Overseas Development Institute

OPINIONS

January 2005

www.odi.org.uk/publications/opinions 35

A Preference Erosion Compensation Fund

A new proposal to protect countries from the negative effects of trade liberalisation

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Developing countries which currently benefit from trade preferences will suffer substantial losses if trade liberalisation proposals currently being negotiated are carried through. They should be compensated by creating a special new fund of approximately $500m p.a. for perhaps ten years – a small share of the total benefit to the world from trade liberalisation.

The problem arises because many poor countries currently receive special preferences – for example under the EU Everything but Arms initiative, which provides duty free access to the EU market for the poorest countries. When trade is liberalised, the preferences which they have received will be reduced, and therefore their rents from higher prices and in most cases also the volume of their exports will fall, reducing income.

It used to be thought that the losses were too small to matter. However, the moves since 2000 to improve preferences, particularly for Least Developed Countries, have increased the potential loss. Countries now giving duty and quota free access for all or essentially all LDC exports include Canada, the EU, New Zealand, Norway and Switzerland.

It is in manufactures that there was first awareness of preference erosion. The potential impact on those who gain from the Multi Fibre Agreement in textiles has been known since its end was negotiated in 1994, to take effect in 2005. Mauritius, Bangladesh, Sri Lanka, and the Maldives are likely to be the most serious losers. The major gains will go to India, China, and Pakistan.

More recent work, for example by the IMF, shows that the major losses from further liberalisation would be in agriculture. The principal losers in relative terms would include several LDCs – Malawi, Mauritania, Haiti, Cape Verde, and São Tomé and Príncipe – and among middle income countries, Mauritius and other Caribbean states. The value of the exports lost by all LDCs would total USD530 million (of which USD222 million was for Bangladesh), so that the absolute numbers are not large on a world economy scale. The largest effects from all preferences are in sugar (42 percent of the effect for middle-income countries), bananas (19 percent), and clothing (12 percent). For some, the losses are so high that no feasible improvements in tariffs, services, or rules of origin could offset them.

One argument could be that there is no case for adjustment assistance: the countries knew that their income depended on preferences, and knew that trade policies could change, so their losses could have been anticipated. There are two reasons for rejecting this, one practical, one developmental: the first is that if they are not offered some compensation, they will have an incentive to delay or frustrate a settlement, which will damage other countries' welfare. The second is that they are developing countries and should have some advantage in WTO agreements, particularly in a Development Round.

The calculation of the losses is in principle no different from any other WTO calculation of losses from trade distortions or changes (such as are done when regions form or disputes are settled). The question has been raised of whether the 'loss' should be the total effect of losses from preferences or the net effect (if negative) from all parts of any WTO settlement. i.e. offsetting the preferences lost by any gains on other goods or services. The former would not be consistent with the normal WTO assumption that any deal will represent a mix of losses and gains, but the principle of special and differential treatment for the poorest countries might suggest a more generous interpretation. Countries need non-repayable support in order to be able to make the investments in physical and human infrastructure and in productive capacity to permit alternative production, adapted to the new trading conditions. $500m p.a. seems about right.

Who should pay? The normal WTO answer would be that this is a negotiation question: the countries which are requesting a change in tariffs, in this case principally the non-preferred developing countries, such as Brazil and the G20, along with some efficient developed country producers, like Australia and the Cairns Group, have to make an offer that will secure agreement. But if the Doha Development Agenda is intended to improve the position of developing countries in the WTO, then this problem seems a clear role for it, and the transfer should be made by the developed countries as part of their contribution to benefit both the gainers and the losers among developing countries.

Should the WTO have a financial mechanism? There is no WTO provision which allows monetary compensation, but it has been proposed in the disputes procedures, when there are no obvious retaliatory actions to take. There is a 'public good' argument for an international fund to meet the costs of compensation: removing (or reducing) distortions to trade will improve efficiency and welfare at the world level, and this is an aim to which countries might be expected to contribute according to their incomes or shares in trade. The funds might be administered by aid agencies, because they are the most experienced in this, but the allocation among countries should be clearly on trade criteria, and any conditions on its use within countries based on judgements about what will produce the most efficient and appropriate adjustment, not according to which countries or types of spending most 'deserving' on normal aid criteria.

Where should the money come from? As with other 'public goods', and a fortiori other WTO penalties, it would be wrong to consider this an aid payment. If we take a normal aid or development approach, making transfers to countries according to the degree of preference that they enjoyed in the past does not meet any criterion for aid, whether to encourage development or to reduce poverty. As those who reform their agricultural systems will have both budgetary savings and national income gains, it is not inevitable that the money should come from current aid budgets.

The length of the transition period can be debated: the MFA was given 10 years adjustment; internal adjustments in countries are sometimes much faster; restructuring an entire economy dependent on a single agricultural commodity for most of its exports is unlikely to be accomplished as rapidly as moving to or from clothing production. Ten years seems plausible. However, whatever the period, the arguments for certainty override those for flexibility: payments should decline in a pre-determined way.

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