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EROSION OF PREFERENCES FOR THE LEAST DEVELOPED COUNTRIES: ASSESSMENT OF EFFECTS AND MITIGATING OPTIONS*

Note by the UNCTAD secretariat

Executive summary

In an effort to assess the value of trade preferences and their erosion as a result of MFN tariff reduction, this note highlights the countries and products that are benefiting most from recent preferential market access initiatives of the European Union, Japan and the United States in favour of LDCs. While underlining the growing role of international trade in services and lesser dependence on preferential market access for goods in several LDCs, the note points out that nearly 20 primary commodities of great importance to LDCs are exported to the relevant three major markets without enjoying preferential treatment, as these products are MFN duty-free (or subject to a very low MFN tariff). On the other hand, about 18 products have been exported by LDCs under significant preferential margins in the same markets. In 2003, nearly half of all exports of goods from LDCs under market access preferences originated in 11 countries and related to 17 product categories.

The note briefly examines possible measures to mitigate the adverse effects of preference erosion. Besides the calls for deepening existing preferences and seeking financial compensation for countries most severely affected by the erosion phenomenon, there is growing recognition of the importance of extending the notion of preferential treatment to policy areas other than market access preference. Specifically, this involves action of direct relevance to productive capacities, with a view to reducing LDCs' dependence on trade preferences and their exposure to the risk of erosion. Various preferential measures to enhance supply capacities are considered desirable. In this context, the Integrated Framework for Trade-Related Technical Assistance to LDCs (IF) makes it possible for IF partners to identify, for any given LDC, the modalities of special treatment, within and outside the trade area, that are deemed important for overcoming competitive disadvantages.

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Introduction

1. Market access preferences granted under autonomous preferential regimes have been among the most concrete examples of the special and differential treatment of developing countries. In their first Ministerial Declaration in Singapore in 1996, members of the World Trade Organization (WTO), agreeing on a Plan of Action for Least Developed Countries (LDCs), emphasized the importance of trade preferences for LDCs and encouraged the trading partners of these countries to take initiatives to improve such preferences.

2. In 2003, the Trade and Development Board, at its fiftieth session, examined the impact of the most recent initiatives in favour of LDCs in the area of market access, including among others the "Everything but Arms" (EBA) initiative of the European Union and the African Growth and Opportunity Act (AGOA) of the United States. A background note by the UNCTAD secretariat[1] pointed out that market access preferences have had a beneficial impact on investment, job creation and poverty reduction through trade in several LDCs, particularly those with competitive export capacities. However, the low degree of utilization of trade preferences was noted as a phenomenon that diminished the value of the relevant concessions. Weaknesses in supply capacities were highlighted as a major factor in underutilization, but factors such as the stringency of rules of origin and the risk of instability of preferences over time were also noted as influencing potential investors' decisions in LDCs. Indeed, erosion of market access preferences for LDCs arising from most favoured nation (MFN) tariff reduction and regional free trade arrangements was underlined as one of the most serious challenges to LDCs in their efforts to overcome their competitive disadvantages in the global economy.

3. With this in mind, the Board asked the secretariat "to perform analyses concerning the consequences for LDCs of the possible erosion of preferences resulting from further trade liberalization and, as appropriate, recommend measures to assist the LDCs to mitigate the adverse consequences" of this phenomenon.[2]

4. This note has been prepared in response to the above request, as an interim step to examine the implications of preference erosion. The second section provides an overview of the exposure of LDCs to the erosion challenge and focuses on the countries and products that have benefited most from trade preferences for LDCs in three major markets. The third section presents the results of a simulation exercise in which the trade impact of full erosion of preferences is estimated, bearing in mind that in many sectors preferences have not been fully utilized. The fourth section discusses a number of possible modalities and options to mitigate the adverse effects of preference erosion on LDCs, with particular reference to the paramount aim of strengthening the competitiveness and supply capacities of LDC economies and reducing their dependence on trade preferences.

Magnitude and significance of trade preferences for LDCs in three major markets

5. Since the adoption of the generalized system of preferences (GSP) in the early 1970s, developing countries have considerably increased their share of world trade, as well as their

[1] UNCTAD document TD/B/50/5.

[2] Agreed conclusions 476(L) of the Trade and Development Board from the "Review of progress in the implementation of the Programme of Action for the Least Developed Countries for the Decade 2001–2010", para. 10.

utilization of trade preferences. "Graduation" mechanisms – implying exclusion from preferential treatment of countries meeting relevant performance criteria – were introduced in 1988 by the United States under its GSP scheme, and by the European Union and Japan in the late 1990s.[3]

6. An increasingly important element of the debate on preference erosion has been the question of the degree of utilization of available preferences.[4] Whereas traditional calculation of preference erosion was based on the assumption that preferences were fully utilized, it is now recognized that most favoured nation (MFN) rates are often applied even where preferential rates exist. Among reasons for the failure of countries to use the preferential treatment offered to them has been their inability to meet rules of origin and standards-related regulations. In some other cases, underutilization of preferences has been explained by positive, as opposed to negative, reasons, as exporters have found that their competitiveness in relevant markets is sufficient even under non-preferential conditions, or that forgoing the tariff preference is less inconvenient than meeting the stringent obligations of the relevant preferential regimes.

7. The debate about erosion of trade preferences has also evolved as a result of significant changes in the economic specialization of many of the preference recipients under consideration.

To whom do preferences matter?

8. The beneficial impact of trade preferences and the adverse effects of preference erosion primarily depend on the export structure of the economy under consideration, and on the social implications of its export structure. Particularly important is the question of the socio-economic impact of erosion on the various social groups likely to be affected (small farmers, factory workers, etc.) in comparison with economic actors in the sectors that do not rely on preferences, such as employees in the tourism and transport industries or in business-related services.

9. While a majority of LDCs (39 out of 50) are predominantly exporters of goods, 11 depend on international services as the source of more than half of their foreign exchange earnings.[5] Of these 11 countries, seven recorded a proportion in excess of 70%. In some LDCs, particularly among those that are small island States, specialization in service industries (generally with a predominant tourism sector) has been dictated by geographical or natural circumstances, notably because environmental assets were conducive to tourism development. In other LDCs, including countries in which exports of goods still exceed exports of services, the rise of service exports has been the result of efforts to diversify the economy into less preference-dependent activities.

10. In 2003, the sectors of LDC economies that relied on market access preferences and accordingly were more or less exposed to the risk of preference erosion accounted for an estimated 33% of the total foreign exchange earnings of these countries. This ratio can be

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[3] See UNCTAD's reports of the Special Committee on Trade Preferences. In a graduation mechanism, competitive limits are generally set by the preference-giving country (as in the scheme of the United States), but trade volume criteria, such as in the scheme of Japan, may also be considered.

[4] In this note, the term *utilization* is understood as the ratio of imports of goods effectively taking place under preferential terms to the total value of normally dutiable imports of the same goods from the same origin in the same market. ("Normally dutiable imports" include imports taking place under preferential terms as well as imports taking place under less preferential terms or MFN terms.) Trade data are recorded on the basis of customs declarations at the time of importation in the preference-giving countries.

[5] These are Cape Verde, Comoros, Djibouti, Eritrea, Ethiopia, Kiribati, Maldives, Samoa, Sao Tome and Principe, Tuvalu and Vanuatu.

referred to as the rate of exposure to the risk of preference erosion, considering, for each country, the structure of goods and services exports. It can be compared with the counterpart ratio that prevailed nearly 20 years earlier (1985), which was considerably higher (64%). However, given the diversity in the scope for diversification among LDCs, the reality of diminishing exposure of LDC economies to the risk of erosion is uneven. While less than a third of all LDCs have been able to reduce their dependence on trade preferences through diversification, a large majority of LDCs remain severely constrained in their efforts to achieve structural progress, and most countries within that majority of LDCs suffer from economic concentration and face the challenge of preference erosion.

11. The following country cases stand out as successful examples of economies that originally were predominantly primary commodity exporters and have made steady structural progress, with lesser dependence on preferential treatment for goods and greater reliance on activities with higher value added. Moreover, international trade in services has had a catalytic impact on the competitiveness of the economy at large in these countries.

12. In Cambodia, where garments account for nearly 60% of foreign exchange earnings, tourism has become the second sector of the economy, and services in general are expected to increase further in importance, reducing dependence on preferential market access for goods.

13. In Ethiopia, air transport recently became the first source of export receipts, whereas 20 years ago it was equivalent to only a fourth of the coffee sector. With a growing business services industry and a sizeable tourism sector, Ethiopia has to some extent experienced structural transformation, as international services now account for 60% of the export economy. The coffee sector, which represented 39% of foreign exchange earnings in 1985, now accounts for only 21% of total export receipts. Eritrea's economy also evolved into a service-dominated economy, with tourism and transport services alone now accounting for nearly 40% of total foreign exchange earnings.

14. Equally notable is the structural progress shown by the Lao People's Democratic Republic, where tourism is now the first source (22%) of export receipts, while the tourism, electricity and transport sectors together account for nearly half of overall exports (47.4%).

15. In Nepal, where the dominant garment sector suffers from preference erosion, tourism, business services and transport services now account for over a quarter of total foreign exchange earnings, and, subject to greater political stability, there is scope for continued structural progress towards less dependence on preferential treatment.

16. Finally, the United Republic of Tanzania and Uganda are outstanding examples of structural progress through tourism development, as this sector has in recent years become the first source of foreign exchange earnings, before minerals and coffee, respectively. While primary activities and fisheries continue to account for more than half of total export receipts in the United Republic of Tanzania, they now represent less than a third of Uganda's exports.

17. Table 1 summarizes LDCs' exports under the main preferential schemes of the European Union, Japan and the United States. All aggregated values are based on trade flows that effectively took place under relevant preferential treatment, as reported to UNCTAD by member States.[6] These data therefore do not include exports of goods that took place on an MFN basis[7] although they were eligible for preferential treatment.

[6] The 2001 and 2002 data in the table are based on the latest figures that were available to UNCTAD from the relevant preference-giving countries by July 2005.

[7] Other authors have followed other methods. See, for example, "Trade preference erosion: potential economic impacts", OECD Trade Policy Working Paper 17.

Table 1

Exports of LDCs to the European Union, Japan and the United States under preferential treatment effectively received in 2002 or 2001

(*all values in thousands of US dollars)*

Preference-giving market	Total imports from LDCs under effectively received preferential treatment	Year	Agricultural products	Non-agricultural products	Total
European Union	Imports from ACP LDCs under ACP preferential treatment	2002	390 695 (22.6%)	1 341 706 (77.4%)	1 732 401
	Imports from non-ACP LDCs under EBA preferential treatment	2002	48 113 (2.2%)	2 172 151 (97.8%)	2 220 264
	Total EU imports from LDCs under preferential treatment		438 808 (11.1%)	3 513 857 (88.9%)	3 952 665
Japan	Imports from LDCs under GSP treatment	2001	3 891 (1.7%)	224 504 (98.3%)	228 395
United States	Imports from AGOA-eligible LDCs under AGOA treatment	2001	7 690 (3.1%)	237 466 (96.9%)	245 156
	Imports from non-AGOA-eligible LDCs under GSP treatment	2001	2 146 (0.1%)	3 035 389 (99.9%)	3 037 535
	Total US imports from LDCs under preferential treatment		9 836 (0.3%)	3 272 855 (99.7%)	3 282 691

Source: UNCTAD.

18. Preferential trade is very important for several LDCs, considering the substantial socio-economic impact of the sectors benefiting from preferences. However, most of the primary commodities exported by LDCs to the major developed-country markets face zero duty without enjoying preferential treatment in these markets, as these products are either MFN duty-free (for a large majority of them) or subject to a very low MFN tariff. These non-preferential products and the relevant main LDC suppliers appear in table 2.

19. LDC exports enjoying significant preferential margins in the relevant three major markets include, *inter alia*, fresh or frozen fish (margin of 10% to 22%, depending on the market); octopus (8%); preserved tuna (9% to 24%); fresh cut flowers (4% to 12%); vanilla (6%); cloves (8%); tobacco (31%); petroleum preparations (4% to 6%); urea (7%); leather (3% to 22%); jute fabrics (4% to 14%); wool carpets (8% to 9.5%); garments (6% to 13%); linen (12%); jute products (3%); footwear (7% to 25%); hats (2% to 6%); and wiring sets (2% to 5%).

20. In recent years, the 20 countries listed in table 3 (on page 8) have benefited most from the market access preferences extended to LDCs by the European Union, Japan and the United States (in decreasing order of the total value of preferential exports to these three markets).[8]

[8] The products mentioned in this list have the following two characteristics in common: they have all been exported to the three relevant markets under significant preferential margins (typically, garments exported under a 12% margin); and the annual export value for each of these products from every one of these countries exceeded $5 million in recent years.

Table 2

Main primary commodities, among products of interest to LDCs, not receiving preferential treatment (MFN duty-free)

Commodities	Suppliers
Aluminum ore	Guinea, Mozambique
Animal skins	Burkina Faso, Djibouti
Cobalt ore[9]	Dem. Republic of the Congo, Zambia
Cocoa beans	Equatorial Guinea, Haiti, Sao Tome and Principe, Sierra Leone, Solomon Islands
Coffee (unroasted)	Angola, Burundi, Central African Republic, Dem. Republic of the Congo, Ethiopia, Malawi, Rwanda, United Rep. of Tanzania, Uganda
Copper[10]	Dem. Republic of the Congo, Zambia
Copra	Kiribati
Cotton seeds	Benin, Burkina Faso, Central African Republic, Chad, Guinea-Bissau, Mali, Sudan, Togo, Uganda
Diamonds	Angola, Central African Republic, Dem. Republic of the Congo, Guinea, Sierra Leone
Gold[11]	Dem. Republic of the Congo, Ethiopia, Mali, Sudan
Gum arabic	Chad, Sudan
Iron ore	Mauritania, Togo
Jute	Bangladesh
Petroleum oil[12]	Angola, Dem. Republic of the Congo, Equatorial Guinea, Sudan, Yemen
Pharmaceutical plants	Sudan, Vanuatu
Phosphates	Togo
Natural rubber	Cambodia, Liberia
Sesame seeds	Burkina Faso, Ethiopia, Myanmar, Sudan, United Rep. of Tanzania
Tea	Burundi, Malawi, Rwanda, Uganda
Wood (non-coniferous or tropical)	Cambodia, Central African Republic, Equatorial Guinea, Guinea-Bissau, Lao People's Dem. Republic, Liberia, Myanmar, Solomon Islands, Vanuatu

Source: UNCTAD.

[9] The MFN duty on unwrought cobalt (HS 810510) imported into the United States is 1.5%.

[10] The MFN duty on cathodes and sections of cathodes of refined copper (HS 740311) is 1% in the United States and 2% in Japan.

[11] The MFN duty on unwrought gold (HS 710812) is 2.1% in the United States.

[12] Japan and the United States apply specific duties to imports of crude petroleum oil (HS 270900) on an MFN basis, while Australia, Canada, the European Union and Switzerland import that product under zero MFN tariff.

Table 3

The 20 LDCs benefiting most from market access preferences in the EU, Japanese and US markets in recent years

Countries	Relevant products
Angola	Crude petroleum oil and preparations thereof; cuttlefish and squid
Bangladesh	Frozen fish, shrimps and prawns; urea; leather; jute fabrics and bags; garments; linen; tents; footwear; hats
Madagascar	Frozen shrimps and prawns; vanilla; cloves; preserved tuna; garments
Senegal	Fresh and frozen fish and fish fillets; cuttlefish and squid; octopus; crude groundnut oil; preserved tuna; leather footwear
Cambodia	Garments; leather footwear
Nepal	Wool carpets; garments; hats
Democratic Republic of the Congo	Crude petroleum oil and preparations thereof
Myanmar	Garments; leather footwear
Mozambique	Frozen shrimps and prawns
Mauritania	Fresh and frozen fish; cuttlefish and squid; octopus
Malawi	Tobacco
Tanzania, United Republic of	Fresh and frozen fish fillets; octopus; fresh cut flowers; tobacco; preparations of petroleum oil
Uganda	Fresh and frozen fish fillets; fresh cut flowers; tobacco
Sudan	Crude groundnut oil
Equatorial Guinea	Crude petroleum oil
Solomon Islands	Preserved tuna
Yemen	Preparations of petroleum oil
Lao People's Democratic Republic	Garments
Zambia	Fresh cut flowers
Guinea	Fresh fish

Source: Ranking of countries and identification of products are based on UNCTAD data on foreign exchange earnings from exports of goods and services.

21. Particularly important is the socio-economic impact of market access preferences for garment exports from LDCs. In Bangladesh, 90% of the 1.8 million people employed in the sector are female workers, who generate an estimated 46% of the total household income of the country. In Cambodia, in 2003, there were more than 200 garment factories concentrated around Phnom Penh and in neighbouring provinces, and they employed about 200,000 workers. Nearly two thirds (64%) of all workers in the manufacturing sector in Cambodia are employed by the garment industry, and 85% to 90% of them are women, mostly under age 24 and from rural poor families. Their income supports at least 100,000 rural households.[13]

22. In Lesotho, garment production for export made employment of about 50,000 workers possible. However, over 20% of all jobs in the textile sector were lost in recent months as a result of the closure of foreign-owned garment factories. This took place after

[13] According to the ILO and preliminary reports of the Asian Development Bank.

considerable losses were incurred in the US market through the combined effects of rapidly rising international competition on the world's textile market in the context of the phasing out of import quotas, and overvaluation of the Lesotho currency vis-à-vis the US dollar. In Lesotho, this unprecedented economic challenge is now translating into a resurgence of poverty in a context of social trauma already caused by the incidence of HIV-AIDS.

LDCs and the preferential schemes of the European Union

23. Trade preferences for LDCs have been granted by the European Union through the Cotonou Partnership Agreement with African, Caribbean and Pacific (ACP) countries[14] and through LDC treatment under the generalized system of preferences (GSP). Before the 2001 "Everything but Arms" (EBA) initiative through which the European Union expanded its GSP coverage for the benefit of LDCs, market access preferences under the Cotonou Agreement (formerly the Lomé Conventions) were more generous than the preferences granted under the GSP scheme for LDCs.[15] In particular, the coverage of agricultural products was much greater under the ACP regime than under the GSP for LDCs.

24. Despite the entry into force of the EBA initiative in 2002, the near-totality of ACP LDCs' exports to the European Union in that year took place under ACP, not EBA, treatment. However, the limited exports that did materialize under the EBA regime are taken into account here.

The Cotonou preferences

25. ACP LDCs have generally utilized Cotonou preferences more fully than non-ACP LDCs utilized the GSP: the average utilization rate was above 70% between 1998 and 2002. This high utilization performance stems from the predominantly agricultural nature of ACP exports, as rules of origin are easier to comply with for these products than for manufactured products.

26. Only a fourth of EU imports from ACP LDCs have been imports of dutiable goods (goods that would face duties if they were exported by non-recipients of preferences), while three quarters of exports from ACP LDCs to the European single market have been duty-free on an MFN basis. The agricultural products from ACP LDCs that benefited most from ACP preferences under the Cotonou Partnership Agreement fell under nine tariff lines in 2002. Some of these appear in table 4.

27. After the entry into force of the 2001 EBA initiative, ACP LDC exporters were expected to switch their utilization of preferences from ACP terms to (EBA) GSP terms, as the latter constituted the most favourable regime for all LDCs. However, a majority of ACP LDCs in 2002 continued to export goods under ACP preferential terms, even though the ACP regime had become globally less favourable to LDCs than the GSP enhanced scheme. The reason for this anomaly, which explains the two categories of trade records – one under Cotonou terms, the other under EBA terms in table 4 – seems to lie in the difference between ACP and GSP certificates of origin. ACP exporters who had been accustomed to using the "EUR 1" certificate of origin imposed under the Cotonou Partnership Agreement continued to

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[14] 41 of the 79 ACP countries are LDCs.

[15] In particular, entry prices for fruits and vegetables and the specific duty applicable to flour and sugar were completely eliminated under the EBA initiative, while they are still applicable, albeit at a reduced rate, under the Cotonou Agreement. See UNCTAD, "Trade preferences for LDCs: an early assessment of benefits and possible improvements" (UNCTAD/ITCD/TSB/2003).

Table 4

Key LDC products imported under the preferential schemes of the European Union in 2002

Product description	Tariff rates			Imports in thousands of US$				Share of all relevant preferential trade	Main supplier and its share of total relevant imports
	MFN	ACP	LDC	Total imports from relevant sub-group of LDCs	Dutiable imports from relevant sub-group of LDCs	Imports of goods covered by relevant preferential treatment	Imports of goods effectively receiving relevant preferential treatment		
Main imports of agricultural products from ACP LDCs under Cotonou preferential terms									
Tobacco	18.4% (min. 22 euros, max. 24 euros per 100 kg)	0.0	n.a.	69 713	69 713	69 713	68 303	20.9%	Malawi (84.7%)
Crude groundnut oil	6.4%	0.0	n.a.	74 462	74 462	74 462	67 254	20.5%	Senegal (78.9%)
Vanilla	6.0%	0.0	n.a.	72 739	72 739	72 739	60 400	18.5%	Madagascar (83.8%)
Total relevant imports				402 269	402 269	402 269	327 296	100%	
Main imports of non-agricultural products from ACP LDCs under Cotonou preferential terms									
Aluminium	6.0%	0.0	n.a.	404 792	404 792	404 792	397 820	34.0%	Mozambique (100%)
Frozen shrimps and prawns	12.0%	0.0	n.a.	191 272	191 272	191 272	181 524	15.5%	Madagascar (55.3%)
Fresh or chilled fish fillets	9.0%	0.0	n.a.	142 333	142 333	142 333	103 493	8.9%	Tanzania (64.6%)
Total relevant imports				1 292 093	1 292 093	1 292 093	1 168 374	100%	
Main imports of agricultural products from non-ACP LDCs under GSP preferential terms									
Other vegetables, fresh or chilled	12.8%	n.a.	0.0	7 063	7 063	7 072	7 030	64.8%	Bangladesh (99.7%)
Total relevant imports				11 341	11 341	11 349	10 845	100%	
Main imports of non-agricultural products from non-ACP LDCs under GSP preferential terms									
T-shirts	12.0%	n.a.	0.0	549 776	549 776	549 503	495 424	25.9%	Bangladesh (95.5%)
Jerseys, pullovers, etc., of man-made fibres	12.4%	n.a.	0.0	472 989	472 989	473 366	335 758	17.6%	Bangladesh (72.9%)
Jersey, pullovers, etc., of cotton, knitted or crocheted	12.4%	n.a.	0.0	171 148	171 148	171 197	117 598	6.1%	Bangladesh (61.5%)
Frozen shrimps and prawns	12.0%	n.a.	0.0	90 354	90 354	90 382	89 355	4.7%	Bangladesh (99.1%)
Men's or boys' trousers, breeches, etc., of cotton	12.4%	n.a.	0.0	181 662	181 662	181 598	88 446	4.6%	Bangladesh (82.3%)
Total relevant imports				2 981 430	2 981 430	2 981 522	1 912 475	100%	

Source: UNCTAD.

do so in 2002 (and probably beyond that year) instead of adopting the "Form A" certificate that is required under the GSP regime. A transaction is, at the time of importation to the EU market, recorded under ACP trade flows or under GSP trade according to the certificate of origin ("EUR 1 or "Form A") that is presented by the importer in the customs declaration. The relative advantage that ACP LDC exporters and their clients may have found in using the ACP regime instead of taking advantage of the EBA treatment varies according to the product: under EBA, exporters may have deprived themselves of the more liberal cumulative rule granted by Cotonou with respect to the origin of inputs; on the other hand, by using the Cotonou terms instead of the EBA terms, they may have missed a more desirable margin of preference.[16]

28. Tobacco benefits from the highest preferential margin by virtue of ACP treatment, as this product faces an MFN tariff of 18.4%, with a minimum specific duty of 22 euros and a maximum specific duty of 24 euros per 100 kilograms. Groundnut oil (Gambia, Senegal) benefits from a preferential margin of 6.4% and has demonstrated a high utilization ratio (over 90%), while vanilla (Comoros, Madagascar) enjoys a preferential margin of 6%. Raw sugar (Eritrea, Malawi, the United Republic of Tanzania, Zambia) has also been exported to the European Union under preferential treatment, albeit at a low utilization rate (50%).[17]

29. In the area of non-agricultural goods, 32 tariff lines, including fisheries products, aluminum and garments, accounted for 85% of all relevant imports from ACP LDCs under Cotonou preferences. The largest trade value within this range has been for unwrought aluminum (Mozambique), under a preferential margin of 6%. There have been higher margins (and high utilization rates) for preserved tuna (24%), with Madagascar and Senegal as the main beneficiaries, while fresh fish from Senegal and Mauritania was exported at a 15% preferential margin. Garments such as T-shirts, jerseys and trousers (Madagascar) are also among goods that have enjoyed over 10% preference and a high utilization rate.

The “Everything but Arms” (EBA) preferences

30. Four tariff lines relevant to garments and one tariff line for shrimps accounted for 59% of all imports of non-agricultural goods from non-ACP LDCs under the (EBA) GSP scheme in 2002. Some 40 tariff lines at the 8-digit level covered 85% of all relevant imports. The non-ACP LDCs that benefited most from this preferential scheme were Bangladesh, Cambodia, Nepal and the Lao People's Democratic Republic. T-shirts and jerseys of cotton and man-made fibre (mainly from Bangladesh) accounted for 42% of all imports of non-agricultural goods from non-ACP LDCs under the GSP. The utilization rate has been high for knitted or crocheted garments from Bangladesh, but always low or near to zero for Cambodia, partly as a result of difficulties in meeting rules of origin.[18]

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[16] See UNCTAD, "Trade preferences for LDCs: an early assessment of benefits and possible improvements" (UNCTAD/ITCD/TSB/2003), pp. 48–49.

[17] A large share of raw sugar exports from ACP LDCs in 2002 actually took place under GSP (EBA) preferential terms.

[18] See UNCTAD, "Trade preferences for LDCs: an early assessment of benefits and possible improvements" (UNCTAD/ITCD/TSB72003/8).

Table 5

Key LDC products imported under the GSP scheme of Japan in 2002

Product description	Tariff rates		Imports in thousands of US dollars				Share of all relevant preferential trade	Main supplier and its share of total relevant imports
	MFN	LDC	Total imports from LDCs	Dutiable imports from LDCs	Imports of goods covered by relevant preferential treatment	Imports of goods effectively receiving relevant preferential treatment		
Imports of agricultural products from LDCs under the Japanese scheme								
Macadamia nuts, fresh or dried	5.0%	0.0	2 334	2 334	2 334	2 243	73.7%	Malawi (100%)
Beeswax	12.8%	0.0	799	799	799	799	26.3%	Ethiopia (51%)
Total relevant imports			3 133	3 133	3 133	3 042	100%	
Main imports of non-agricultural products from LDCs under the Japanese scheme								
Octopus	7.0%	0.0	41 088	41 088	39 822	39 822	20.9%	Mauritania (97.3%)
Cathodes and sections of cathodes of copper	2.0%	0.0	55 372	55 372	55 372	33 253	17.5%	Zambia (67.7%)
Other footwear	33.8%	0.0	28 738	28 738	28 738	28 738	15.1%	Bangladesh (39.7%)
Other footwear	33.8%	0.0	20 916	20 916	20 916	20 916	11.0%	Cambodia (38.1%)
Total relevant imports			215 490	215 490	214 224	190 230	100%	

Source: UNCTAD.

LDCs and the preferential scheme of Japan

31. On the Japanese market, two products, macadamia nuts and beeswax, accounted for 78% of all agricultural preferential imports from LDCs in 2002, with preferential margins of 5% and 12.8%, respectively.

32. For non-agricultural products, 14 tariff lines accounted for 85% of all imports from LDCs under the Japanese scheme. Octopus has been the leading product (mainly from Mauritania), with a preferential margin of 7% and a 90% utilization rate. Footwear imports (mainly from Bangladesh, Cambodia and Myanmar) took place under a high preferential margin (33.8%), while copper from Zambia was the main import from sub-Saharan Africa, with a preferential margin of 3%.

LDCs and the preferential schemes of the United States

33. Not all US imports from LDCs are duty-free and quota-free. LDCs actually tend to face, on the US market, higher average tariffs than other suppliers. In 2003, the average US tariff on imports from LDCs was almost three times as high as the average tariff on non-

preferential imports into the US market (1.59%). There have been two reasons for this situation.

34. First, the United States does not grant market access preferences to LDCs by virtue of systematic special treatment of these countries. A long-standing principle of US trade policy has been to make preferential treatment conditional on recipients' adherence to certain eligibility criteria, which largely relate to the laws and policies of the relevant countries. Two preferential schemes, the US GSP scheme and the AGOA regime, extend preferential treatment to a range of developing countries, including several LDCs. While 41 LDCs are recipients of maximum preferential treatment under the US GSP programme (under the designation "least developed beneficiary countries",[19] which is unrelated to the United Nations' LDC categorization), six are denied any GSP treatment and therefore excluded from "least developed beneficiary country" preference.[20] The remaining three LDCs[21] benefit only from the basic GSP regime.

35. The second reason relates to the commodity structure of US trade with LDCs: apparel remains excluded from the GSP scheme, thereby limiting the product coverage of US preferential trade with LDCs, insofar as garments represent a substantial part of potential exports to the United States from several LDCs. Table 6 (on page 14) shows that a few countries and tariff lines account for a large share of the benefits derived by LDCs from the two main preferential schemes of the United States.

36. With $2.7 billion of Angolan exports under the US GSP scheme in 2002, crude petroleum oil largely dominates the list of US preferential imports of goods from LDCs. Without Angolan oil, the overall value of LDC exports to the United States under effective preferential conditions was only $203 million in the same year, or little above the total value of LDC exports to Japan under preferential terms.

37. Malawi, with preferential exports of tobacco in the amount of $5.3 million under AGOA, had a utilization rate of only 25% but accounted for nearly 70% of total agricultural imports from LDCs under AGOA terms in 2002. In the non-agricultural area, AGOA exports from LDCs mainly fall under seven tariff lines relating to garments from Lesotho and Madagascar, which accounted for 84% of all relevant preferential exports.

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[19] See UNCTAD, *Generalized System of Preferences: Handbook on the Scheme of the United States of America*, 2003 (UNCTAD/ITCD/TSB/Misc.58/Rev.1), p. 4.

[20] The Lao People's Democratic Republic, Liberia, Maldives, Myanmar, Sudan and Timor-Leste.

[21] Eritrea and Senegal (also AGOA beneficiaries) and the Solomon Islands.

Table 6

Key LDC products imported under US preferential schemes in 2002

Product description	Tariff rates: MFN	Tariff rates: AGOA	Tariff rates: "Least developed" regime under the GSP	Imports in thousands of US dollars: Total imports from relevant sub-group of LDCs	Imports in thousands of US dollars: Dutiable imports from relevant sub-group of LDCs	Imports in thousands of US dollars: Imports of goods covered by relevant preferential treatment	Imports in thousands of US dollars: Imports of goods effectively receiving relevant pref. treat.	Share of all relevant preferential trade	Main suppliers and their share of total relevant imports
Imports of agricultural products from LDCs under AGOA									
Tobacco	37.5 c/kg	0.0	n.a.	22 398	22 398	22 398	5 340	100%	Malawi (98.2%)
Total relevant imports				22 398	22 398	22 398	5 340	100%	
Main imports of non-agricultural products from LDCs under AGOA									
Sweaters, pullovers & similar articles	17.8%	0.0	n.a.	109 146	109 146	109 108	57 760	29.5%	Lesotho (59.5%)
Women's or girls' trousers of cotton	16.9%	0.0	n.a.	81 989	81 989	81 103	51 224	26.1%	Lesotho (66.6%)
Men's or boys' trousers of cotton	16.9%	0.0	n.a.	80 602	80 369	80 369	45 022	23.0%	Lesotho (59.1%)
Total relevant imports				331 129	331 129	329 796	196 103	100%	
Main imports of agricultural products from LDCs under the GSP scheme for countries regarded as "least developed"									
Ginseng	1%	n.a.	0.0	517	517	517	517	35.1%	DRCongo (100%)
Gelatine sheets and derivatives	2.8 c/kg + 3.8%	n.a.	0.0	286	286	286	286	19.4%	Bangladesh (100%)
Cigarettes containing tobacco	$1.05/kg + 2.3%	n.a.	0.0	253	253	253	253	17.2%	Cambodia (100%)
Total relevant imports				4 663	4 663	4 663	1 472	100%	
Imports of non-agricultural products from LDCs under the GSP scheme for countries regarded as "least developed"									
Petroleum oils	10.5 cents per barrel	n.a.	0.0	2 919 443	2 919 443	2 919 443	2 707 022	100%	Angola (85.3%)
Total relevant imports				2 919 443	2 919 443	2 919 443	2 707 022	100%	

Source: UNCTAD.

Anticipated trade effects of preference erosion

38. Table 7 (on page 16) presents the results of a simulation involving a scenario of total erosion of trade preferences, on the basis of a partial equilibrium model applied to some of the tariff lines examined earlier and to the trade flows that effectively took place under preferential terms. The simulation of the anticipated trade effects of preference erosion on selected products was created via WITS (World Integrated Trade Solution), a tool developed by UNCTAD in cooperation with the World Bank. This tool is particularly useful for analysing the first round of effects of trade liberalization for specific tariff lines. Inter-sectoral effects, which could be captured only through a general equilibrium model, are disregarded in this exercise, as are non-tariff barriers, including quantitative restrictions. Regarding garments, the model does not take into account the elimination of quotas under the WTO's Agreement on Textiles and Clothing.

39. Two types of anticipated trade effects are reflected in table 7. The trade creation effect results from changes in the demand for the relevant product in the market under consideration as a consequence of the price changes associated with the lowering of MFN tariffs.[22] The trade diversion effect reflects the substitution of goods imported from the relevant supplying country for similar goods originating from other supplying countries as a result of changes in the relative import prices associated with the tariff changes in the context of preference erosion. The negative diversion effect that is observed throughout the trade diversion column of table 7 represents the anticipated trade losses (for "losing suppliers") to foreign competitors in the relevant market after a hypothetical full erosion of preferential margins has taken place.

40. Despite the limitations arising from the absence of inter-sectoral consideration, the table indicates that there will be losses of market share among LDCs under some of the tariff lines that were identified as benefiting most from trade preferences. For the few products in the EU and Japanese markets (except for vanilla and fish fillets on the European single market) and for Malawi's tobacco exports to the United States, the (negative) diversion effect largely exceeds the (positive) creation effect, which corroborates the fear of an increased marginalization of relevant LDCs through losses in market shares. This adverse anticipated impact of preference erosion is particularly significant for tobacco growers in Malawi, aluminium producers and shrimp farmers in Mozambique, and footwear manufacturers in Cambodia. In the US market for garments, on the other hand, the trade creation effect of the simulated free trade (preference erosion) scenario is substantially larger than the trade diversion effect for two of the three tariff lines highlighted in table 7, mainly for the benefit of Asian LDC producers. Losses are anticipated in some of the LDCs that have been most dependent on market access preferences, such as Lesotho and Madagascar.

41. The latter segment of the simulation exercise is limited to a scenario of full erosion of preferential margins irrespective of the recent context of textile and garment quota elimination. These results therefore only reflect anticipated competitive responses to trade liberalization, all things being equal. For some LDCs, the elimination of quotas for textile products, while involving maintained preferences, may have more severe socio-economic consequences than the hypothetical scenario of full erosion of preferences summarized in table 7.

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[22] One assumes that the price changes fully reflect the relevant tariff changes – that is, that the tariff changes will fully benefit the consumers.

Table 7

Simulation of the impact on LDC exports of selected products of a free-trade scenario in the EU, Japanese and US markets

(All values in thousands of US dollars)

Product	Actual MFN tariff before the free trade scenario	Anticipated trade effects on LDCs		First gaining supplier		First or major losing supplier	
		Trade creation	Trade diversion	Country	Total trade effect	Country	Total trade effect
Simulated impact of the free trade scenario on EU imports of agricultural products of interest to ACP LDCs that have been recipients of Cotonou preferences							
Tobacco	18.4% (min. 22 euros, max. 24 euros per 100 kg)	63	-4 075	United States	6 160	Malawi	-3 345
Crude groundnut oil	6.4%	491	-1 017	Argentina	1 632	Senegal	-373
Vanilla	6.0%	890	-770	United States	329	Madagascar	-10
Simulated impact of the free trade scenario on EU imports of non-agricultural products of interest to ACP LDCs that have been recipients of Cotonou preferences							
Aluminum	6.0%	1,598	-36 581	Russia	52 646	Mozamb.	-34 986
Frozen shrimps and prawns	12.0%	4,752	-6 813	Argentina	5 604	Mozamb.	-3 555
Fresh or chilled fish fillets	9.0%	2,130	-915	Kenya	1 164	Jamaica	-24
Simulated impact of the free trade scenario on Japanese imports of non-agricultural products of interest to LDCs that have been recipients of relevant GSP preferences							
Octopus	7.0%	52	-3 573	Morocco	14 052	Mauritania	-3 458
Cathodes and sections of cathodes of copper	3.0%	915	-1 077	Chile	4 024	Myanmar	-428
Other footwear	33.8%	0	-2 774	Italy	3 013	Bangladesh	-1 111
Other footwear	33.8%	4	-3 692	Italy	4 769	Cambodia	-3 219
Simulated impact of the free trade scenario on US imports of agricultural products of interest to LDCs that have been recipients of AGOA preferences							
Tobacco	37.5 c/kg	223.0	-3 331	Brazil	9 527	Malawi	-3 136
Simulated impact of the free trade scenario on US imports of non-agricultural products of interest to LDCs that have been recipients of AGOA preferences							
Sweaters, pullovers and similar articles of cashmere	4.0%	224	-1 424	Hong Kong	12 536	Madagascar	-1 204
Sweaters, pullovers and similar articles of man-made fibres	32.0%	3 871	-3 695	Hong Kong	470 545	Lesotho	-921
Men's or boys' shirts of cotton	19.7%	4 261	-2 351	Hong Kong	185 807	Lesotho	-29

Source: UNCTAD.

42. Other recent studies have estimated the anticipated losses in relevant LDC exports at 1.7% of total exports from these countries, notably as a result of the concentration of these exports in products that enjoyed substantial preferential margins.[23]

Possible modalities and options to mitigate the adverse effects on LDCs of preference erosion

43. For nearly 30 years, market access preferences have been granted to alleviate the competitive handicaps of LDCs and facilitate their economic growth through export diversification. Although this objective remains vital to many LDCs, preferences have been and will continue to be eroded, and alternative or complementary approaches to supporting LDC trade are deemed necessary. As was recently pointed out in the Millennium Project's report to the Secretary-General of the United Nations, international trade policies ought to improve market access and terms of trade for the poorest countries and enhance their supply-side competitiveness through increased investment in infrastructure and trade facilitation.[24]

44. A number of important initiatives to improve market access for LDCs were recently undertaken by the main trading partners of these countries. It is generally recognized that the notion of preferential treatment could be explored more widely. In particular, special international support measures to enhance the supply capacities of LDCs have been called for, while intensifying utilization of remaining preferences and obtaining financial compensation for preference erosion are considered important objectives.

45. This section touches on a few possible options for mitigating the adverse effects of preference erosion: (a) improvement of the effectiveness of market access preferences; (b) financial compensation; and (c) a widened approach to the notion of special and differential treatment in the multilateral trading system, including preferential measures of direct relevance to the aim of supply capacity development.

Improving trade preferences

46. In the area of market access, there are ways to contain the magnitude or impact of preference erosion. Most importantly, developed trading partners should meet their commitment to extend bound duty-free, quota-free treatment to all products imported from LDCs, with rules of origin matching the industrial capacities of these countries. This request was reiterated by LDCs in relevant ministerial declarations (Zanzibar, Dhaka, Livingstone). The Doha Declaration reflected this request but fell short of achieving progress towards a binding of trade preferences and/or flexibility in rules of origin.

47. As several UNCTAD reports have stressed,[25] there are many gaps in the existing preferential schemes, with some countries and many products denied preferential treatment,

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[23] In particular, Limao finds that Bangladesh, Malawi and Madagascar will undergo the largest losses in absolute terms, while Malawi, Lesotho and Sao Tome and Principe are likely to be the top losers in terms of the ratio of losses to GDP. (See N. Limao and M. Olarreaga, "Trade preferences to small developing countries and the welfare costs of lost multilateral liberalization", *Policy Research Working Paper* 3565, 2005.) Another author has pointed out that Malawi, Mauritania, Haiti, Cape Verde and Sao Tome and Principe were found most vulnerable to preference erosion. See also D. Lippoldt and P. Kowalski, "Trade preference erosion: potential economic impacts", *OECD Trade Policy Working Paper* 17.

[24] See UN Millennium Project, Report to the UN Secretary-General, *Investing in Development: A Practical Plan to Achieve the Millennium Development Goals,* January 2005.

[25] See, in particular, "Trade preferences for LDCs: an early assessment and possible improvements" (UNCTAD/ITCD/TSB72003/8).

either in principle or in practice. It is highly advisable that developed trading partners endeavour to fill these gaps as soon as possible, preferably through conversion of unilateral preferential schemes into legally enforceable obligations. In contrast to the ordinary, unilateral GSP treatment of other developing countries, preferential access for LDCs could be made binding and permanent.

48. LDCs in which there is scope for progress towards graduation from LDC status through trade expansion (particularly in the garment industry) could gain much from increased efforts in that direction on the part of a major trading partner such as the United States. With regard to the EU market, current rules of origin tend to hinder utilization of EBA preferences in some manufacturing activities. The European Commission's recent initiative to simplify rules of origin provides an opportunity to revisit these rules with a view to enhancing preference utilization. Harmonization of rules of origin for trade preferences granted to LDCs remains, as UNCTAD has consistently argued, a highly desirable policy option.[26]

Compensating financially for preference erosion

49. Though legitimate by virtue of the Enabling Clause and considered an important aspect of international cooperation between trading partners, preferential market access has been a policy matter outside the competence of the GATT Secretariat (until 1994) or the WTO (since 1995). The legal status of the GSP within the multilateral trading framework has been that of an exception to some of the basic rules of multilateral trade, but not a binding obligation.[27]

50. The idea of financially compensating countries for the adverse effects of preference erosion has never been envisaged as a multilateral trade issue. On the other hand, financial packages have been common in most bilateral and regional integration schemes. In particular, compensatory financing mechanisms existed under the Lomé Conventions between the EU and ACP countries and were retained in the Cotonou Partnership Agreement, as illustrated by the FLEX instrument, which provides budget support to ACP countries.[28] In 1999, a Special Framework for Assistance (SFA) was established by the European Commission to support ACP banana producers in the context of the anticipated phasing out of the preferential treatment they had been enjoying in the EU market. Another product-specific financial assistance programme (with a scope of 70 million euros) was established in favour of the Caribbean rum industry to compensate producers for the erosion of preferential margins in the EU and US markets for spirituous beverages after these markets were liberalized in 1996.

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[26] See the reports of UNCTAD's Working Group on Rules of Origin; and S. Inama, "A comparative analysis of GSP rules of origin", *Journal of World Trade* 29 (1), February 1995.

[27] A recent proposal also suggesting that the Enabling Clause be revisited and that many technical questions be answered envisaged replacing market access preferences with import subsidies; see Nuno Limao and Marcelo Olearraga, "Trade preferences to small developing countries and the welfare costs of lost multilateral liberalization", World Bank, 2004. In theory, import subsidies could be as efficient as market access preferences in remedying the competitive disadvantage of LDCs. Proponents of this approach to preferential treatment argued that its cost would be marginal, given the expected annual gain (estimated at $2.9 billion) for LDCs in relevant markets.

[28] Financial support under the Stabex (a financial compensation mechanism aimed at offsetting – ex post – instability in export earnings) covered only a set of eligible products, with a view to supporting the relevant commodity sector. FLEX was introduced in 2000, in the framework of EU-ACP cooperation, to assist ACP governments facing sudden losses of export earnings. It provides budgetary support to countries that have incurred a 10% loss in their export earnings (2% in the case of LDCs) and a 10% worsening of their programmed budget deficit.

Financial cooperation with developing countries in the form of grants to mitigate the adverse effects of trade liberalization has been common practice on the part of the European Union.[29]

51. In 2004, the International Monetary Fund (IMF) announced the establishment of a trade integration mechanism (TIM) to help developing countries overcome the balance-of-payments problems they would encounter as a consequence of multilateral trade liberalization.[30] The IMF quoted the erosion of tariff preferences, adverse changes in the terms of trade of countries that depended on food imports, and the dismantling of quotas under the Agreement on Textiles and Clothing as likely causes of balance-of-payments difficulties for many developing countries.

52. The TIM has been extensively debated by the international community. Some have noted that the proposed mechanism will increase the debt burden of the poorest countries. Others have pointed out that utilizing the TIM may turn out to be difficult, as was the case for the IMF's Compensatory Financing Facility (CFF) in the 1960s. The CFF had been designed to assist countries hurt by fluctuations in world commodity prices, but the conditionalities attached to it made the facility go largely unused.

53. The idea of establishing a compensatory fund to respond to the issue of preference erosion has also been proposed.[31] The rationale for such a fund arises from the notion that, while the Doha development agenda (DDA) is a "global public good" of overall interest to the international community, the benefits expected from its realization are unlikely to be equitably distributed among WTO members, and even among developing countries within the membership. Since trade liberalization remains the ultimate overall objective of the DDA, and since that implies much greater adjustments costs for some countries than for others, a fund based on contributions from donor countries could aim at compensating disadvantaged countries for relevant adjustment efforts, particularly in the context of preference erosion. While this idea has generally been welcomed by concerned members, a number of questions regarding the criteria for assessing preference erosion and determining compensation, as well as the management of the fund, still have not been answered. Potential recipient States also noted that, to be significant, the financial contributions allocated to the compensatory fund should be additional to the amounts already available under bilateral programmes.

54. Admittedly, the question of financial compensation for LDCs that are faced with the challenge of preference erosion should be at the heart of the current debate on "aid for trade", which is a cornerstone of the international community's thrust to meet the United Nations Millennium Development Goals.[32] To be effective and have the desired impact, aid for trade should be neither debt-generating nor encumbered by conditionalities, and it should have a long-term approach to development needs as opposed to responding to balance-of-payments shocks with temporary adjustment measures.

[29] Such assistance was deemed essential to fulfil the objectives of the European Union's Mediterranean policy in response to the difficulties faced by Mediterranean economies in meeting their regional and multilateral obligations.

[30] "Financing of Losses from Preference Erosion", Communication from the International Monetary Fund (WT/TF/COH/14), 14 February 2003. The idea of a mechanism to support trade-related balance-of-payments adjustment was developed by the Policy Development and Review Department of the IMF. The TIM was officially established by a decision of the Fund on 13 April 2004.

[31] See Sheila Page and Peter Kleen, "Special and differential treatment of developing countries in the WTO", Report to the Ministry of Foreign Affairs of Sweden, 2004.

[32] A 1-billion-euro aid-for-trade pledge was made on behalf of the European Union by European Commission President José Manuel Barroso before the opening of the G8 Summit in Gleneagles (United Kingdom) in July 2005.

Remedying the adverse effects of erosion in a wider context

55. Proposals for a reform of special and differential treatment modalities have been made in the context of negotiations under the DDA, and in the recent literature.[33] Some have taken the view that the Trade Policy Review (TPR) mechanism of the WTO could be enhanced as the forum where the special treatment of developing countries in general, and LDCs in particular, by their trading partners ought to be assessed and monitored. Full transparency in this matter could be achieved through the TPR of individual LDCs and cross-examination of their situation through the TPR of their development partners. It has been noted that the TPR mechanism offers a practical window on the extent to which WTO-consistent special treatment principles are adhered to and effectively implemented. Outside the WTO membership, development-related organizations can derive from the TPR precious information on the range of special treatment modalities from which any relevant country has benefited. Such information will cast light on possible additional needs for concessionary treatment and allow the determination of sound packages of international support measures.

56. The Integrated Framework for Trade-Related Technical Assistance to LDCs (IF) admittedly facilitates joint examination of actual or desirable international support measures, within and outside the sphere of international trade, in favour of individual LDCs. The diagnostic work underlying IF technical assistance makes it possible for IF partners to determine how to effectively support individual LDCs in their efforts to overcome competitive and institutional disadvantages in the global economy, including constraints resulting from preference erosion. An inventory of needs for special treatment modalities in individual countries in the context of preference erosion could be undertaken as a complement to IF work. UNCTAD could provide relevant analytical inputs to the comprehensive review of LDCs' need for concessionary treatment.

57. The international debate on alternative special treatment modalities in the context of preference erosion started from the observation that preferential market access was not a sufficient condition for enhancing the export structure and export performance of developing countries. Accordingly, it has been widely recognized that preferential support from development partners ought to benefit the supply side of LDC economies directly, with a view to enhancing productive capacities.[34]

58. Preference-giving countries could make tax advantages available to their investors insofar as these invested in LDCs and committed themselves, for the benefit of recipient countries, to pursuing related objectives such as facilitating technology transfers, supporting environmental protection, promoting inter-sectoral linkages, and training counterpart persons in host countries. Should preferential options in the form of tax revenue forgone in developed countries be regarded as equivalent to subsidization, they could require approval of an exception or waiver to basic principles in the WTO. In that context, subsidies granted for foreign direct investment (FDI) and related commitments in LDCs should be considered non-actionable.[35]

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[33] See, for example, Bernard Hoekman and Susan Prowse," Development and WTO" in *Bridges*, February and March 2005 issues.

[34] See UNCTAD, *The Least Developed Countries Report 2004: Linking International Trade with Poverty Reduction* (UNCTAD/LDC/2004).

[35] Double taxation treaties between developed and developing countries are *de facto* equivalent to modalities of preferential treatment in favour of the countries that host or will host foreign investment. Assume that foreign investor X originating from developed country A has invested in enterprise Y in developing country B. By virtue of the double-taxation-related agreement between the two countries, X will be allowed to deduct from taxable profit in home country A the taxable profit earned in host country B if the latter earnings are reinvested there. Such

59. Other special treatment modalities could include subsidization of insurance in the context of foreign investment in LDCs,[36] particularly for countries that are prone to natural disasters. Special financing facilities through a global fund to bring FDI to LDCs could also be envisaged as an avenue for triggering inter-sectoral linkages through small and medium-sized enterprises (SMEs) in these countries, with particular support to SMEs that decided to join forces with foreign partners.[37]

Conclusion

60. There is a generally accepted notion that the benefits globally expected from a development-oriented outcome of the DDA will make financing of international responses to the adverse effects of preference erosion possible, and will, it is hoped, do so through newly generated resources as opposed to alternative uses of existing resources. However, global welfare gains from trade liberalization may not materialize for many communities that suffer from preference erosion. In the case of clothing exports, the effects of the recent elimination of quotas, combined with the erosion of preferences resulting from MFN tariff reduction, poses a challenge of unprecedented magnitude to large segments of the population of some LDCs.

61. Ongoing discussions on the use of trade preferences should lead to efforts on the part of preference-giving partners to improve rules of origin and other trade-related obstacles. However, while deepening of unilateral trade preferences is always possible, enhancing productive capacities ultimately remains the only structural response to the challenge of overcoming preference erosion in LDCs. Supply-side-related preferences, notably modalities to encourage FDI in LDCs, ought to be explored as an option at least as important as the immediate goal of making the best possible use of existing preferences.

62. The IF could facilitate country-specific international action on these two parallel fronts. New avenues for progress towards alternative special treatment options could be found through enhanced work under the IF. There is a need to identify the complete range of special treatment modalities that are deemed vital to any given LDC in the context of preference erosion, within as well as outside the sphere of multilateral trade. It has been suggested that the TPR mechanism within the WTO constitutes a framework through which progress could be achieved towards a better understanding of efforts by developed members to bring to fruition the special treatment of LDCs.

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arrangements constitute an incentive to invest in country B, and a sort of preferential treatment of that country. A related mode of preferential treatment (equivalent to a subsidy) would consist of extending to investor X the same right to avoid taxation, in home country A, of the profit earned in host country B even if X has faced little or zero taxation in country B.

[36] See Americo Beviglia Zampetti and Tobjörn Fredrikson, "The development dimension of investment negotiations in WTO: challenges and opportunities" in *Journal of World Trade* 4 (3), June 2003.

[37] See T. de Velde, "Promoting TNC-SME linkages: the case for a global business linkage fund", ODI, 2002.