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CRITERIA FOR GRADUATION UNDER THE GENERALIZED SYSTEM OF PREFERENCES (GSP)

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The views expressed in this study are those of the author and do not necessarily reflect the views of the UNCTAD secretariat.

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INTRODUCTION

1. The mandate for this study on graduation is provided in paragraph 2 of annex I of the report of the Special Committee on Preferences on its twenty-first session and detailed in paragraph 8 of the Chairman's summary.

2. Graduation must be considered in connection with the objectives of the GSP, namely to increase export earnings, to promote industrialization, and to accelerate economic growth. Thus, the ultimate aim of the GSP is to achieve economic development through industrialization which, in turn, is to be assisted by preferential access to markets of preference-giving countries.

3. Achieving these objectives will occur in stages beginning with the development of competitive industries in standardized manufactured products. As a particular beneficiary country becomes competitive in a given industry, the need for GSP preferential treatment will gradually disappear for the products of that industry and can be withdrawn without adverse effects on the exports of that beneficiary country.

4. However, this does not mean that the country is developed; it is developed regarding that industry but not other industries. GSP treatment for other products will contribute to achieving competitiveness in additional industries. The industrial sector will broaden to include a wider range of industries. Ultimately, the country will become competitive in a wide range of industries comparable to that enjoyed by developed countries. Once a high level of development has been achieved, preferential treatment is no longer warranted.

5. Thus, there are two concepts of success which warrant the withdrawal of preferential treatment, i.e. graduation. The first is industry-specific competitiveness that warrants graduation for products in that industry exported by the successful preference-receiving country, i.e. partial graduation.[1] The second is pursuant to the achievement of a high level of economic development that warrants graduation from preferential treatment for all products, i.e. full graduation.[2]

6. This paper contains four sections. Section I introduces the concept of graduation and distinguishes graduation techniques from other measures designed to safeguard import-sensitive industries in the preference-giving countries. Section II provides a review of the graduation provisions under the various GSP schemes. Section III suggests and analyses alternative criteria for graduation, with an emphasis on objective criteria. The findings of this study as well as some recommendations are contained in section IV.

I. THE CONCEPT OF GRADUATION

7. The concept of graduation has several meanings in the context of international trade. Part IV of the General Agreement on Tariffs and Trade (GATT) contains an enabling clause to provide for differential and more favourable treatment for developing countries.[3] This clause is quite flexible and might be used by a developed country to provide preferential treatment including tariffs and non-tariff measures for selected developing countries or for developing countries in general.

8. At the same time there is pressure for the developing countries to accept greater discipline and responsibility. Depending upon the stage of development, individual developing countries are to bring their trade regulations increasingly into compliance with GATT rules. A similar philosophy applies under the new World Trade Organization (WTO). For example, developing countries are given longer periods of time to bring their trade-related investment measures (TRIMs) into consistency with the WTO rules; specifically, inconsistent measures of developed countries must be eliminated within two years, within five years for developing countries and within seven years for least developed countries.[4] Regarding subsidies, developing countries are granted an eight year period to phase out existing prohibited subsidies.[5]

9. In this context graduation means that a developing country's preferential treatment, i.e. accepted variances from compliance with internationally agreed rules, has been eliminated. Thus, the trade regulations of graduated countries are in full compliance with WTO accords.

10. The concept of graduation is different under the GSP. The GSP is a system of preferential tariff reductions to promote exports from developing countries. It is a non-reciprocal programme to assist developing countries. The preference-giving countries consider the GSP to involve unilateral concessions that impose costs on the preference-giving countries. In particular, the preferential tariff reductions of any particular preference-giving country create incentives for all beneficiary developing countries to divert exports to that country. Such a surge in imports might cause injury to that preference-giving country's import-competing sector.

11. One technique to minimize the incentives for trade diversion is for all preference-giving countries to participate in a common generalized system of preferences, i.e. with identical product coverage, GSP tariff reductions, rules of origin, etc. However, the individual preference-giving countries have different import-competing concerns and, consequently, could not agree on a common system. Thus, the GSP programme includes different GSP schemes for each preference-giving country, with the European Union member States participating in a common scheme.

12. This fear of possible trade diversion was expressed as a concern among the preference-giving countries that the costs be equitably shared, i.e. burden sharing. This concept of burden sharing became the rationale for the introduction of safeguards that were actually designed to protect domestic producers in the preference-giving countries from undue import competition stimulated by GSP tariff reductions.[6]

13. The safeguard measures took on a number of different forms:

- the exclusions of import-sensitive products from the GSP programme, i.e. product exclusions;

- quantitative limits on the total volume of imports of a particular product from all beneficiaries combined that would receive GSP tariff reductions -- imports in excess of the limit would be charged MFN tariff rates, i.e. product limits;

- quantitative limits on the volume of imports of a particular product from individual beneficiary countries that would receive GSP tariff reductions -- imports in excess of the limit would be charged MFN tariff rates, i.e. product-country limits; and

- the withdrawal of GSP treatment in cases where GSP imports cause injury to a domestic industry, i.e. an escape clause.

14. The objectives of these safeguard measures were to protect domestic industry in preference-giving countries not to graduate beneficiary countries on the basis of economic development criteria.

15. From the beginning the GSP scheme of the United States included a unique provision designed to gradually phase out GSP treatment on a country-by-product basis.[7] Whenever a beneficiary country successfully exported a GSP eligible product to the United States (in value or in market share), GSP treatment would be terminated.[8] Future imports of the product from the country would be charged the MFN tariff rate. In effect the product was graduated from the United States GSP programme for that particular beneficiary country. Other beneficiary countries would continue to benefit from GSP preferential tariff

reductions on exports of that product and the particular beneficiary country would continue to enjoy GSP treatment on other eligible products. This type of graduation will be referred to as ***partial or country-product graduation***.

16. The agreement leading to the establishment of the GSP schemes envisaged a programme that was non-reciprocal and would have a finite duration, initially for ten years. By the end of the initial 10-year period the objectives of the GSP had not been achieved. Consequently, the schemes were renewed and are likely to be renewed for a further decade. However, some of the beneficiary countries have achieved remarkable success; many question whether continued preferential treatment for these countries is warranted. Some preference-giving countries have introduced criteria to remove the more advanced developing countries from their GSP schemes entirely. This provision will be referred to as ***full or country graduation***.

17. Partial graduation and full graduation should not be viewed as competing concepts of graduation. There is a role for each of these graduation concepts. Experience has demonstrated time and again that a particular beneficiary country can develop an internationally competitive industry without achieving a stage of development comparable to those of developed countries. Moreover, it is not uncommon for a country to first become internationally competitive in those segments of an industry that are at the lower edge of technological sophistication. In cases of true international competitiveness, the country is able to export without preferential treatment. In such instances, country-product graduation is appropriate. However, the fact that a country is competitive in one narrow product sector does not mean the country has achieved the status of a developed country. In such cases country graduation is not warranted.

18. Over time, a country that is competitive in the exportation of a low value added product might be expected to develop competitiveness in more sophisticated and higher value added products in the same industry. There are numerous examples of countries that first became competitive in low-quality textile products but now export up-scale apparel products. But this does not mean all of these countries are developed countries. Nevertheless, it is hoped and expected that some developing countries will succeed, i.e. achieve a capability of exporting a wide range of sophisticated products. Whenever a beneficiary developing country achieves a stage of development comparable to that of the preference-giving countries, country graduation is appropriate. But country graduation requires more than a capability to export. It must reflect a stage of development and an ability of the economy to generate a standard of living comparable to that enjoyed by citizens of the developed countries.

19. Simply stated, there is a role for country-product graduation and there is a role for country graduation. Moreover, since country graduation is equivalent to joining the ranks of the developed countries, it should also be equivalent to joining the ranks of the preference-giving countries.

II. GRADUATION PROVISIONS IN FORCE

20. The GSP was initially envisaged as a programme of limited duration. Consequently, none of the initial GSP schemes included provisions for country graduation. There were instances in which developing countries claimed beneficiary status under the self-election principle but were denied beneficiary status under particular GSP schemes.[9] But these cases were not the result of country graduation criteria; they were the result of political realities.[10] On the other hand, the initial GSP scheme of the United States included competitive needs criteria for the phase-out of GSP treatment for the more competitive beneficiary developing countries. The phase-out was accomplished by withdrawing GSP treatment only for those products in which the beneficiary country was judged to be competitive in the United States market, i.e. country-product graduation. Some of the other GSP schemes included safeguard provisions using quantitative limits that operated somewhat like the United States country-product graduation provision.

21. This section will be divided into two parts: the first part will examine the alternative methods of partial graduation (broadly defined) and the second part will examine full graduation provisions which have been introduced as individual GSP schemes have been renewed.

1. Partial graduation

22. The GSP scheme of the United States included competitive need criteria that were administered on a country-by-product basis. These criteria included a value limit (US$ 25 million with a growth factor equal to the percentage growth in United States GNP since 1974) and a share limit (50 per cent of United States imports of the product).[11] If United States imports of a particular product from a given beneficiary country exceed the value or share limit for a calendar year, preferential treatment would be terminated at the beginning of the following GSP year (currently 1 July to 30 June).[12] Preferential treatment might be reinstated if, during a subsequent year, United States imports of the product from the beneficiary country did not exceed the value or share limit.[13]

23. The GSP schemes of the European Union and Japan contain ceiling limits for products based upon import volumes and import sensitivity. GSP imports from all beneficiary developing countries combined are monitored. Imports entering the European Union or Japan below the ceiling limits receive preferential tariff treatment; imports in excess of the ceiling limits are charged MFN tariff rates.[14] These schemes also contain maximum amount limits which are administered on a country-by-product basis.[15] As with ceilings, whenever imports from a particular beneficiary developing country exceed a maximum amount limit, MFN tariff rates are charged. Since GSP treatment does not apply on any increase in imports, GSP does not provide incentives to expand trade. As such, these ceiling and maximum amount provisions are often referred to as country-product graduation. But in reality the ceiling provisions are primarily safeguard measures and not graduation measures.

24. On the other hand, the maximum amount limits affect only the more effective exporting beneficiary countries and only those products that are effectively exported to the European Union or Japan. Consequently, the maximum amount limits operate much like country-product graduation. The primary difference is that GSP treatment is not withdrawn, it is frozen at the maximum amount limits; imports below the limits continue to receive GSP preferential tariff reductions. To the extent that the more competitive beneficiary developing countries are increasingly bound by maximum amount limits, the growth of their GSP exports would slow compared to that of other beneficiary countries. The effect would be a gradual phasing down of the share of GSP trade originating in the more competitive beneficiary countries.[16]

2. Full graduation

25. When the United States GSP programme was renewed in 1986, it contained a new provision to remove beneficiary countries from the list of countries eligible for GSP treatment.[17] The criteria for identifying countries to be graduated is based on GNP per capita; GSP treatment is to be eliminated over a two-year period when a beneficiary country's GNP per capita exceeds a calculated limit which is currently US$ 11,400.[18] Countries graduated under this criteria include Bahrain, Bermuda, Brunei Darussalam and Nauru; Israel is to be graduated by 1995.[19] The United States has also removed four beneficiary countries from its GSP scheme under the discretionary authority of the President to establish the list of countries eligible for GSP treatment; beginning in 1989 imports from Taiwan Province of China, Hong Kong, the Republic of Korea and Singapore were no longer eligible for GSP preferential treatment on any products exported into the United States.[20]

26. Other preference-giving countries with country graduation provisions based only on per capita GNP include Bulgaria, New Zealand and Poland. Bulgaria and Poland graduate beneficiaries having per capita GNP in excess of their own per capita GNP. New Zealand graduates beneficiaries having per capita GNP in excess of 70 per cent of New Zealand's per capita GNP.[21]

27. The European Union reintroduced its GSP scheme beginning 1 January 1995

with significant revisions. The new scheme does not include ceiling or maximum amount limits. It does include two provisions to deal with import-sensitive products. First, the GSP preferential margins will be smaller for sensitive products than for non-sensitive products. Secondly, there is a traditional safeguard provision to withdraw GSP preferential tariffs if GSP imports cause injury to domestic industry. On the other hand, when GSP applies, it will apply without limit. Moreover, unlike the previous scheme which was authorized for one year at a time, the new scheme is envisaged to operate unchanged for four-year periods.

28. The new GSP scheme of the European Union also includes a graduation provision. The underlying philosophy of the new scheme is that the GSP is to be a development tool aimed to benefit the neediest developing countries, i.e. the poorest. At the same time, it recognizes that even the more competitive developing countries might not be internationally competitive in all industrial sectors. Consequently, the renewed GSP does not presently contain any provision for country graduation.[22] It does, however, include provisions for country-sector graduation. Graduation is based on objective criteria which aim to determine whether the particular developing country continues to require GSP treatment to remain competitive in the particular industry or sector.

29. The country-sector graduation criteria include level of development and sector specific specialization. The development index is based on per capita income and exports of manufactured products; the specialization index is based upon competitiveness in the sector market.[23] There is also a share limit for graduation. Country-sector graduation will be introduced whenever a single beneficiary accounts for more that 25 per cent of total GSP imports of any sector. There are also two *de minimis* clauses under which country-sector graduation will not be enforced. Beneficiary countries with a low level of development (i.e. a development index of less that -2) and countries which account for a small share of GSP imports in the sector (i.e. not more than 2 per cent) are exempt from graduation.

30. Since the graduation system of the European Union scheme is new and different from any existing graduation mechanism, additional comments are in order. This is not an attempt to evaluate the new system. The graduation mechanism is based on objective criteria with a phase-out period. These are two very good characteristics. Evaluation must wait until experience is obtained with this new graduation mechanism.

31. The European Union has identified 37 beneficiaries for possible country-sector graduation.[24] The development index is used to classify these countries into four groups. An illustrative grouping of some of the countries and territories has been provided by the European Union, as follows: Group #1: Hong Kong, Republic of Korea and Singapore; Group #2: Brazil, Malaysia, Mexico, Saudi Arabia and Thailand; Group #3: Argentina, China, India and Indonesia; Group #4: Chile, Oman and Pakistan. Countries in Group #1 are likely to experience significant graduation. They will be graduated for products in any sector in which their sectoral index exceeds one, i.e. whenever their share of European Union imports in the sector exceed their average share of total European Union imports, provided they exceed the *de minimis* limits.[25] Countries in Group #2 will be graduated for products in any sector in which their sectoral index exceeds 1.5. Countries in Groups #3 and #4 have much higher graduation thresholds; the sectoral indices must exceed 5 and 7, respectively. Countries in the latter two groups will be graduated only for sectors in which their exports to the European Union are very heavily concentrated.

32. The country-sector graduation mechanism is unlikely to affect significantly any country classified by the World Bank as a low-income country other than the very large countries, i.e. China, India, Indonesia and Pakistan. Countries classified as lower-middle-income countries (i.e. GDP per capita up to US$ 2,500 in 1991) are also unlikely to be seriously affected, with the possible exception of Malaysia which ranks at the very top of the lower-middle-income category. It appears that the graduation mechanism will only affect the very large and the high income beneficiary developing countries. This analysis does not take into consideration the second graduation mechanism, namely when

GSP imports of products in a sector from a single beneficiary exceed 25 per cent of total GSP imports in the sector; this criterion is expected to have limited impact in practice except for China. The analysis also ignores the extent to which the *de minimis* criteria will prevent sector-product graduation.

III. ALTERNATIVE CRITERIA FOR GRADUATION UNDER THE GSP

33. In discussing alternative criteria that might be used for full and partial graduation, it is first important to separate the concept of graduation from that of safeguarding domestic industry. The role of graduation is to phase-out preferential treatment when it is no longer warranted, i.e. when the beneficiary country is able to compete in world markets without preferences. The role of a safeguard is to remedy situations in which preferential imports cause injury to domestic industry. Without effective safeguards, it would be difficult to build the political consensus in the preference-giving countries necessary to enact GSP schemes.

34. There are roles for both graduation mechanisms and safeguard measures within the context of GSP schemes. But the roles are clearly different. Each should be based upon appropriate objective criteria. Safeguard measures should be based on criteria that establish linkages between GSP imports and injury to a domestic industry in a preference-giving country. Graduation measures should be based on criteria which demonstrate that a particular beneficiary country no longer needs preferential treatment to compete in export markets in general (i.e. full graduation) or for particular products (i.e. partial graduation).

35. The country graduation provisions in the GSP schemes of Bulgaria, New Zealand, Poland and the United States are all based solely on per capita GNP. Per capita GNP is not a sufficient criterion to demonstrate that preferential treatment is no longer needed. There are several high-income developing countries that are not industrialized, have very concentrated export sectors or are not successful exporters of manufactured products, e.g. Argentina, Botswana, Gabon, Oman, Saudi Arabia, Trinidad and Tobago and Venezuela. Nevertheless, per capita GNP is certainly an objective criterion that is independent from safeguard measures and might be appropriate when used with other objective criteria related to the objectives of the GSP.

36. The country-product graduation provision included in the United States “competitive need criteria” is based on the export performance of beneficiary countries. The new European Union scheme has criteria for country-sector graduation that are somewhat more complex; the criteria include per capita GNP, the performance in exporting manufactured products, and the concentration of exports by sector. All of these criteria are objective and independent from safeguard considerations.

37. We now turn to suggested alternative objective criteria that might be used for full graduation or partial graduation. These criteria will not embody any safeguard objectives; it is assumed that safeguard objectives are to be addressed by other provisions in the GSP schemes offered by the various preference-giving countries. Full graduation and partial graduation will be discussed separately, beginning with partial graduation.

1. Partial graduation

38. The existing graduation provisions of the United States and European Union include as one criterion the “share of GSP imports”. This withdraws preferential treatment from beneficiaries that account for a significant share of GSP imports for any given “product”. Under the new scheme of the European Union, GSP treatment is to be withdrawn when GSP imports from a particular beneficiary country of products in a broadly defined sector exceed 25 per cent of total GSP imports in the sector. Under the United States scheme, the threshold share is normally 50 per cent of GSP imports of products defined under a much narrower tariff line category; the threshold is reduced to 25 per cent for selected competitive beneficiary countries.

39. This criterion, the share of GSP imports supplied by a single beneficiary country, is not sufficient to determine whether a beneficiary is a competitive supplier. In practice, it is designed to achieve benefit sharing. However,

empirical studies have revealed that withdrawing GSP preferences from the more effective exporting beneficiaries does not significantly increase GSP trade for the remaining beneficiaries; the result is mainly to reduce GSP imports by the volume of trade supplied by the graduated beneficiary country.[26] The point is that benefit sharing has not been achieved by partial graduation. Certainly the less developed among the developing countries have not been helped by denying GSP treatment on imports from the more advanced beneficiary developing countries. Even more damaging to these criteria is that they have nothing to do with the objective of partial graduation, namely to withdraw preferential treatment when the beneficiary is capable of exporting competitively on an MFN basis.

40. Does this mean that "market share" criteria are misdirected? Certainly not. The question is whether the trade subject to graduation is competitive -- *vis-à-vis* developing-country and developed-country suppliers. If a beneficiary country's exports of a particular product are truly competitive, the withdrawal of GSP treatment should not result in a significant reduction in that country's exports of the product to the preference-giving country. Moreover, if the market grows, exports from the graduated beneficiary should also grow, and vice versa. Further, if the withdrawal of GSP preferential treatment results in a reduction in the beneficiary country's exports to that preference-giving country, then that beneficiary is not truly competitive. GSP treatment should be restored.

41. What are appropriate partial graduation criteria? The ultimate test is whether the beneficiary country is a competitive exporter of the product. It is not enough for the country to be competitive *vis-à-vis* other developing countries that are receiving GSP treatment or even all other developing countries combined. The country must be competitive *vis-à-vis* all other supplying countries including developed countries.

42. A market share criterion does seem appropriate provided beneficiary imports are measured against imports from all other sources combined, i.e. "share of total imports of the product". Market share criteria, however, can yield undesirable outcomes in particular instances. The reasonableness of market share criteria depends upon the degree of aggregation used to define products. If a particular product is defined very narrowly, the total imports of the product might be supplied by a few source countries and account for a very small value of trade. In such cases, market share criteria can produce graduation even when a beneficiary is not a competitive exporter. The European Union and the United States both recognize this problem; their partial graduation provisions both include *de minimis* thresholds to be applied in conjunction with market share criteria. If a beneficiary would be subject to graduation under country-product or country-sector market share criteria but the value of imports involved is below a minimal level, then GSP treatment is not to be withdrawn.

43. This combination of criteria (share of total imports and a *de minimis* threshold) appears to be a reasonable solution for the problem created when products are defined too narrowly. However, if products are defined quite broadly, by using sectors that include many individual products, an opposite problem might occur.[27] A beneficiary might be subject to country-sector graduation for all products in an entire industry as a result of competitive exports of a narrowly defined product within the sector. GSP graduation would deny the beneficiary preferential treatment for all of the other products in the sector even though the beneficiary might not be a competitive exporter of the other products in the sector. This might be particularly damaging to the development prospects of the beneficiary if the sector included products of increasing stages of processing, especially if the beneficiary were graduated because of competitive exports of a lower staged product. This problem could be solved by coupling the market share criterion with a distribution criterion. One suggestion is to compare preference-giving country imports of products in the sector from the beneficiary with imports from developed countries. If imports from the beneficiary are significantly more concentrated in a small number of products in the sector, graduation would only apply to the narrowly defined products that are being competitively exported. GSP treatment would continue to apply for other products within the sector.[28]

44. One last point: since partial graduation is based on export performance which might change from one year to the next, a beneficiary country might exceed the graduation criteria rather unexpectedly. Such a sudden introduction of graduation might jeopardize trading relationships built on GSP treatment. A more constructive approach would be to announce that partial graduation would be introduced with a grace period or a phase out period during which GSP preferential treatment would continue to be applied. This would give the beneficiary country exporters and preference-giving country importers time to adjust to the withdrawal of GSP treatment.

45. To summarize there are four major considerations for partial graduation:

(i) graduation should be based on a demonstration that the beneficiary is a competitive exporter of the product to be graduated, i.e. *vis-à-vis* all other supplying countries;

(ii) the degree of product aggregation can influence the effect of graduation criteria:

- if products are defined narrowly, then market share criteria should be coupled with a *de minimis* criterion

- if products are defined broadly, then market share criteria should be coupled with a distribution criterion;

(iii) there should be a grace period before GSP treatment is withdrawn with a possible phase out of the preferential tariff reductions; and

(iv) following each partial graduation case, imports should be monitored to determine whether graduation was unwarranted, i.e. if imports are adversely affected by graduation, GSP preferential treatment should be restored.

2. Full graduation

46. All of the existing full graduation provisions are based on a single criterion, namely per capita income. Bulgaria and Poland graduate countries whose per capita income equals or exceeds their own. New Zealand graduates countries whose per capita income exceeds 70 per cent of that of New Zealand. The United States graduates countries whose per capita income exceeds a calculated figure, roughly US$ 11,000.[29] While these criteria are objective and independent from safeguard measures, one might question whether this single criterion is sufficient to determine when preferential treatment is no longer warranted.

47. The overall purpose of the GSP is to promote economic development. Under the GSP the most advanced countries in the world have introduced preferential trading schemes designed to stimulate economic development of the developing countries. The issue of country graduation is to determine when a country is so developed that preferential treatment is no longer warranted. The answer to this difficult question is made much more difficult by the fact that all countries, rich and poor alike, are developing. In essence, country graduation criteria must be designed to hit a moving target.

48. It must also be recognized that the level of development differs among the preference-giving countries. Thus, if a uniform country graduation criteria based on per capita income were to be established - say 75 per cent of the preference-giving country's per capita income - beneficiary countries would be graduated from different GSP schemes at different times.[30] Moreover, the variation of per capita income among the preference-giving countries is so large that a 75 per cent rule would permit several of the lower-income preference-giving countries to qualify as beneficiaries under several higher-income preference-giving country's GSP schemes.[31]

49. Per capita income is clearly an important indicator of the level of development achieved by a country. But is it the only indicator? Is it a sufficient indicator to determine when a beneficiary country is able to compete in world markets on an MFN basis?

50. One approach to addressing these questions is to examine the countries that are commonly recognized as developed countries, i.e. the advanced preference-giving countries. Various indicators of development can be collected to construct profiles of development for each of these countries and, in turn, a representative or average profile of development. Popular indicators of stage of development would include per capita income, life expectancy, literacy, distribution of GNP (agriculture, industry, manufacturing and services), per capita energy consumption, food as a share of consumption, distribution of exports (primary commodities and manufactures) and population growth rate. Such data have been collected; they are reported in table 1.

51. The top part of table 1 shows data for the preference-giving country with the lowest and highest indicator together with the average for all preference-giving countries and the standard deviation. The middle part shows the indicators for the upper-middle-income countries as classified by the World Bank; these countries would be the prime candidates for country graduation under the GSP. The lower part of the table presents the average indicators for the three groups of countries classified by the World Bank, namely low-income, lower-middle-income and upper-middle-income countries. The indicators that are lightly shaded fall within the minimum-maximum range for the preference-giving countries included in the table. The indicators that are darkly shaded fall outside the minimum-maximum range, however, in a direction consistent with a high level of economic development.

52. The logic of the indicators and the implications for country graduation will be discussed in turn, beginning with per capita income.

(a) Per capita income

53. The objective of economic development is to provide a high standard of living for the peoples of all countries. The single most important indicator of the standard of living is the ability to purchase goods and services which derives from the productive ability of a country. Production generates income; high income generates high ability to purchase.

54. The range of income per capita among the preference-giving countries is quite large.[32] The figures in table 1 show a range between US$ 11,000 and US$ 34,000 with an average (unweighted) of US$ 20,500. Only three upper-middle-income countries and territories have income per capita that fall within this range (Hong Kong, Israel and Singapore); all three are on the low side and are below a full standard deviation lower than the average. Income per capita of Hong Kong and Singapore exceeds that of five preference-giving countries, i.e. New Zealand and the European Union member States of Ireland, Greece, Portugal and Spain. The income per capita of Israel is slightly below that of New Zealand and Spain and slightly above that of Ireland.[33]

(b) Health criteria - expected age

55. Life expectancy (age of death expected at birth) is quite high and with a small range for the preference-giving countries, averaging 77 years. The developing countries have a significantly lower life expectancy. Moreover, this indicator is highly correlated with level of development. The low-income countries have an average age expectancy of 53 years, rising to 66 years for the lower-middle-income countries and to 69 years for the upper-middle-income countries. Only three countries among the upper-middle-income countries have age expectancies within the range of the preference-giving countries (including Singapore with an age expectancy one year lower than the minimum for the preference-giving countries).

(c) Education - illiteracy

56. All of the preference-giving countries have very good educational systems. The share of population counted as illiterate is less than 5 per cent for each of these countries.[34] The developing countries have educational systems that are much less effective. As with health, educational effectiveness is highly correlated with level of development. The illiteracy rate for the low-income countries averages 53 per cent, 25 per cent for the lower-middle-income countries and 16 per cent for the upper-middle-income countries. There are five countries or territories among the upper-middle-income countries with illiteracy rates within the range of the preference-giving countries, namely Hong Kong, Israel, Singapore, Republic of Korea and Uruguay.

(d) Distribution of GNP

57. Historically, development was first associated with a declining share of population engaged in agriculture, followed by a declining share of agriculture in GNP. The mirror of this trend was the dramatic increase in the industrial sector, including manufacturing. More recently, the high income countries have experienced de-industrialization which, in turn, is reflected in the rise in services as a share of GNP.

58. The developing countries seem to be following this pattern of development but lag far behind. Agriculture accounts for an average of 4 per cent of GNP in the preference-giving countries with the upper-middle-income developing countries only marginally higher at 6 per cent. All but one of the upper-middle-income countries have reduced dependence upon the agricultural sector to fall within the minimum-maximum range of the preference-giving countries.[35] The low-income and lower-middle-income countries have agricultural sectors accounting for 37 per cent and 18 per cent of GNP, respectively.

59. At the other extreme, the service sector accounts for almost two-thirds of GNP in the preference-giving countries, ranging from 56 per cent to 80 per cent. In contrast, the developing countries' share is 41 per cent for the low-income countries and 52 per cent for the lower- and upper- middle-income countries. Five of the upper-middle-income countries/territories have service sectors within the minimum-maximum range for the preference-giving countries, namely Hong Kong, Mexico, Singapore, Trinidad and Tobago and Uruguay.

60. The industrial sectors, including manufacturing, are more difficult to analyse. Those countries with small service sectors will necessarily have larger agriculture and industrial sectors combined. This problem is not serious for the low-income countries; they have service sectors that are one-third smaller than the preference-giving countries and they also have industrial sectors one-third smaller. In comparison, the lower-middle-income countries have service sectors that are one-fifth smaller than the preference-giving countries; however, their industrial sectors average the same 30 per cent of GNP. For the upper-middle-income countries, services account for a smaller share of GNP (by 12 per cent) while the industrial sector accounts for an equivalent larger share (by 11 per cent).

61. A more revealing look at industrialization can be obtained by examining the distribution of GNP excluding services. The distribution between agriculture and the industrial sectors for the preference-giving countries differs dramatically from that of the low- and lower-middle-income countries. The average shares of agriculture versus industrial sectors are highly correlated with level of development and the differences by country group are very large. The low-income countries have industrial sectors accounting for 38 per cent of GNP, the lower-middle-income countries 63 per cent, and the upper-middle-income countries 87 per cent.

62. A comparison between the preference-giving countries and the upper-middle-income countries is very interesting; all of the latter countries fall within the minimum-maximum range for the preference-giving countries regarding both the shares of agriculture and industrialization. However, this comparison is heavily influenced by the inclusion of Ireland and New Zealand (with unusually large agriculture sectors) and Hong Kong and Singapore (with non-

existent agriculture sectors). If these four countries are eliminated from the averages, the agriculture sector shrinks to 9 per cent for the preference-giving countries and increases to 15 per cent for the upper-middle-income countries. Moreover, one third of the upper-middle-income countries have agriculture shares that exceed the maximum for the preference-giving countries.

63. Another significant indicator that distinguished countries by level of development is the share of manufacturing in GNP, excluding services. The average share of manufacturing ranges from 22 per cent for the low-income countries to 54 per cent for the preference-giving countries.[36] Manufacturing only accounts for an average 39 per cent for the upper-middle-income countries. Nevertheless, two thirds of the upper-middle-income countries/territories fall within the minimum-maximum range for the preference-giving countries, although only four have manufacturing sectors that would be at or above the average for the preference-giving countries including Hong Kong and Singapore with exaggerated manufacturing shares owing to the non-existence of agriculture; the other two countries are Mexico and Uruguay.

(e) Energy consumption

64. Almost no indicator is more closely correlated with level of development than energy consumption per capita. It takes energy to produce and distribute goods. And many services are highly energy intensive, e.g. transportation. The preference-giving countries have 40 times the energy use per capita of the low-income countries; 6 times that of the lower-middle-income countries and double that of the upper-middle-income countries. Only three upper-middle-income countries have reported energy usage above the average for the preference-giving countries (Saudi Arabia, Singapore and Trinidad and Tobago); two of these countries are major oil-producing countries and the third is a major entrepôt trader. Excluding these three countries would yield an average energy usage for the upper-middle-income countries that is only one third of that of the preference-giving countries.

(f) Exports of manufactured products

65. A major objective of the GSP is to stimulate the export of manufactured products. The share of manufactured products in total exports is clearly correlated with level of development ranging from a low of 25 per cent for the low-income countries to a high of 72 per cent for the preference-giving countries; the lower-middle-income countries and upper-middle-income countries have shares of 32 per cent and 47 per cent, respectively.[37] Most of the upper-middle-income countries fall within the minimum-maximum range for the preference-giving countries. However, this range is heavily influenced by the inclusion of Australia, New Zealand and Norway, which are significant exporters of primary agricultural products or petroleum. The minimum share of manufactures for the other preference-giving countries is 62 per cent, a share exceeded by only Hong Kong, Israel, Singapore and Republic of Korea among the upper-middle-income countries/territories.

(g) Export diversification and concentration

66. An important objective of the GSP is to reduce the dependence of developing countries on the exports of a few primary commodities by promoting a diversification of exports. There are actually two concepts included in this idea. The first emphasizes the extent to which a country is heavily dependent upon a few commodities for its export earnings. If a very high share of a country's export earnings are derived from a few commodities, the country's export pattern is considered highly concentrated, i.e. the export concentration index is high. Such a pattern of exports is normally stemming from narrow industrial base and low level of economic development.

67. The second concept emphasizes a comparison of the structure of exports of a particular country to that of other countries in general. If a country exports a wide variety of products, the country's export pattern is considered highly diversified in comparison to other countries. A low export diversification index, measured as the deviation from the world average,

indicates a higher than average degree of concentration or a low degree of export diversification. Such a pattern of exports is consistent with a narrow industrial base and a low level of development.

68. Data from the UNCTAD Handbook of International Trade and Development Statistics[38] reveal that most of the upper-middle income countries listed in table 1 have export patterns that are similar to those of the preference-giving countries. However, there are significant exceptions including Gabon, Oman, Trinidad and Tobago, Saudi Arabia, and Venezuela. The implication is that even though these countries have relatively high per capita incomes, GSP tariff preferences could continue to provide incentives to help these countries achieve important goals of the GSP, namely export diversification and industrialization.

(h) Population growth rate

69. The preference-giving countries have an average rate of growth of population of 1/2 to 1 per cent. Only two of these countries have growth rates in excess of 1 per cent (Australia and Canada) which, in large part, is the result of immigration. In contrast, all three of the developing country groups have population growth rates in excess of 2 per cent. There is only one upper-middle-income country (Uruguay) with a population growth rate of less than 1 per cent.

(i) Food cost

70. The last indicator is the share of income allocated to the purchase of food. The preference-giving countries spend 15 per cent of income on food versus 48 per cent for the low-income countries. Among the preference-giving countries only four allocate more than 20 per cent of income for food, namely, Greece, Ireland, Portugal and Spain. Among the upper-middle-income countries/territories only three allocated less than 20 per cent of income for food, namely Hong Kong, Singapore and Trinidad and Tobago.

(j) Implications for country graduation

71. The purpose of country graduation within the context of the GSP is to provide for the withdrawal of preferential treatment once the goals of the GSP have been achieved. The initial goals of the GSP were to increase export earnings, to promote industrialization and to accelerate economic growth.

72. Since preferential treatment was highly concentrated in industrial products, and particularly in manufactured products, the first goal is to stimulate exports of manufactured products. The second goal is to link manufactured products to industrial production in the beneficiary developing countries. This is not a trade goal but is to be achieved with the assistance of trade. In essence this goal reflects a desire to reduce the dependence of developing countries on primary sectors for income and to increase the share of income generated through industrial production. The third goal is to reduce the gap in income between the developing and the developed countries. Only through the acceleration of growth rates can the developing countries catch up with the developed countries. This goal ultimately aspires to provide the developing countries with high levels of per capita income.

73. To synthesize these goals into objective criteria for country graduation, we must emphasize:

- exporting manufactured products;
- diversifying the economies of developing countries by increasing the share of income derived from the industrial sector; and
- providing a high level of income per capita.

74. In our examination of profiles of development earlier in this section, we observed a high degree of correlation among the various indicators of development -- though with some exceptions.[39] We also observed a high degree of correlation among the indicators directly related to the goals of the GSP

(manufactured exports, significance of the industrial sector and income per capita) with a number of other indicators (life expectancy, literacy, energy consumption, population growth and food costs).

IV. FINDINGS AND RECOMMENDATIONS

75. The GSP has lived beyond its initial 10-year life, and deservedly so. It was unreasonable to envisage that the goals of the GSP could be achieved within such a short period of time. Given the early negotiations, it is also reasonable to understand why no one contemplated graduation as a central concept in the GSP. However, as GSP schemes are being extended and the beneficiary countries are progressing, provisions for an ultimate phase out of the GSP programme have become a central issue of negotiation. This concern is currently focused on the more advanced beneficiary countries. It is necessary, however, to think further down the line, while recognizing the concerns of the preference-giving countries as well as of those developing countries that are far from graduation. And we must not forget the needs of those beneficiary countries that are currently benefiting from the GSP.

76. A country may be a competitive exporter of a particular manufactured product without being capable of exporting other manufactured products. In such cases, partial graduation is appropriate. For the vast majority of developing countries this is the case. However, in a few instances beneficiary countries are progressing to become economically equal to the lower-income preference-giving countries. In these cases, full graduation is appropriate. Partial graduation and full graduation are not alternative techniques for the ultimate phase-out of GSP preferential treatment. Instead, these two techniques should be considered as complementary.

77. Finally, countries that have benefited from the GSP and that have succeeded, should accept the responsibility of helping others. The underlying rationale of the GSP would suggest that those preference-receiving countries that have achieved sufficient successes to be graduated should join the ranks of the preference-giving countries.

78. A list of recommendations follows:

(i) Graduation should be independent of safeguard measures.

(ii) Graduation should be based on objective criteria related to the intent of graduation.

(iii) There is a role both for partial graduation and full graduation; the intent of partial and full graduation should be clearly distinguished.

(iv) Partial graduation should be based on objective criteria related to the ability of the beneficiary country to export the products subject to graduation:

- exports should be competitive *vis-à-vis* all other supplying countries;
- there should be a *de minimis* criterion for narrowly defined products; and
- there should be a distribution criteria for broadly defined products.

(v) Full graduation should be based on objective criteria related to the level of development of the beneficiary country:

- the profile of development indicators should place the beneficiary country within the range of preference-giving countries; and

- the development indicators should include the ability to export manufactured products, the significance of the industrial sector, and the level of income per capita.

(vi) Graduation, when introduced, should include a grace or phase-out period as appropriate.

(vii) Graduation should be rescinded in those cases in which the withdrawal of GSP treatment has an adverse effect on the beneficiary country's exports.

(viii) The more advanced developing countries should consider becoming preference-giving countries to benefit less advanced developing countries.

Notes

1. Partial graduation is often referred to as country-product graduation or country-sector graduation.

2. Full graduation is often referred to as country graduation.

3. See GATT, ***Analytical Index: Guide to GATT Law and Practice***, 6th edition, 1994, p. 53. The enabling clause was adopted by the Contracting Parties on 28 November 1979. The GSP programme was initially authorized by a 10-year waiver of the GATT MFN principle; this waiver expired in 1981. Current GSP schemes are authorized under the enabling clause.

4. GATT, ***Draft Final Act of the Uruguay Round***.

5. GATT, ***Draft Final Act of the Uruguay Round***.

6. Safeguards of this nature are often necessary to garner the political support sufficient to enact programmes to benefit other countries.

7. The United States scheme included other provisions to safeguard domestic industry.

8. This provision is referred to as “competitive need criteria” and will be described in more detail below.

9. One of the first problems in creating the GSP was agreeing on a list of developing countries that would benefit from GSP preferential tariff reductions. This problem was solved by adopting the principle of self-election. Under this principle any country could claim to be a developing country and, thereby, qualify for GSP treatment; several developed countries claimed beneficiary status for their colonies, e.g. the United Kingdom claimed beneficiary status for Hong Kong. However, the preference-giving countries declined to grant GSP to selected countries for reasons which they might hold “compelling.” For example, the United States did not grant beneficiary status to countries belonging to OPEC or to communist countries; however, Taiwan Province of China was granted beneficiary status as was Yugoslavia. The European Communities granted beneficiary status to members of the Group of 77 which included Yugoslavia but not Taiwan Province of China.

10. The United States GSP scheme is the only scheme that includes criteria which developing countries must meet in order to be designated as eligible for GSP tariff reductions. Countries which cannot be designated as eligible beneficiary countries include communist countries, OPEC countries that participated in the 1973 oil embargo and developing countries that grant preferential treatment on imports from developed countries. Discretionary criteria include countries which nationalize or expropriate property owned by a United States citizen or corporation without adequate compensation, countries which refuse to cooperate with the United States in the fight against illegal drug traffic, and countries which fail to enforce investment dispute awards granted to a United States party through mutually agreed arbitration. When the United States GSP programme was renewed under the Trade and Tariff Act of 1984 two additional criteria were added, namely countries which do not enforce intellectual property rights and countries which do not afford workers internationally recognized workers’ rights. During 1985-93 there were 109 petitions to remove countries from the GSP programme and 4 petitions to reinstate a country's beneficiary status. Of these petitions 80 involved workers’ rights, 16 involved intellectual property rights, 11 involved expropriation of property without adequate compensation. As a result of these petitions 11 beneficiary countries were suspended or removed from the United States GSP programme (4 were subsequently reinstated); all 4 of the petitions for reinstatement were approved. See United States General Accounting Office, ***Assessment of the Generalized System of Preferences Program***, document GAO/GGD-95-9, November 1994.

11. The value limit for 1993 was US$ 108 million. In 1987 the value and share limits were reduced for selected competitive products imported from relatively advanced developing countries.

12. There is a waiver for products not produced in the United States and a *de minimis* waiver if total United States imports of the product did not exceed US$ 12.6 million during 1993.

13. Country-product graduation has sometimes been justified as a technique to achieve a more equitable sharing of the benefits of GSP among the developing countries. Concern for benefit sharing has increased as a result of the fact that a few of the more advanced beneficiary countries account for very large shares of total GSP

trade. However, when the more advanced beneficiaries are removed from the GSP programme using country-product graduation, the total GSP benefits decline and the resulting benefit sharing is heavily skewed in favour of the more advanced among the remaining developing countries. See C. MacPhee, "Effects of competitive need exclusions and redesignations under the United States scheme of generalized preferences," UNCTAD document UNCTAD/ST/MD/29, 13 February 1986 and United States International Trade Commission, ***An Evaluation of United States Imports under the generalized system of preferences***, USITC Publication 1379, May 1983.

14. Both the European Union and Japan have provisions to continue GSP treatment even when imports exceed a ceiling limit; these exceptions are administered on a case-by-case basis.

15. The maximum amount limits are generally 50 per cent of the ceiling for the product; the European Union has lower maximum amount limits for some import-sensitive products. The maximum amount in Japan was originally set at 50 per cent of the global ceiling. It was revised to 33 per cent in 1984 and to 25 per cent in 1987.

16. This conclusion must be qualified in that the ceilings and maximum amounts are adjusted upward periodically to account for normal growth in markets. Japan has updated the base year used to calculate ceilings five times since 1971; the result has been increases in ceilings. In addition, Japan uses a system of "flexible administration" under which GSP treatment continues to apply even when ceilings are exceeded; this system is applied in selected cases. The GSP scheme of the European Union includes provisions to increase the ceilings on an annual basis.

17. The legislation authorizing the United States GSP programme contained an initial duration of ten years ending 31 December 1985.

18. The limit is calculated as US$ 8,500 augmented by one-half the rate of growth in United States GNP since 1984.

19. Bahrain's beneficiary status was restored in 1990 after revised GNP data revealed the country had not exceeded the GNP per capita limit.

20. Per capita GNP for Hong Kong and Singapore exceed that for Israel; consequently, these two countries would be graduated under the current country graduation criteria.

21. On 12 March 1991 the Government of Australia announced that GSP preferences for Hong Kong, the Republic of Korea, Singapore and Taiwan Province of China would be phased out beginning 1 July 1992.

22. Article 6 of the authorizing legislation states: "The most advanced beneficiary countries shall be excluded ... as from 1 January 1998 on the basis of objective, clearly defined criteria for which the Commission shall submit appropriate proposals before 1 January 1997." ***Official Journal of the European Communities***, Vol. 37, 31 December 1994, L348.

23. The development index is; the specialization index is where $_{Ypc}$ is per capita GNP, X_m is exports of manufactured products, superscripts b and EU indicate beneficiary countries and the European Union, respectively, M_{EU} is imports into the European Union, superscripts b and W indicate beneficiary countries and the World, respectively, and superscripts s and T indicate the sector and all products, respectively.

24. The countries and territories are: Albania, Argentina, Armenia, Azerbaijan, Bahrain, Belarus, Brazil, Brunei Darussalam, Chile, China, Georgia, Hong Kong, India, Indonesia, Kazakhstan, Kuwait, Kyrgyzstan, Libyan Arab Jamahiriya, Macao, Malaysia, Mexico, Nauru, Oman, Pakistan, Qatar, Republic of Korea, Republic of Moldova, Russian Federation, Saudi Arabia, Singapore, South Africa, Tadjikistan, Thailand, Turkmenistan, Ukraine, United Arab Emirates and Uzbekistan. See ***Official Journal L348, Annex II***.

25. To illustrate, if Hong Kong accounts for 4 per cent of total European Union imports, they will be graduated from any sector in which Hong Kong accounts for more than 4 per cent of European Union imports.

26. See footnote 11 above.

27. The graduation philosophy of the European Union is that GSP treatment is not warranted for those beneficiaries with a competitive industry or sector. In such cases, GSP treatment is to be withdrawn for all products in the industry or sector for the particular beneficiary country.

28. This possibility is precluded from the current scheme of the European Union; graduation, when applied, will affect all products in the industry or sector.

29. The figure is calculated as US$ 8,500 augmented annually by 1/2 the rate of growth in United States income since 1984.

30. This concept could also be used to introduce GSP schemes by the more advanced beneficiary countries. For example, they might establish GSP preferences on imports from other beneficiary countries having per capita incomes below 75 per cent of their per capita income.

31. Using data published by the World Bank for 1991, Japan, Sweden and Switzerland all had per capita income in excess of US$ 25,000; the following preference-giving countries had per capita incomes less than 75 per cent of this level: Australia, Greece, Ireland, Italy, New Zealand, Portugal, Spain and United Kingdom.

32. Portugal and Greece have been excluded because their income per capita is more than two standard deviations below the average for the preference-giving countries. In addition these two countries participate in a single GSP scheme for the European Union as a whole. Were the European Union scheme treated as a single entity the European Union income per capita was US$ 16,778 (unweighted by country population) or US$ 18,054 (weighted by population) during 1991.

33. Greece and Portugal have significantly lower income per capita.

34. Greece and Portugal have illiteracy rates greater than 5 per cent.

35. Ireland and New Zealand still have significant agricultural sectors. If these countries were removed from the preference-giving country sample, one-half of the upper-middle-income countries now falling within the minimum-maximum range of the preference-giving countries would exceed that maximum.

36. The figure for the preference-giving countries is significantly influenced by special cases: Ireland has a very small manufacturing sector as a result of its large agriculture sector, Australia and New Zealand also have large agriculture sectors and Norway's economy is dominated by petroleum. Excluding these countries the preference-giving countries with the smallest manufacturing sector would be Germany and the Netherlands with manufacturing shares of 56 per cent.

37. The converse indicator would be dependence on primary exports: these shares range from 75 per cent for low-income countries to 27 per cent for preference-giving countries.

38. UNCTAD Handbook of International Trade and Development Statistics, table 4.5.

39. For example, in comparison with the preference-giving countries, Hong Kong and Singapore fall within the minimum-maximum range for almost all indicators. However, Republic of Korea appears to be a competitive exporter of manufactured products yet income per capita is far below the average of the preference-giving countries; moreover, the agriculture sector is double the preference-giving country average and the service sector is inadequately developed.