Testimony
United States Senate Finance Committee
Hearing on "U.S. Preference Programs: How Well Do They Work?"
May 16, 2007

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Mr. Chairman, Senator Grassley, and other distinguished members of the Committee, thank you for the privilege of speaking with you today about this important subject.

1 Introduction

For over thirty years, the United States has offered unilateral trade preference programs as the cornerstone of its efforts to improve economic growth and development in poor countries around the world. These programs include the Generalized System of Preferences (GSP) as well as more recent additions, such as the African Growth and Opportunity Act (AGOA) and the Andean Trade Promotion and Drug Eradication Act (ATPDEA). They are designed to help developing countries increase their exports and reap the benefits of globalization. The question I would like to address today is this: do they work?

At first glance, this may seem like a superfluous question. After all, preference program beneficiaries are eligible to export thousands of products to the US with zero tariffs. This is often a better rate than the one other suppliers of the same products face when selling to the US market. How could preference programs *not* work?

Helping poor countries grow through trade is vitally necessary, both ethically as well as for the longer-term interests of the United States. Nonetheless, I will argue that, *measured against their own stated objectives*, unilateral trade preference programs are not effective. On the contrary, they have proved to be counterproductive in many cases because they forsake the core features of the successful global trading system: reciprocity, non-discrimination, and enforceable legal bindings. Unilateral preference programs thereby institutionalize perverse incentives that inhibit the growth of trade on the part of beneficiary countries. I emphasize that this critique applies equally to the preference programs maintained by the European Union and other developed countries as well. To correct these problems, I advocate a shift to full WTO trade relations with GSP beneficiaries, with (a) WTO commitments to zero duties on all GSP-eligible tariff lines, on a most-favored-nation (MFN) basis, enforceable through standard WTO procedures; (b) at least modest new MFN concessions by the US on key products with the greatest export potential for GSP beneficiaries; (c) linking these WTO concessions to reciprocal liberalization by GSP beneficiaries; (d) after that, the elimination of GSP.

[1] The research upon which this testimony is based was co-authored with Dr. Çaglar Özden. I would also like to thank Prof. Marc Busch of Georgetown University for helpful comments.

2 The Political Economy of Nonreciprocal Trade Preferences

To start, let me draw a comparison. A world without GSP-style preferences would be one in which US trade relations with developing countries would be framed by rules and commitments within the World Trade Organization (WTO). The WTO framework is distinguished by the principles of (a) reciprocity, (b) nondiscrimination, and (c) enforcement through the rule of law. That is, members concede to lower their own trade barriers only because others do the same. They agree in principle to apply the same terms of market access to all producers of 'like' products. Thus no country need fear that the access to a partner's market that it has negotiated will be undermined by better terms offered to a subsequent party. And each country has recourse to a robust dispute settlement mechanism to ensure its trading partners live up to their end of the deal. These features allow member-states to confront the political challenges of freer trade more effectively, realizing greater gains from the process, and making private traders and investors more confident that the policy environment will not shift beneath them. An institutional framework like the WTO's helps make freer trade "good politics" as well.

Where do trade preference programs such as GSP fit into this picture? The key to understanding the impact of such programs is that they establish a trade relationship which explicitly *waives* the three principles that make the WTO so effective. The result is a system of trade relations falling outside of the WTO's rule of law. This yields a "perfect storm" of perverse incentives, which make exports more costly and risky for beneficiary countries. Needless to say, this is not a system in which a fledgling export economy can thrive. Let me explain, taking each of the three structural problems in turn.

2.1 Problem # 1: preferences are nonreciprocal

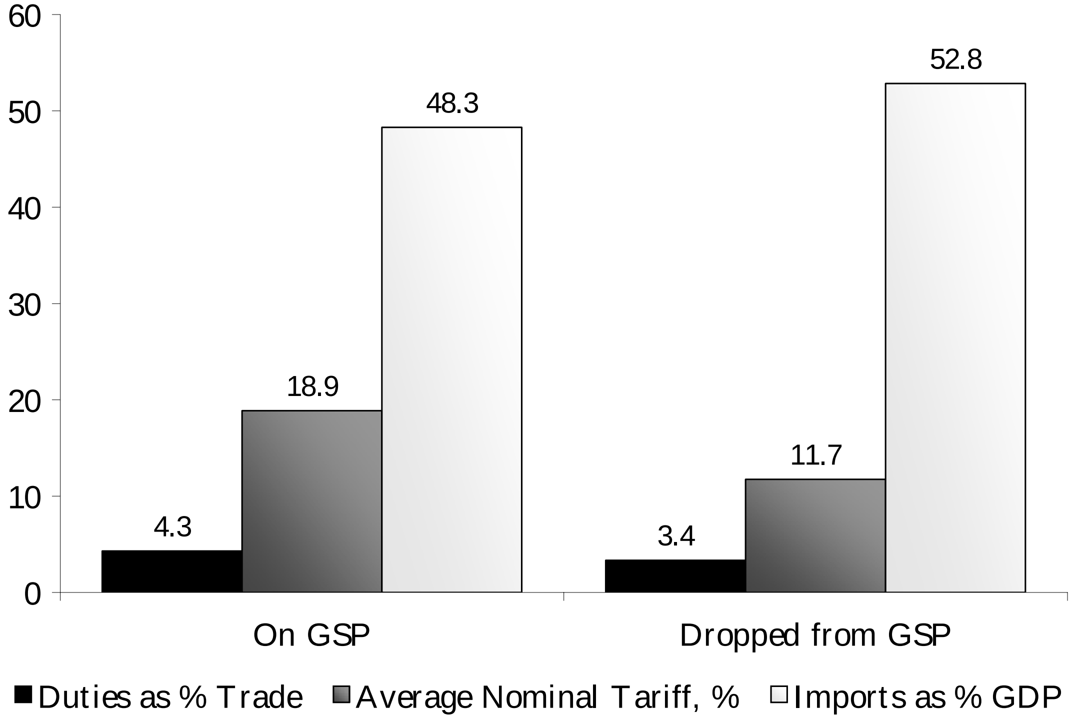
The first problem is that GSP-style preferences are not reciprocal. Beneficiaries receive access to the US market without being required to reduce their own trade barriers in return. This has several damaging consequences. Specifically, because US tariffs will be zero regardless of its own government's trade policy, the export sector in a beneficiary country has little incentive to lobby for freer trade at home. As a result, their own import sectors remain protected and consume resources that would otherwise be devoted to more productive activities, where they have comparative advantage. This makes a beneficiary country's economy less efficient and decreases its export potential.

Consider the case of Chile. This example comes close to a "smoking gun" in support of my claim. Chile was suspended from the GSP at the beginning of 1988 for violating internationally recognized worker rights as the Pinochet regime stalled the last stage of democratic transition. Its GSP status was later restored in 1991, after democratic elections had occurred. What happened to its trade policy in the interval? Just days after the GSP withdrawal, Chile's Finance Minister Hernan Buchi announced that the formerly "sacred" 20 percent nominal tariff would be cut to 15. He stated explicitly that the cut aimed to lower the burdensome imported input costs for Chilean exporters, to compensate for the loss of GSP duty-free status in the US market. As a result, Chilean exports immediately shot up by 30 percent that year. Chile cut its tariff another 4 points, down to 11 percent, by the year its GSP eligibility was restored. The suspension of GSP had a great deal to do with the timing and extent of Chile's move towards trade liberalization.

Korea offers a similar lesson. Korea was included in the first wave of countries to be 'graduated' from GSP, in 1989. For years prior to that, it had not undertaken significant reductions in its own barriers to imports. Prompted by the withdrawal of GSP, however, within a few years it slashed its own tariffs to about half their prior level, and cut them further in the form of concessions in the Uruguay Round of WTO negotiations. Its export performance has improved markedly since then as well.

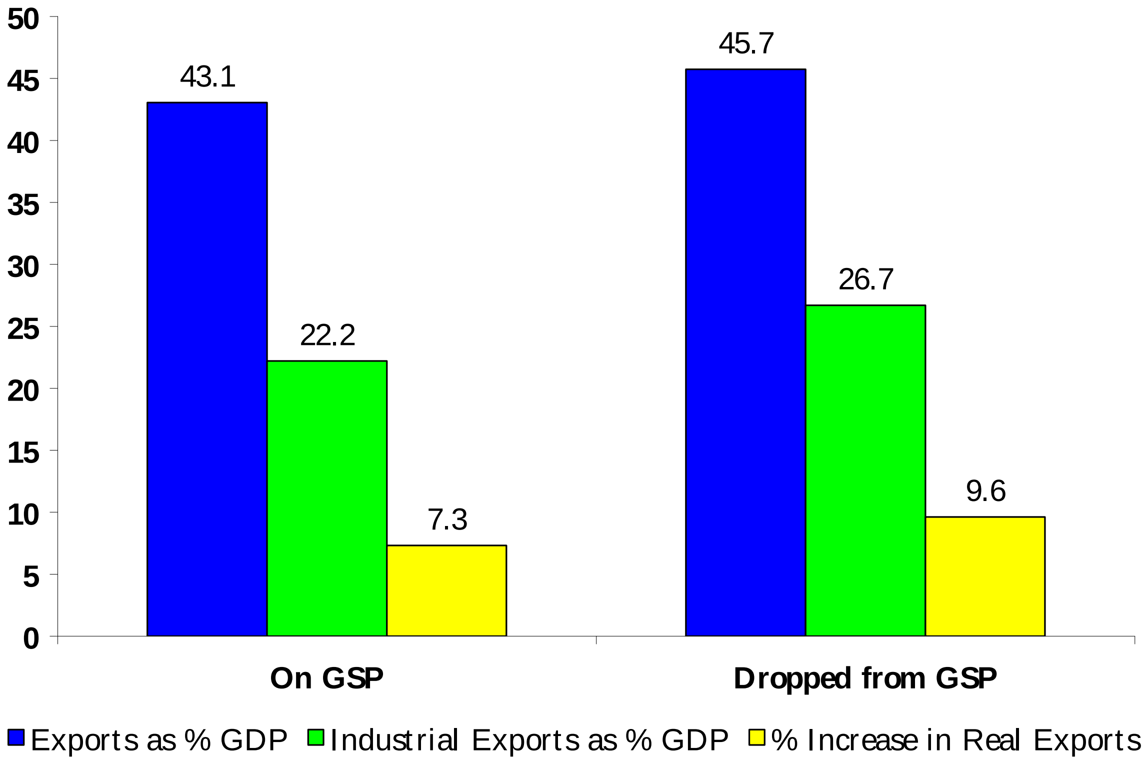
This pattern is evident in the experience of the dozens of other countries whose GSP eligibility was removed at some point between 1989 and 2000. What happened to these countries' own tariffs once they were removed from the US GSP program? Figure 1 gives the answer, comparing indicators of 27 of these countries' own openness to imports, averaged over five-year periods before and after the withdrawal of GSP. Just like the case of Chile above, these countries' tariffs dropped from about 19 percent to 12 percent, on average, in the years after GSP withdrawal. This comparison does not even factor in the tariff averages of countries never removed from the program. Their trade barriers are typically even higher.

Figure 1. Average Annual Trade Policy Indicators, Five Years Before and After GSP Withdrawal, 27 Dropped Countries



What happened to these countries' exports once they were withdrawn from the US GSP program? Figure 2 shows the results of another before-and-after comparison for five-year periods around the time of GSP withdrawal for 30 countries. Many, though by no means all, of the countries dropped from the program have been the export success stories in the developing world, and we would expect them to have fast-growing exports prior to withdrawal of the benefits. But, surprisingly, their exports do not slow down after their removal from the program. Rather, their export growth rate increases from 7.3 to 9.6 percent annually – and this is a pattern echoed even in their exports to the United States. This is clearly a function of the reduced costs exporters face when they can *import* more affordably, which is what happens when GSP removal inspires their governments to cut tariffs.

Figure 2. Average Annual Export Performance Indicators, Five Years Before and After GSP Withdrawal, 30 Dropped Countries



The nonreciprocal nature of GSP-style preferences has two other damaging consequences. If the beneficiary developing country is not itself liberalizing, then industries in the United States that could benefit from more exports to that developing country do not gain from the arrangement. They thus lose the incentive to support trade barrier reductions by the United States in areas of greatest interest to poor countries. This skews the representation of economic interests within the United States – with respect to decisions about GSP – towards those with protectionist demands. Hence nonreciprocal preferences tend to *exclude* the areas in which developing country beneficiaries have the *greatest comparative advantage*. Products like leather and footwear, textiles and apparel, and ceramics and glassware are mostly ineligible for preferences under the US GSP program. In the year 2000, just 47 percent of the $175.6 billion of US imports from GSP beneficiaries were in tariff lines listed under the program. The nonreciprocal nature of GSP thus works against the efficient allocation of resources by the market, stimulating poor countries to engage in less productive economic activities.

The nonreciprocal feature of GSP also makes developing countries more reluctant to fully engage multilateral trade liberalization negotiations at the World Trade Organization (WTO). Many developing country proposals in the Doha Development Agenda negotiations now stalled at the WTO have put least priority on multilateral liberalization. If the European Union, for example, significantly reduced its remaining barriers to imports from all WTO member-states, that would effectively undermine the margin of preference received by the beneficiaries of its GSP-style arrangements. Preference schemes thus convert beneficiary developing countries from active supporters of MFN liberalization to active opponents of it. Collectively, however, by leveraging the prospect of their own *reciprocal* liberalization, the largest GSP recipients could act as a powerful market group to help overcome roadblocks to the agreement on the part of the European Union and other developed members. The WTO institution's principle of nondiscrimination is in place to ensure that all parties have the right incentives in such negotiations. Global GSP arrangements nullify this potential benefit of the WTO and have much to do with the lack of progress in WTO talks today.

2.2 Problem # 2: preferences are not legally bound

The second structural problem is that nonreciprocal trade preferences lie outside of the international framework of legal rights and obligations provided by the WTO or other free trade agreements (FTAs). Consequently, the market access these preferences nominally provide is not guaranteed; it is subject to unilateral removal. If a country's exports to the United States under the program become sufficiently competitive, it is inevitable that US groups harmed by those exports will appeal for cessation of the preferences. This, of course, can happen even before the exporter bumps up against the current statutory "competitive need limit" threshold. When domestic groups lobby for removal of a product or country from GSP eligibility, those benefits are more easily cut, because they are not legally protected by any trade agreement. Even if they are not removed, the constant cloud of uncertainty about the status of preferences hangs over an exporter's head. GSP thus offers a better margin of preference but at a much higher risk than would exist under a WTO- or FTA-governed relationship. This dampens investments necessary for long term export-led growth and depresses the beneficiary's potential exports.

Take the case of Cambodia and Bangladesh. *Non-GSP* imports to the United States from these two "least developed countries" experienced real growth of 127 and 16 percent, respectively, from 2000 through 2006. Yet imports under the GSP program grew at *less than half* those rates in that same period. Indeed, Cambodia's top-selling

GSP product in 2006 was gold or platinum jewelry, but GSP exports of that product to the US *dropped* by 50 percent from 2000 to 2006. Exports of Bangladesh's top GSP product, golf club parts, similarly plummeted by 46 percent during that interval. Because non-GSP-eligible sectors are not faced with the same doubts about the sustainability of access to the US market, they end up being more dynamic and faster-growing than GSP-eligible sectors.

In practice, the upper limits on GSP eligibility by statute and, more importantly, by anticipation, constitute a powerful constraint on the scale of business organizations that export under the program. This is of course not the case for US importers of GSP-eligible products, which are in many cases multinational conglomerates. As a result, in GSP-eligible sectors, suppliers in beneficiary countries often have a chronic capacity disadvantage in negotiating contracts with US importers. This means that US firms are able to extract a large portion of the profit due to the GSP margin of preference. This is not necessarily a bad thing from the short-term US perspective. However, it does undermine the program's effectiveness in achieving its stated goals.

The impact of AGOA on export prices in apparel serves as an example. As one study[2] showed, the export prices of AGOA-eligible products rose an average of 6 percent in the years after the program took effect in 2001. The margin of preference, comparing the average MFN tariff to the zero duty rate under AGOA, was about 20 percent, in these tariff lines, however. So African suppliers obtained only about a third of the profits to be had from the program. This is hardly likely to stimulate long-run export growth.

2.3 Problem # 3: preferences are discriminatory

The third structural problem with trade preference programs is that they are inherently discriminatory, to use the language of international trade law. They accordingly create artificial incentives to allocate resources to activities in which eligible countries do not have comparative advantage. Indeed, when external policy conditions change — for example, when global textile and apparel quotas are removed, or when other countries become eligible for preferences, too — a beneficiary country ends up with investments sunk into an economic activity that is no longer sustainable in genuinely competitive world markets. Some observers, for instance, have raised questions about the sustainability of apparel exports under the Andean preference program, once quotas limiting imports from China are relaxed in 2008. A fragile discriminatory preference is not a sound basis for building a viable industry capable of competing effectively in world markets.

The discriminatory nature of unilateral preference programs has another downside as well. Discrimination opens up the possibility for ineligible suppliers to circumvent tariffs by transshipment through a country eligible for the preferences. To prevent this, discriminatory trade systems need to use rules of origin. But complying with complex rules of origin is particularly costly for many small developing country exporters.

[2] Marcelo Olarreaga and Caglar Ozden, "AGOA and Apparel: Who Captures the Tariff Rent in the Presence of Preferential Market Access?", *World Economy* 28:1 (2005), 63-77.

Indeed, rules of origin for the US GSP program add such a large processing cost to using the system that many eligible suppliers simply opt to market their products without taking advantage of the preferences at all. Indeed, the utilization rate – the share of imports of eligible products actually entering under the GSP preference – is *less than a third* for most products.

Consider the case of AGOA. Just 7 of the 36 beneficiary countries of this program account for 99 percent of AGOA apparel imports into the US. Why? The remaining countries in eligible for AGOA, which are mostly French-speaking, typically lack English-speaking accountants and lawyers to guide them through the necessary rules of origin paperwork.

3 Moving Forward

I have argued that special trade preference programs, despite the best of intentions, are ineffective, because of the way they abandon the key institutional features that make international trade agreements succeed. Without reciprocity, nondiscrimination, and legal bindings, GSP and similar preference programs create perverse incentives for all parties that reduce the export potential of beneficiary countries.

I would like to emphasize again that the problems I have mentioned are not unique to the United States GSP system. Other donor states' preference schemes have similar features, with similar results.

How can we improve the existing preference programs to make them more effective? My argument suggests a particular answer to this question. Namely, the goals of the programs would be best served if the United States shifted its trade relations with beneficiary countries fully into the normal practices of the WTO system. Developing countries on the program will benefit most if they "pay to play," reducing their own, often quite large, trade barriers in order to gain access to developed country markets. This should provide extra inducements for developed country donors, such as the United States, to liberalize more fully in sectors (e.g., agriculture, textiles and apparel, etc.) in which developing countries have the greatest comparative advantage. An extra benefit for the United States would be the additional leverage that could be brought into play, vis-à-vis the European Union and other advanced industrial countries, in the ongoing Doha Development Agenda trade talks.

Two alternative reforms are conceivable. First, beneficiary countries have long pushed for an approach that would correct just one of the three structural limitations I have identified with GSP. Specifically, they have often proposed explicitly incorporating GSP and related preferences within the system of legally binding WTO commitments. I argue that such a corrective measure would be a mistake and would provide only marginal improvements by itself. This is because it would do nothing to reduce a beneficiary's own levels of trade protection, nor to encourage donor states to liberalize in sectors where poor countries have the greatest potential export gains. It would also not eliminate the costly rules of origin problem. Finally, it would not reduce the uncertainty that potential exporting firms face under preference arrangements, because the value of their preferences could always be undermined by subsequent discriminatory market openness decisions by the donor with respect to third-party countries. Legal bindings by themselves are not a panacea.

Second, there is always the option of simply eliminating the preferences "cold turkey." This, too, would be inadvisable in my view, even outside of the considerable costs for the United States of the ensuing loss of goodwill on the part of developing countries around the world. If the goal is to help poor countries develop by encouraging their exports, then the United States (and the other advanced industrial nations, even more so) needs to maintain, and significantly increase, its openness to imports in sectors in which those countries have the greatest comparative advantage. My point is that this is best accomplished through a reciprocal and nondiscriminatory system, especially that of the WTO. In that multilateral setting, there are greater gains to be had for US exporters. This could come partly from additional access to developing country markets that would be forthcoming under a reciprocal approach. But it also could come from any additional leverage the United States might get, vis-à-vis our fellow industrial nations, from the greater role developing countries might play in multilateral trade talks. In any case, shifting from a preference-based to a WTO-based trade relationship with developing countries offers the greatest promise for improving their exports and their broader integration into the world economy.

I would like to thank you once again, Mr. Chairman and Senator Grassley, for the opportunity to speak to this important question in this forum.

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