world markets. This argues for standard rules of origin to be applied across all of the EU's preferential schemes (both unilateral preferences and bilateral FTAs) and to combine this with full cumulation of origin across all beneficiaries.

In order to reduce the transactions costs of obtaining preferences and increase access to preferential treatment the Commission has proposed changing the existing system for presenting proof of origin. At present this is based on a certificate which is signed by the exporter and certified by the competent authority in the developing country. The proposal is to change this to a system of prior registration, by the authorities of the beneficiary country, of exporters who would self-certify their own exports. A potential problem with this system, however, is that any failure in procedures would result in EU importers' paying the full MFN duty and if they perceive that the new system increases the risk of this occurring then this risk premium can be expected to be built into contracts with suppliers in beneficiary countries, resulting in a smaller proportion of the tariff preference accruing in the developing countries. In theory, EU importers could negotiate contracts which shifted this risk to the exporters in the beneficiary country, but in practice there is likely to be uncertainty regarding the enforcement of such contracts. One solution to this dilemma could be to operate a dual system offering the old and new procedures at least until confidence in the new system had been established.

Further Improvements to Unilateral Preferences

The EU's non-reciprocal preferences with the ACP countries under the Cotonou Agreement are at present covered by a WTO waiver. This expires at the end of 2007 and the EU is seeking to replace these preferences with WTO compatible free trade agreements (Economic Partnership Agreements) with six regional groupings of ACP countries. The negotiation of these agreements has, however, proved to be highly contentious. Simulations of possible static welfare effects have indicated small positive effects, or in some cases small negative effects and in all cases smaller gains than from multilateral trade liberalisation.[23] In addition, these estimates do not take into account adjustment costs and the loss of government revenue from import duties. They also assume that the whole of the reduction in tariffs is passed on to consumers in the form

[23] Massimiliano Cali, Dirk Wilem de Velde: The Potential Effects of Economic Partnership Agreements: What the Quantitative Models Say, London 2006, Overseas Development Institute.

of lower prices whereas, in practice, the reverse preferences given to EU exporters by the EPAs are likely to result in a rise in import prices. It is possible that the ACP countries may only have to liberalise around 80% of their imports from the EU and this would enable them to minimise the effects on government revenues and sensitive local industries. Maintaining high tariff items while abolishing duties on low tariff items, however, would increase the degree of effective protection of these items and further distort the allocation of domestic resources. Further difficulties have arisen over the EU insistence on including the liberalisation of services and three of the "Singapore issues" (competition policy, investment and government procurement) in the negotiations, which the developing countries had excluded from the Doha Round, while insisting that aid for adjustment assistance is not part of the negotiations. The four regional groupings in sub-Saharan Africa also cut across existing regional groupings, particularly in Southern and Eastern Africa, while 40 of the 78 signatories of the Cotonou Agreement are least developed countries qualifying for EBA and therefore already have guaranteed quota and duty-free access to the EU. As a result, the EPAs have proved very difficult to negotiate and all but the negotiations with the Caribbean countries are well behind schedule for completion by the end of 2007. Failure to complete the negotiations by this date will mean that the ACP countries will only be able to retain their existing preferences if the EU persuades the member states of the WTO to grant another waiver for Cotonou preferences.

The Cotonou Agreement does include a commitment to examine all possible alternatives to EPAs which provide equivalent preferences and which would be in conformity with the WTO rules (Article 37.6). The most obvious alternative is to align the GSP+ (not available at the start of the negotiations of the EPAs) with those in the Cotonou Agreement, since all of the non-least developed ACP countries are eligible for these preferences providing they agree to the conditions covering the ratification of the regional international conventions. Research by Perez indicates that switching from Cotonou preferences to the GSP would be less costly for most ACP countries than adopting EPAs, while simulation of a Cotonou equivalent GSP indicates that this would be the optimum choice for ACP countries.[24]

Cotonou equivalence needs, however, to be defined with care since the product coverage of a new trade agreement will determine its effects on particular ACP countries. Careful analysis of this requirement by Stevens and Kennan indicates that the required additions to the GSP+ would be small.[25] Preferences for beef, sugar and bananas are significant for particular ACP countries. Six ACP countries have significant concessions for beef exports within country-specific tariff quotas but in practice have been unable to fully utilise their quotas because of both supply problems and difficulties in meeting stringent EU veterinary and public health checks. Sugar quotas are allocated to 16 ACP countries under a separate Protocol to the Cotonou Agreement and are of particular significance to Mauritius, Fiji, Guyana, Jamaica and Swaziland. The legal status of this Protocol is, however, uncertain as the EU contests whether it is of "indefinite duration", while in the absence of a waiver it could, almost certainly, be challenged in the WTO. The value of this preference has also been substantially reduced by the reduction in the CAP price (which has been combined with a switch to direct subsidies to EU farmers) to a level which makes future production for high cost ACP producers problematic. Preferences (within a tariff quota) for banana producers in W. Africa and the Caribbean have been subject to repeated challenges in the WTO from the US and Latin American producers (so called "$ bananas") and the current specific duty on these producers has again been subject to further challenge in the WTO, yet without high levels of protection most of these ACP producers could not compete against "$ bananas" in the EU market. The future for these products is therefore complex but problematic and removing these products together with products where the margin of preference is very small (ad valorem tariffs of 2% or less, or €2 per 1,000 Kg. or less specific duties) reduces the list of non-GSP+ products to a total of 13 items. Extending the GSP+ to this list of additional products may still be contentious but is does indicate that the required change would be marginal. There are, however, other important differences between Cotonou and GSP+ preferences. First, Cotonou provides duty-free access to the EU market unless otherwise stated (positive list) whereas the GSP+ only provides preferential access for the products listed (negative list). Clearly the former has a potentially greater capacity to stimulate trade than the latter. Second, Cotonou is a negotiated agreement between the EU and the ACP whereas the GSP is a unilateral offer. Third, the Cotonou rules of origin allow full cumulation between the parties to the agreement whereas the GSP+ only allows limited diagonal cumulation. The past perform-

[24] Roman Perez: Are the Economic Partnership Agreements a First-best Optimum for the African, Caribbean and Pacific Countries, in: Journal of World Trade, Vol. 40, No. 6, 2006, pp. 999-1019.

[25] Christopher Stevens, Jane Kennan: GSP Reform: a longer-term strategy (with special reference to the ACP), Sussex 2005, Institute of Development Studies.

ance of the ACP states suggests that these constraints are unlikely to be binding, but that may not necessarily hold for the future. The GSP+ could therefore be enhanced by incorporating these characteristics of a negative list for eligible products, full cumulation of origin, and periodic consultation with eligible countries. These measures, together with stronger incorporation into the framework and procedures of the WTO (outlined previously) would increase the effectiveness and security of non-reciprocal preferences. They would also enable the EU to offer a GSP+ which provided a realistic alternative to EPAs for non-least developed ACP countries which did not wish to conclude a free trade agreement with the EU.

Preferences can only stimulate exports where the governments of the beneficiary countries provide a domestic economic environment that is conducive to increasing output, in particular a supportive physical and institutional infrastructure (notably minimal "red tape" and a legal system which supports enforceable contracts) and the ability to obtain intermediate products, used in production, at world prices. Even this environment may not be sufficient to enable small and medium sized enterprises (SMEs) to benefit from preferences each directly as exporters, or indirectly as suppliers to larger enterprises who export to the EU. The support of aid donors for the private sector in recent years has tended to concentrate on support for microenterprise as a means of helping to achieve the Millennium Development Goals, especially in sub-Saharan Africa where performance has been falling well below targets set for 2015. As a consequence, support for SMEs has tended to be neglected. The Cotonou Agreement extended the Lomé convention range of objectives for support for the private sector in the ACP countries channelled, in particular, through the Centre for Development of Enterprises and the European Investment Bank. These objectives are almost totally comprehensive, covering the "four pillars" of: the business environment, economic infrastructure, support institutions, and direct assistance to enterprises. These objectives, however, bear little relationship to the very limited resources of these two institutions, and do not specify the ways in which EU aid is complementary to the development assistance of the EU member states and international institutions such as the World Bank. There is therefore a strong case for these two institutions, and particularly the EIB, to reduce the scope of these activities and to target the last of these four pillars, concentrating their direct financial, technical and commercial assistance on enabling enterprises to benefit from the EU's trade preferences. This support, organised through regional offices, could build on the existing forms of involvement including identifying market opportunities offered by preferences, identifying competitive sources of intermediate products to fulfil rules of origin, assistance with overcoming problems in production and in achieving quality standards in the EU market, advice on financial controls and the negotiation of contracts, organising and controlling shipment, and meeting administrative requirements. Widening this support to include all countries covered by the GSP+ would further enhance the effectiveness of EU non-reciprocal preferences.

Conclusions

The standard analysis of the potential gains from unilateral trade preferences envisages a once and for all gain to the beneficiaries. This, however, ignores the potential growth-enhancing gains from preferences, especially for small economies. Recent theoretical research indicates that just one source of these dynamic gains, "learning by doing" externalities, produces, at the margin, greater welfare gains than an amount of aid equivalent to the tariff revenue forgone by the donor country.

The potential gains from preferences depend crucially on the terms and conditions of the offer, and a sufficient degree of predictability of preferential treatment to persuade traders and investors to increase the total volume of exports, rather than simply substitute existing production between alternative markets. Empirical studies have largely drawn conclusions about unilateral preferences based on the US scheme and have failed to take adequate account of the greater breadth and predictability of the EU schemes (despite its greater importance to developing countries) and have therefore tended to underestimate the trade stimulating effect of preferences. This view is strongly supported by recent empirical evidence both on the EU schemes and in a comparison of the EU and US schemes.

Research on preferences has also largely concentrated on trade effects and there is very little evidence regarding the potentially more important dynamic effects. Evidence for Mauritius suggests that preferences can act as a catalyst for the economic development of a small economy where the economic environment is conducive to the development of the private sector, though they may also, to some degree, have created a "false" comparative advantage and slowed necessary reforms in trade policy. Further research is needed to identify the structural relationships through which preferences affect exports and the general economic

development of beneficiaries, particularly in small economies.

The EU has, in recent years, pursued a policy of improving the breadth and depth of unilateral preferences, while targeting them on those countries which could particularly benefit from preferences as a means of integrating them more fully into the world economy. Analysis of the recent WTO Appellate Body ruling on the EU's special preferences for particular GSP beneficiaries indicates that there is now a strong legal basis for such preferences (as secure from successful challenge as preferences under the EU's existing FTAs with developing countries). The previous view that unilateral preferences have to be offered equally to all developing countries can now be rejected, provided such preferences are based on objective (open) criteria identifying developing countries with particular needs. In conformity with this ruling the EU has introduced the GSP+ and this in turn opens up the possibility of making relatively minor improvements to the product coverage of the GSP+ which could provide an effective alternative to the EPAs.

The Commission's proposed changes to value added criteria for the rules of origin could substantially improve the effectiveness of preferences, but research indicates that achieving this objective will not be easy because the optimal threshold values vary according to the sector of production, the size of the economy and the level of development. This suggest that values need to concentrate on the minimum required to avoid trade deflection and not try and set them at higher levels to encourage increased domestic value added in beneficiaries.

The effectiveness of preferences could be further enhanced by greater coordination between EU preferences and Community aid to enterprises in vulnerable and low income countries so as to increase their capacity to benefit from preferences, particularly in agricultural, horticultural, and processed products.

Globalisation threatens to produce substantial gains for the larger and more economically advanced countries, but at the expense of marginalising small, vulnerable, and low income countries. Preferences offer an effective policy instrument to assist such countries. The effects of bilateral preferences under the EU's FTAs with developing countries are, however, contentious and an enhanced GSP+ offers an important alternative source of non-reciprocal preferential access to the EU market, while at the same time enabling these countries to pursue their own non-discriminatory trade policies.