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This UNCTAD GSP Newsletter provides government authorities and exporters in developing countries with information on current developments in the generalized system of preferences (GSP) and related issues. Following a period of re-organization, a few issues of Newsletters are expected each year while special issues will be published when relevant new information becomes available.

### *Contents*

- **RECENT DEVELOPMENTS IN THE GSP OF THE EUROPEAN UNION**
  - **The India-EU dispute case on the EU GSP 'Drugs Arrangement'**
- **UNCTAD TECHNICAL COOPERATION ACTIVITIES IN BRIEF AND LIST OF PUBLICATIONS ON GSP**

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## ➤ RECENT DEVELOPMENTS IN THE GSP OF THE EUROPEAN UNION - THE INDIA-EU WTO CASE ON THE EU GSP "DRUGS" ARRANGEMENT

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On 23 June 2005, EU Member states agreed on a new GSP scheme, which will come into force on 1 January 2006. The new scheme places particular emphasis on vulnerable economies, as well as expanding the range of products it covers and establishing simpler criteria for 'graduation' from the GSP benefits. The reformed EU GSP scheme streamlines the previous five different regimes into three, namely: the general scheme applicable to all developing countries; the special scheme limited to LDCs, i.e. the 'Everything But Arms' (EBA) initiative; and the special incentive arrangement for sustainable development and good governance, known as the 'GSP-Plus'. The additional preferences under 'GSP-Plus' will be applied before January 2006.

This new system is in no small part a response to the April 2004 WTO Appellate Body ruling on the EU GSP, the so-called 'Drug Arrangement'. The Panel and Appellate Body rulings on *European Communities – Conditions for the Granting of Tariff Preferences to Developing Countries* (complaint by India) seems to have affected the way the EU decided to modify its GSP scheme.<sup>1</sup> They also seem to have broader systemic implications to trade preferences in general within the multilateral trading system. The case pertained to the conditions for granting tariff preferences to developing countries under its GSP scheme, specifically special arrangements to combat drug production and trafficking (the 'Drug Arrangements').

The dispute on the EC GSP drugs and special labour and environment incentives was brought by India in March 2002. Under this scheme, a number of developing countries, mostly Central American and Andean countries,<sup>2</sup> as well as Pakistan, are provided with two major benefits vis-à-vis other non-LDC GSP beneficiaries. First, the scheme provides duty-free treatment for a wide arrays of products (some 3,600) including textiles and apparel products (and the suspension of specific

duties where present) for which only tariff reduction (thus not duty free) is granted under the general GSP scheme. Second, preferences have also been extended to an additional 316 products for the exclusive advantage of EU GSP 'Durgs Arrangement' beneficiaries, which are excluded from the general GSP scheme. India felt that, following the inclusion of Pakistan under the special drug arrangement,<sup>34</sup> Indian exporters were placed at a disadvantage, particularly in the apparel sector. India thus disputed the WTO compatibility of these special arrangements with both GATT Article I and the Enabling Clause.

It is worth recalling that in October 2000 Brazil had already complained, in respect of soluble coffee, of being graduated (i.e. excluded) in this product from the EU GSP scheme while neighbouring countries were given GSP special drugs benefits. On that occasion, the EU and Brazil were able to achieve an amiable solution by agreeing to set up a duty-free quota for Brazil (10,000 metric tons) in the EU market. The concern over the WTO consistency of such positive incentive schemes led the EU to seek, without success, a WTO waiver from Article I:1 of GATT 1994 for its scheme applicable to countries combating drug production and trafficking.<sup>5</sup>

No amiable solution was possible with respect to India's complaint, and WTO's DSM machinery was, therefore, put into motion.

On 5 March 2002, India<sup>6</sup> initiated a dispute settlement procedure against the EC's regime of

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<sup>3</sup> EC Council Regulation 2501/2001.

<sup>4</sup> On 1 January 2002, EC included Pakistan as beneficiary country under its Special Tariff Arrangement for Combating Drug Production and Trafficking under its 2002-2004 GSP Scheme.

<sup>5</sup> *Request for a WTO waiver - New EC special tariff arrangements to combat drug production and trafficking* (G/C/W/328).

<sup>6</sup> Besides the United States, several developing countries were third parties to the case, namely Bolivia, Brazil, Colombia, Costa Rica, Cuba, Ecuador, El Salvador, Guatemala, Honduras, Mauritius, Nicaragua, Pakistan, Panama, Paraguay, Peru, Sri Lanka, and Venezuela.

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<sup>1</sup> WT/DS246/R and WT/DS246/AB/R.

<sup>2</sup> Bolivia, Colombia, Costa Rica, Ecuador, El Salvador, Guatemala, Honduras, Nicaragua, Panama, Peru, and Venezuela.

special tariff preferences for developing countries.<sup>7</sup> India claimed that these special tariff incentive schemes are inconsistent with Article I:1 of GATT 1994 and are not justified by the Enabling Clause.<sup>8</sup> In its initial submission, India had challenged all special incentive schemes of the EU GSP, including for countries implementing certain international conventions regarding environmental and labour standards, but subsequently decided to withdraw this part of the challenge to limit its claims under the EU GSP 'Drugs Arrangement' scheme.<sup>9</sup> The Panel issued its Report on 1 December 2003. In essence, the Panel upheld both two principal claims of India. The Panel found that the Drug Arrangements was inconsistent with the MFN obligation of the GATT (Article I:1) and could not be justified with the requirements set out in paragraphs 2 (a) and 3 (c) of the 'Enabling Clause'.<sup>10</sup> The Panel also found that 'non-discriminatory' in footnote 3 of the Enabling Clause requires that "*identical tariff preferences under GSP schemes be provided to all developing countries without differentiation, except for the implementation of a priori limitations*" such as graduation mechanism (emphasis added).<sup>11</sup>

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<sup>7</sup> The 'Drugs Arrangement' had been part of the European GSP Scheme since 1990. For India this became relevant in 2001 when the EC had decided to extend the benefits under the arrangement to Pakistan. India argued that the EC had chosen a selective tariff preference and that the price had been paid not by the EC, but by other developing countries. (WT/DSB/M/167, 27 May 2004).

<sup>8</sup> First written submission of India, para. 67.

<sup>9</sup> Due to the initially broader nature of the claim, the case is called "*Conditions for the Granting of Tariff Preferences to Developing Countries*". Ultimately, however, the conditions were not the actual subject matter of the dispute.

<sup>10</sup> The Decision on Differential and More Favorable Treatment, Reciprocity, and Fuller Participation of Developing Countries (the "Enabling Clause") (GATT Document L/4903, 28 November 1979). Para 2 (a) of the Decision requires that any GSP tariff preferences granted to developing countries be "generalized, non-reciprocal and non-discriminatory".

<sup>11</sup> Para 7.176, WT/DS246/R.

The EU contested the finding and lodged an appeal to the Appellate Body to request the AB to reverse the Panel's conclusions on these basic claims.<sup>12</sup>

The Appellate Body's Report was circulated on 7 April 2004 and adopted on 20 April 2004 by the Dispute Settlement Body. Significantly, the Appellate Body reversed the Panel's conclusion on differentiation of trade preferences among (non-LDC) GSP beneficiaries. The Appellate Body found, unlike the Panel, that the term 'non-discriminatory' in footnote 3 to paragraph 2 (a) of the Enabling Clause does not require preference-granting countries to provide *identical tariff treatment for all developing countries*.<sup>13</sup> Rather, the Appellate Body found that the Enabling Clause authorizes preference-granting countries to 'respond positively' to 'needs' that are not necessarily common or shared by all developing countries, but such 'needs' of developing countries refers to 'development, financial and trade needs'. Second, any such 'response' must be a 'positive' one. Finally, any such response of a preference-granting country to the *varying* needs of developing countries must not impose unjustifiable burdens on other Members.

The Appellate Body also reversed the Panel's finding on the term 'developing countries' in para 2 (a) of the Enabling Clause that this term meant *all* developing countries. The Appellate Body made it clear that 'developing countries may mean *less* than all developing countries' and that footnote 3 and para 3 (c) does not preclude the granting of differential tariffs to different sub-categories of GSP beneficiaries (subject to compliance with the remaining conditions of the Enabling Clause).

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<sup>12</sup> The Panel had also rejected an EC claim that the measure could be justified under GATT Article XX (b), the (General exception) which allows a Member to implement trade-restrictive measures necessary to protect human, animal, or plant life or health. Upon appeal however, the EC did not seek review of the Panel's legal conclusions based upon Article XX (b) of the GATT.

<sup>13</sup> In its discussion of the term 'non-discrimination' in the Enabling Clause, the Panel devoted a substantive part of its report to examining UNCTAD documents related to GSP. The AB, however, did not follow the Panel's approach.

Accordingly, the Appellate Body ruled that under the Enabling Clause, in granting differential tariff treatment, preference-granting countries are required by virtue of the term 'non-discriminatory' to ensure that identical treatment is available to all *similarly-situated GSP beneficiaries*, with the same 'development, financial and trade needs' to which the treatment in question (i.e. drug incentive) is intended to respond. It recognized that these needs must not be determined arbitrarily, but be assessed according to an *objective standard*. This meant that GSP granting countries can apply differential treatment to GSP beneficiaries based on their development, trade and financial needs. While the Appellate Body allows that GSP preferences can be granted on a conditional basis, the ruling also requires any such conditions to have development objectives, and to be non-discriminatory with regard to similarly situated GSP beneficiary countries. In other words, in granting differential tariff treatment, preference-granting countries are required to administer it in a 'non-discriminatory' way to ensure that identical treatment is also available to all 'similarly-situated' GSP beneficiaries.

Nonetheless, the Appellate Body found certain substantive and procedural failings in the EU's drug scheme in the light of the requirement as identified above, and concluded that the preferences granted under the EU drug arrangements were not WTO compatible. This is because the enhanced preferences were only available to a 'closed list' of 12 beneficiary countries and not available to all GSP beneficiaries who also happened to be affected by the drug problem. Furthermore, the drug scheme "does not provide for transparent mechanism or objective criteria that would allow for other developing countries in similar circumstances to be added to the list of existing beneficiaries". The Appellate Body thus called for amendments to the EC Council Regulation governing the drug arrangements.

As noted above, the EU Council regulation for the new GSP scheme for 2006-2015 seeks to incorporate these recommendations so as to ensure its full conformity with WTO obligations. Issued on 20 September 2004, the WTO arbitrator's report

set 1 July 2005 as the deadline for the EC to implement the WTO recommendations.

The ruling is particularly significant as it provides justification and the criteria for differentiation among developing countries based on conditionality in providing different tariff treatment under the GSP schemes. It would therefore have practical and systemic implications to the operation and viability of the GSP programmes in general and differentiation of developing countries in particular. This, in turn, might have further bearing on the discussion of special and differential treatment for developing countries within the multilateral trading system enshrined in the WTO.<sup>14</sup>

One systemic implication of this ruling is that it dispenses preference-granting countries of the need to obtain a WTO waiver when providing differential treatment under GSP schemes, as long as they are based on objective criteria and administered in a transparent manner. It may be recalled, as noted above, that the EU had once sought to obtain WTO waiver for its drug incentive scheme in the WTO. In fact, in the DSB meeting adopting the report, several countries expressed concerns over the possibly significant systemic implications of the Appellate Body's (AB) ruling.<sup>15</sup> Some of them considered that the AB interpretation of 'developing countries' in paragraph 2 (i.e. that it might mean less than all developing countries) opened up an uncertain future for SDT within WTO, as it would be subject to criteria that is deemed to be objective but may, in fact, be based on arbitrary standards. Others concluded that the AB report could be understood as legitimizing GSP as a foreign policy tool. Another concern related to the creation of new sub-category of developing countries and differentiation among developing countries, the multilateral framework currently only recognizes three categories of countries: developed, developing and least developed countries. Yet

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<sup>14</sup> It may be noted that in the context of the ongoing WTO Doha negotiations on the review of special and differential treatment, an attempt was made to initiate discussion on differentiating developing countries based on the 'situational needs' of individual countries.

<sup>15</sup> Minutes of the meeting of the DSB on 20 April 2004 (WT/DSB/M/167, 27 May 2004).

another concern was raised as to the manner in which preference-granting countries would identify 'similarly-situated beneficiaries'.

## ➤ UNCTAD PUBLICATIONS

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Handbook on the Scheme of **Australia** (UNCTAD/ITCD/TSB/Misc.56)

Handbook on the Scheme of **Bulgaria** (UNCTAD/ITCD/TSB/Misc.67)

Handbook on the Scheme of **Canada** (UNCTAD/ITCD/TSB/Misc.66)

Handbook on the Scheme of the **Czech Republic** (UNCTAD/ITCD/TSB/Misc.63)

Handbook on the Scheme of the **European Community** (UNCTAD/ITCD/TSB/Misc.25/Rev.1)

Handbook on the Scheme of **Hungary** (UNCTAD/ITCD/TSB/Misc.64)

Handbook on the Scheme of **Japan** (UNCTAD/ITCD/TSB/Misc.42/Rev.2)

Handbook on the Scheme of **New Zealand** (UNCTAD/ITCD/TSB/Misc.48)

Handbook on the Scheme of **Norway** (UNCTAD/ITCD/TSB/Misc.29)

Handbook on the Scheme of **Poland** (UNCTAD/ITCD/TSB/Misc.51)

Handbook on the Scheme of the **Slovak Republic** (UNCTAD/ITCD/Misc.50)

Handbook on the Scheme of **Switzerland** (UNCTAD/ITCD/TSB/Misc.28/Rev.1)

Handbook on the Scheme of the **United States** (UNCTAD/ITCD/TSB/Misc.58)

Digest of Schemes (UNCTAD/TAP/136/Rev.7)

Digest of Rules of Origin (UNCTAD/TAP/133/Rev.7)

Improving Market Access for Least Developed Countries (UNCTAD/DITC/TNCD/4)

Quantifying the Benefits Obtained by Developing Countries from the GSP (UNCTAD/ITCD/TSB/Misc.52)

Globalization and the International Trading System – Issues relating to rules of origin (UNCTAD/ITCD/TSB/2)

Compendium on Rules of Origin, Part I (UNCTAD/ITD/GSP/31)

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