CHAPTER 12

DEVELOPING COUNTRIES AND ECONOMIES IN TRANSITION

For a long time, the GATT was a club that was primarily of relevance to OECD countries. Developing countries did not participate fully in the exchange of concessions in negotiations, although they benefitted from generally applicable national treatment and MFN disciplines. With the creation of the WTO this changed. Developing countries became subject to a large number of obligations—some newly negotiated in the Uruguay Round, others originally negotiated during earlier rounds among industrialized nations. The resulting implementation 'overhang' had significant repercussions for the organization, resulting in 'development concerns' becoming a more prominent agenda item and the creation of mechanisms to provide assistance to developing country members. The implementation problems are part of the broader challenge of integrating developing and transition economies into the global trading system. Almost all countries have become much more open to trade and FDI, but a large subset have not sustained high growth or diversified their economies.

Although differences in view persist on the appropriate role of government intervention to support or restrain trade (see Chapters 1 and 9), there is general agreement on the strong positive association between economic development and trade expansion. The WTO promotes trade, and in that sense could be expected to be seen as an institution that promotes development. However, despite

the boom in world trade that has occurred in the last 30+ years—in part under the stewardship of the GATT/WTO—and the increasing participation of many developing countries in world trade, many observers have been concerned about the impact of the GATT/WTO on the economic development prospects of poor countries (see e.g. Stiglitz, 2000; Oxfam, 2002).

These concerns often boil down to two specific problems. First, the focus of the institution on negotiating market access 'concessions' on a reciprocal basis. Here, the problem is that in the case of small developing countries which are of only limited interest from an export perspective, the system of reciprocity does not 'work'. Political scientists would characterize this as a reflection of the huge asymmetries in power between WTO members. Being price-takers on world markets, such countries cannot offer enough to induce larger traders—the most interesting markets—to improve access. This also reduces the value of the WTO as a commitment mechanism as it implies fewer enforcement incentives (see Chapters 1 and 3).

Second, common policy disciplines may not be appropriate for all countries. For example, taxing trade may be the most effective method for a government of a developing country to raise revenue, implying that reducing tariffs, even if in principle seen as desirable by a government, only becomes feasible once the capacity exists to reliably tap domestic tax bases. Increasingly, the ambit of the WTO extends beyond trade policy. Although harmonization of regulatory policies may reduce negative spillovers on foreign firms, there may be strong economic efficiency rationales for regulatory diversity. Even where harmonization is welfare-enhancing, it may give rise to asymmetric implementation costs, in that the burden may fall disproportionately on poorer countries (Finger and Schuler, 2000).

This chapter discusses developing country participation in the GATT/WTO, efforts in the Doha Round to address developing countries' concerns, and the ongoing debate regarding the appropriate role of the WTO in helping its poorer members to more fully use trade opportunities to increase economic growth and welfare. The chapter also discusses the experience with accession to the WTO by developing and transition economies, including by China in 2001.

12.1 Developing Country Participation

The terms of developing country participation in the multilateral trading system have oscillated between reciprocity and disengagement. A timeline of major highlights is summarized in Table 12.1. Four stages can be identified:

Table 12.1. Developing countries and the trading system

Date	Event
1947	Twelve of what would now be called low-income countries accede to the GATT on essentially the same terms as developed countries. An infant-industry protection clause (Article XVIII) is the main development-specific provision in GATT.
1954–5	Article XVIII is modified to include XVIII:*b* allowing for QRs to be used for BOP purposes whenever foreign-exchange reserves are below what is considered necessary for economic development. This vague test constitutes much weaker discipline than Article XII. It has been invoked extensively (see Chapter 9).
1964	Establishment of UNCTAD. A Committee for Trade and Development is created in the GATT to address development-related concerns.
	The International Trade Centre (ITC)—a technical cooperation agency in the area of trade promotion—is created by GATT contracting parties charged with assisting developing countries to promote exports.
1965	A new Part IV on Trade and Development is added to the GATT, establishing the principle of nonreciprocity for developing countries. However, Part IV contains no legally binding obligations, other than to consult.
1968	The US accepts the Generalized System of Preferences (GSP)—as called for by UNCTAD—under which industrialized countries voluntarily grant tariff preferences to developing countries.
	The ITC becomes a joint venture between GATT and UNCTAD.
1971	A GATT waiver is granted authorizing tariff preferences under the GSP. Another waiver is adopted for the Protocol on Trade Negotiations among Developing Countries (Geneva Protocol).
1973–9	More than 70 developing countries participate in the Tokyo Round. The Enabling Clause is adopted. It formalizes the concept of 'special and differential treatment' (SDT), makes the 1971 waivers permanent and includes language on graduation. Most developing countries abstain from signing the various Tokyo Round codes.
1986	Developing countries participate in the preparation for a new round. The Punta del Este ministerial declaration launching the Uruguay Round contains numerous references to SDT.
1994	All developing country GATT contracting parties join the WTO, adopting the results of the Uruguay Round as a Single Undertaking.
1997	The Integrated Framework for Trade-related Technical Assistance for Least Developed Countries is created at the Singapore ministerial.
1999	Developing countries put forward more than half of all the submissions for the Seattle ministerial meeting.
2000	US passes the African Growth and Opportunity Act (AGOA), granting duty- and quota-free market access to African countries.
2001	Doha Development Agenda launched; ministerial declaration calls for 'strengthening of SDT provisions and making them more precise, effective and operational' (para. 44).
	EU 'Everything But Arms' duty- and quota-free initiative for LDCs adopted.
	China accedes to the WTO.
2002	WTO Global Trust Fund established to help developing countries participate in and benefit from negotiations.
2003	Creation of the G20, a coalition of developing countries including Brazil, China, India and South Africa; Brazil launches disputes against US cotton subsidies and EU sugar subsidies.
	Four LDCs, Benin, Burkina Faso, Chad and Mali—the so-called cotton four—push for a Doha Round accelerated initiative on cotton (see Chapter 6).

Table 12.1. *(Continued)*

Date	Event
2005	Agreement at the Hong Kong ministerial for high-income countries to provide LDCs with duty- and quota-free access for at least 97% of trade.
	The hundredth dispute is initiated by a developing country.
2006	WTO taskforce calls for an Aid for Trade initiative.
2008	Donors and LDCs put in place the Enhanced Integrated Framework.
	Expiry of the WTO waiver for EU–ACP preferences on 1 January.

(1) limited membership of low-income countries in GATT (12 of the original 23 signatories were developing economies) based on a formal parity of obligations (1947–64);
(2) substantial expansion of developing country membership, based on the concept of more favourable and differential treatment (1965–86);
(3) deepening integration of developing countries into the GATT-WTO system, with a return to greater reciprocity (1987–97); and
(4) a shift back to an emphasis on special and differential treatment (SDT), especially for LDCs, increasing de facto differentiation and heterogeneity of views (1998–present).

The initial premise underlying GATT 1947 was essentially parity of obligations—making no distinction between rich and poor trading nations, despite arguments by India and other countries that provisions were needed to allow developing countries to protect industries (Hudec, 1987). A number of provisions allowing for such measures to be applied were included in the GATT, but they implied reciprocity in that their invocation was subject to disciplines (see Chapter 9). In the mid-1950s, with a large number of colonies approaching independence, the concept of giving SDT to developing countries arose. The underlying justification for this reflected development thinking at the time—most notably work by Raúl Prebisch and Hans Singer—which was premised on the argument that developing countries needed to foster industrial capacity both to reduce import dependence and to diversify away from traditional commodities. Diversification was needed in part because commodities were held to be subject to long-term declining terms of trade (because of low income elasticity of demand) as well as detrimental short-term price volatility (Singer, 1950; Prebisch, 1952). This gave rise to the policy prescription of high trade barriers so as to protect infant industries—i.e. import-substitution industrialization—and a call for exemptions from the GATT negotiating principle of reciprocity in the exchange of market access commitments.

At the same time it was recognized that exports were important as a source of foreign exchange and that the local market might be too small for a protected local industry to be able to realize economies of scale. The second plank of the SDT

agenda therefore revolved around calls for preferential access to export markets—a general system of preferences that would give developing countries better than most-favoured-nation (MFN) treatment in the major markets of the world—the industrialized countries. A final plank of SDT was development assistance targeted towards helping developing countries penetrate export markets. This was the rationale for the creation of the ITC in 1964 by the GATT CONTRACTING PARTIES. Despite an effort to improve 'coherence' by making the ITC a joint body of the GATT and UNCTAD in 1968, this plank of the response to developing country concerns became a bit of an orphan in subsequent years. It was somewhat ironic that renewed recognition of the need for proactive assistance came back to the fore in the Doha Round, resulting in the creation of an 'enhanced integrated framework' to assist LDCs to benefit from trade opportunities.

All three types of preferential treatment were justified in various ways. One argument was so-called export pessimism. The fear was that if developing countries relied upon exports for growth, their supply of commodities would exceed what could be absorbed by the world. The resulting excess supply and consequent decline in world prices justified trade restrictions by developing countries—in effect, they should impose tariffs to improve their terms of trade (Prebisch, 1952; Bhagwati, 1988). Given their reliance on exports of commodities, export pessimism was complemented by the view that developing countries needed protection to achieve industrialization and economic development, and that a 'new world trade order' was required to break the vicious circle of underdevelopment. It was also argued that developing countries suffered from foreign exchange shortages and that protectionist policies were needed to protect their balance of payments. International trade was seen by some as an instrument of exploitation and self-sufficiency as an appropriate objective for policy.

Part IV of the GATT and the Enabling Clause

The institutional expression of this line of thinking was embodied in the creation of UNCTAD in 1964, and the formation of a political bloc of developing countries in the UN called the 'Group of 77' (G77). In 1965, developing country demands for special status in the multilateral trading system led to the drafting of a new Part IV of the GATT. This formalized the concept of SDT for developing countries. To a large extent the adoption of Part IV can be seen as a reaction of GATT contracting parties to the creation of UNCTAD and the generalized system of preferences (GSP) established under UNCTAD auspices.[1] As of that moment, SDT was a core component of the trading system.

[1] UNCTAD was founded in 1964, with Raúl Prebisch, an Argentine national, as the first Secretary-General.

Special and differential treatment implied that developing countries were not expected to grant reciprocal tariff concessions and bind tariffs.[2] For example, the 1973 ministerial meeting that launched the Tokyo Round stated that the negotiations should secure additional benefits for developing countries in order to achieve a substantial increase in their foreign exchange earnings, diversification of their exports and an acceleration of the rate of growth of their trade. It confirmed that developed nations should not expect reciprocal concessions from developing economies. The inconsistency between these goals and the policy of allowing developing countries to maintain protection and GATT-inconsistent trade regimes was not openly remarked upon. However, during the negotiations, high-income countries repeatedly voiced their dissatisfaction with the reluctance of developing countries to agree to expand GATT disciplines. This found its expression in the negotiation of codes on various issues in which membership was voluntary, see Chapters 5 and 11, thus avoiding the veto that was likely by developing countries if an attempt was made to amend the GATT to include new obligations.

One result of the Tokyo Round was the 1979 Framework Agreement, which included the so-called Enabling Clause. Officially called Differential and More Favorable Treatment, Reciprocity and Fuller Participation of Developing Countries, it provided for departures from MFN and other GATT rules. The Enabling Clause created a permanent legal basis for the operation of the GSP. It codified principles, practices and procedures regarding the use of trade measures for BOP purposes (Articles XII and XVIII), and made GATT's Article XIX redundant for developing countries by giving them flexibility in applying trade measures to meet their 'essential development needs'. It also weakened the reach of Article XXIV on regional integration by eliminating the 'substantially all trade' requirement and the provision prohibiting an increase in the average level of external protection for customs unions.

The quid pro quo for the codification of these exemptions was the inclusion of a graduation principle. This was vaguely worded, however, and was more in the nature of a statement of principle. An important reason for this fuzziness was that most of the SDT provisions were (and remain) 'best endeavour' commitments—they are not binding. No dispute settlement cases can be launched by a developing country government on the basis that a high-income country is not delivering on the promises that are made in the various agreements.

[2] Much depended here on how a country acceded to the GATT. Most developing countries acceded under Article XXVI:5*c*, under which former colonies could undertake to accept the obligations initially negotiated by the metropolitan government. As these had generally not established separate tariff schedules for their colonies, newly independent states were able to accede without submitting a schedule. Countries that were not ex-colonies were generally required to negotiate accession under Article XXXIII GATT, a tougher proposition that required establishment of a tariff schedule.

The idea that the most successful developing trading nations should begin to move back towards a parity of obligations first appeared in the late 1970s. The basic objective of OECD countries was to progressively integrate into the GATT system developing countries with large markets or substantial trade levels and growth. This strategy was not so much inspired by growing evidence that economic development required liberal trade and pro-market policies—which was being compiled under the leadership of scholars such as Jagdish Bhagwati and Anne Krueger—but because a number of countries had managed to grow sufficiently to become attractive markets. The fact that many such countries often had large positive trade balances with industrialized countries provided an additional incentive to try to impose graduation criteria. Conversely, the developing countries concerned had more of an incentive to play the reciprocity game to improve and defend their access to export markets.

A problem with graduation was that no agreement existed on what constituted a developing country. Indeed, the issue was carefully avoided. For example, when Portugal and Israel claimed developing country status in the GATT Balance-of-Payments Committee so as to be able to invoke Article XVIII:*b*, the committee avoided pronouncing itself on the matter. It was left to countries to self-declare their status, usually upon accession to the GATT. Individual contracting parties could also decide for themselves whether to treat a particular trading partner as a developing country. This continues to be the case under the WTO. An exception concerns the group of 49 least-developed countries, where the UN definition is used. In practice, therefore, graduation was and is left to bilateral interaction and tends to be limited to obvious candidates. The decision by Korea to cease invocation of Article XVIII to justify trade restrictions (discussed in Chapter 9) is an example. However, to this day countries such as Singapore and South Korea continue to define themselves as developing countries in the WTO—'graduation' happens *de facto* not *de jure*, and often on an issue or agreement-specific basis.[3]

Although the rationale for SDT was based on prevalent theories that import substitution was a necessary element in effective development strategies, as mentioned previously, the GATT reciprocity dynamic was less effective in a developing economy context. A necessary condition for reciprocity to work is that decision-makers confront lobbies that seek better access to foreign markets. A problem was that potential gainers from such greater access, export industries, often did not exist or were small in developing countries. Moreover, those that might have favoured domestic liberalization as a quid pro quo for better access to foreign markets often benefitted from preferential (GSP) treatment, reducing their incentive to go head-to-head with domestic import-competing industries. Frequently,

[3] In the case of nonreciprocal preference programmes (GSP or GSP+), the donor country defines what the eligibility and graduation criteria are. These vary widely across OECD countries.

export industries were also granted exemptions from tariffs on their imported inputs, further reducing incentives to oppose protection at home.

Policymakers in many developing countries were also highly sceptical of the benefits of full participation in the GATT. Although the key problem from a development perspective was not GATT and its reliance on reciprocity, but the pursuit of inappropriate economic policies, GATT did little to help convince governments to adopt more liberal trade policies. Only if a country managed through its own efforts to grow, run a trade surplus, and become a potentially attractive export market, were pressures exerted to bring the country into the GATT fold. Finally, global foreign policy considerations also played a role in the acceptance of SDT. Some high-income countries believed that an insistence on reciprocal obligations might help push poor nations to join the Soviet bloc (Kostecki, 1979). A concerted decision by major developing countries not to participate in the GATT would have been contrary to Western interests.

Increasing pursuit of economic self-interest

Developing country stances towards trade policy changed in the early 1980s, reflecting the debt crisis and the associated need to generate more foreign exchange and improve economic performance, the demonstration effect of the benefits of the export-oriented policy stance taken by the dynamic economies of South-East Asia, and the gradual collapse of central planning. As national trade policies became more neutral and export industries grew, interest in the GATT increased. Preferences and free riding were less beneficial to developing countries than they had expected. One reason was that MTNs were essentially conducted among developed trading nations, which concentrated on their own trade interests. As discussed in Chapter 4, the principal supplier rule used in MTNs helps ensure that free riding is minimized (Finger, 1974, 1979). Products of major importance to developing countries such as agriculture or textiles and clothing were either excluded from GATT or granted protectionist treatment on an ad hoc basis. Indeed, as noted in earlier chapters, the fact that developing countries were not playing the GATT game is one explanation for the continued existence of protectionist policies on textiles and clothing, footwear and other 'sensitive' labour-intensive sectors in OECD countries in the 1980s. Once developing country governments started to pursue unilateral liberalization and export-oriented strategies, the existence of high market access barriers in these sectors mobilized export lobbies to support more active participation in the GATT.

Unilateral changes in national policy stances led to a major shift in both the strategy and the tactics of developing countries in the GATT. They participated actively in the Uruguay Round, including the reciprocal exchange of 'concessions', and had a significant impact on the design of the GATS, and the Agreements on Textiles and Clothing, Safeguards and Agriculture. This influence was manifest from

the very start of the talks. At the 1986 Punta del Este ministerial meeting, a group of smaller developing and developed economies (the Swiss-Colombian coalition) played an important mediating role between the US, the EU, and large developing countries such as Brazil and India. This marked a sea change not just in terms of increased participation, but also because it became obvious that it was no longer appropriate to regard developing countries as a bloc. (This had never been the case but it became increasingly obvious in the Uruguay Round.) Instead, countries pursued their self-interest in a much more open way than in the past. This included teaming up with high-income countries if this was appropriate. The Cairns Group, discussed in Chapter 6, was a prominent example of a North-South coalition of countries that sought to liberalize world trade in agricultural products.

In contrast to the Kennedy and Tokyo Rounds, the Uruguay Round was a single undertaking: all agreements were to apply to all members, and all members were to submit schedules of concessions and commitments. With the Uruguay Round an important step was taken towards ending the dichotomy that had characterized the GATT for several decades. The primary reflection of SDT in the Uruguay Round were the various transition periods for the different agreements and the more limited extent of tariff cuts that needed to be made by developing countries. But the key change relative to the GATT years was that all the agreements applied to all developing countries.

Although the single undertaking implied a dramatic change for developing countries, the creation of the WTO did not mean SDT is dead. Ending SDT was not on the Uruguay Round agenda. Indeed, the Punta del Este Ministerial Declaration explicitly stated that

> CONTRACTING PARTIES agree that the principle of differential and more favourable treatment embodied in Part IV and other relevant provisions of the General Agreement... applies to the negotiations... [D]eveloped countries do not expect reciprocity for commitments made by them in trade negotiations to reduce or remove tariffs and other barriers to trade of developing countries. (p. 7)

Thus, SDT remained embedded in the WTO. Special provisions for developing and least developed countries can be grouped under five headings: lower level of obligations, more flexible implementation timetables, commitments by developed countries to take into account developing country interests, more favourable treatment for LDCs, and promises of technical assistance and training. With the exception of the Agreement on Subsidies and Countervailing Measures, no criteria for 'graduation' were agreed to. As mentioned in Chapter 5, the SCM agreement has *de minimis* provisions for developing countries and exempts nations with per capita incomes below US$1,000 from CVDs on export subsidies as long as global market shares do not exceed 3.5 per cent for a product. Although BOP rules and procedures were tightened, revocation of Article XVIII remains an issue that is effectively negotiated on an ad hoc basis.

Developing countries play an active role in the WTO, although there is enormous variation across countries in terms of participation in the WTO committee structure, dispute settlement and MTNs. Large countries such as Brazil and India are very active, as are many middle-income countries in Latin America and Asia. They increasingly take a leadership role and collaborate on an issue-by-issue basis. As discussed in Chapter 4, the creation of negotiating coalitions such as the G20 and G33 has had a major impact on the dynamics of negotiations. The number of submissions made to WTO bodies by developing countries has expanded steadily. In the run-up to the Seattle ministerial meeting, for example, developing countries submitted close to 100 proposals on topics ranging from traditional market access issues to 'second generation' topics such as competition and investment policy (WTO, 2000).

During the Doha Round negotiations developing countries submitted many hundreds of proposals and defended their trade interests actively. For example, in the nonagricultural market access (NAMA) negotiations, ministers agreed in Doha 'to reduce or as appropriate eliminate tariffs, including the reduction or elimination of tariff peaks, high tariffs, and tariff escalation, as well as non-tariff barriers, in particular on products of export interest to developing countries' (Article 49). Much of talks revolved around the so-called exchange rate or balance of concessions between agriculture and NAMA negotiations. In this, as in other areas of the negotiations, SDT objectives were pursued vigorously. For example, the G33 group of developing countries proposed that up to 20 per cent of their agricultural tariff lines be defined as 'special' and that up to half of these would be exempted from tariff cuts, with the rest being subjected to only modest reductions (see also Chapter 4).

Another proposal tabled by the Mercosur members—Argentina, Brazil, Paraguay and Uruguay—called for developing country customs unions to be granted additional opportunities to shield products from tariff cuts, in order to preserve their common external tariff. Specifically, they proposed subjecting up to 16 per cent of industrial products to tariff cuts half as deep as those that would normally be required by the Swiss formula, with no cap on the share of imports involved. The argument for additional flexibility was that customs union members have only restricted ability to use flexibilities, as the common external tariff requires shielding the same products from tariff reduction resulting from the application of the 'Swiss formula' and the set of sensitive products differed across members of Mercosur. Although strongly opposed by other WTO members, in 2008 negotiators were more open to the idea of granting a limited measure of special consideration to the Southern African Customs Union (SACU), reflecting the fact that SACU includes two LDCs (Swaziland and Lesotho) and two countries that account for only a very small fraction of world trade (Namibia and Botswana).

More active participation extended to the poorest countries, even those without representation in Geneva, who formed into regional or issue-specific negotiating

groups. Examples are the Africa group and the LDC group, which developed collective positions in the Doha Round in separate ministerial level meetings before major WTO conferences. These groups were supported by regional institutions—such as the African Union in case of Africa countries—as well as organizations such as the Agency for International Trade Information and Cooperation (AITIC), established in 2004, the International Centre for Trade and Sustainable Development (ICTSD), and International Lawyers and Economists Against Poverty (ILEAP). The latter are sources of advice, assistance and analysis and have done much to complement the activities of larger entities such as UNCTAD and the ITC to increase awareness and knowledge of the topics on the negotiating table. Although it remains the case that huge disparities exist in the ability of countries to participate in the WTO processes—many LDCs still do not have offices in Geneva for example—limited involvement may also be rational in that the payoff to participation may be limited for poor countries.

Developing countries are active users of the dispute settlement system, accounting for about 40 per cent of all complaints between 1995 and 2007, up from around one-third during the GATT years, and increasingly use WTO procedures against each other (Box 12.1; see also the discussion in Chapter 3). Particularly striking is the growth of cases against developing countries during the WTO period. Developing countries were defendants in only 8 per cent of all the cases brought during the GATT years (Busch and Reinhardt, 2002); in the 1995–2007 period this rose to 40 per cent. This is in part a reflection of the fact that GATT rules often did not bind and the increase in both coverage of multilateral disciplines and membership of developing countries.

The increased use of DS clearly illustrates the tendency for developing countries to defend their national economic interests. Despite the fact that many countries actively participated in negotiating coalitions, this has not impeded them from using the DS system against each other to enforce WTO agreements. The tendency to pursue self-interest is even more clearly illustrated by the use of DS to attack unilateral preference programmes that benefit only subsets of developing countries. Starting in the late 1990s more advanced and larger developing countries began to contest preference programmes that did not comply with WTO rules (the Enabling Clause requirement that preferences be 'generalized, non-reciprocal and nondiscriminatory').

An example was the December 1998 decision by Brazil to contest the EU GSP scheme as inconsistent with the Enabling Clause and the MFN rule and resulting in the impairment of benefits accruing to Brazil. This request for consultations, joined by a number of other Latin American nations, led to a six-year waiver being negotiated for the EU ACP preferences in Doha in 2001, and the launch of the EPA negotiations between the EU and ACP countries. As discussed in Chapter 3, the agreement on the waiver was also part of the MAS negotiated in *Bananas-III*, another example of a distributional conflict between groups of developing countries.

Box 12.1. Developing countries and dispute settlement

Developing countries have begun to use multilateral procedures to settle disputes much more than in the past. These go beyond the high-profile cases discussed in Chapter 3 (such as *Bananas*). A random selection of cases provides an indication of the types of disputes that have been brought.

- Singapore versus Malaysia (1994). The first case brought to the WTO. Singapore objected to Malaysian import procedures for plastic resins, alleging discrimination. The case was settled bilaterally in 1995.
- Brazil versus Peru (1997). Brazil objects to a countervailing duty investigation being carried out by Peru against imports of buses from Brazil.
- Chile versus US (1997). Chile contests a CVD investigation on imports of salmon, claiming insufficient evidence of injury.
- Colombia versus US (1997). Colombia argues that US safeguard measure against imports of broom-corn brooms violates the Agreement on Safeguards.
- India, Malaysia, Pakistan and Thailand versus US (1996). Contest a ban on importation of shrimp and shrimp products by the US under Section 609 of US Public Law 101–162 arguing violation of MFN and use of QRs (see Chapter 13).
- Brazil versus EU (1998). Contests the EU GSP regime as inconsistent with the Enabling Clause.
- Honduras and Colombia versus Nicaragua (1999). Claim Nicaragua's Law 325 of 1999, which provides for the imposition of charges on goods and services from Honduras and Colombia, violates MFN and tariff concessions.
- Argentina versus Chile (2000). Claim against Chilean price band system for safeguard actions.
- India versus Argentina (2001). Measures preventing imports of medicines.
- India versus EU (2003). Claim that the EU GSP+ scheme violates Enabling Clause.
- Antigua and Barbuda versus US (2003). Measures against cross-border supply of gambling services (mode 1).
- Brazil, Thailand and Australia versus EU (2003). Alleged violations of disciplines on export subsidies for sugar.
- Brazil versus US (2003). Contests US subsidy programmes assisting upland cotton producers.
- Bangladesh versus India (2004). Imposition of antidumping duties.
- Pakistan versus Egypt (2005). Measures against imports of safety matches.
- Panama versus Colombia (2006). Customs measures against certain imports.

A case brought by India against the EU GSP+ programme in 2003 is another example. This programme gave additional preferences to countries satisfying specific nontrade policy-related criteria (implementation of measures to combat the production and trade of narcotics). *EC—Tariff Preferences* was an important case because the 2004 Appellate Body ruling clarified what is permitted under the Enabling Clause. It concluded, somewhat surprisingly, that in principle WTO members *are* permitted to grant preferences to specific groups of developing

countries as long as the targeted (preferred) group shares the same 'development, financial or trade need' as defined by an objective standard or set of criteria, *and* the need can be effectively addressed by granting preferences. Thus, differentiation is permitted as long as any developing country that meets the specified standard or norm is eligible for the preference. What constitutes 'objective criteria' is left to the donor country to determine—what matters is that there is no exclusion of countries that satisfy whatever criteria are established. Following the dispute, the EU changed the GSP+ programme, extending eligibility criteria (conditionality) to span compliance with (adoption of) 27 international conventions pertaining to labour standards, and making eligibility conditional on not exceeding certain trade performance thresholds.[4]

A final example is the case brought by Brazil in 2003 against EU export subsidies for sugar that was discussed in Chapter 6. Although ostensibly directed at EU violation of its export subsidy commitments for sugar, the case had major implications for ACP countries that had benefitted from guaranteed access to the EU market. The result of the case was that the EU was obliged to cut back exports of sugar significantly, with direct consequences for ACP producers. The reforms to CAP—in part to bring the EU into compliance with WTO commitments—lowered intervention prices, reduced EU output and substantially diminished rents for ACP sugar producers, generating adjustment costs in these countries as well as for EU producers. The fact that the EC did not ring fence the ACP sugar export volume in the reform of its sugar regime was an exogenous shock for the ACP that they could not have foreseen, even though it had been clear for some time that the EU would change the programme in the context of its decision to negotiate reciprocal trade agreements to replace the Cotonou Convention, and that there would also be some 'erosion' of rents as a result of the EBA initiative to grant duty-free, quota-free access to LDC exports of sugar as of 2009 (Hoekman and Howse, 2008).

[4] Trade criteria are a common feature of all preferential access programmes. For example, under the US GSP countries may lose eligibility for a specific product if exports exceed a 'competitive need limit' (US$110 million per tariff line in 2005) or account for more than 50 per cent of total US imports in that category. An inter-agency committee makes eligibility and graduation decisions after reviewing petitions from interested parties. Hudec (1987) concludes that a consequence is that import-competing lobby groups have made GSP a bastion of unregulated protectionism in the United States. Since the programme first entered into force in 1976, some 40 countries have 'graduated' from the GSP programme. Country eligibility for the EU GSP is determined by 'indices' that combine the development and specialization level of the country: $I=0.5[\ln(Y_i/Y_{EU})+\ln(X_i/X_{EU})]$, where Y_i (Y_{EU}) is the GDP per capita in the beneficiary country (EU) and X_i (X_{EU}) is the manufactured exports of the beneficiary country (EU) to the EU (beneficiary country). The index increases in value as the beneficiary country becomes more developed and/or runs a surplus in manufactured goods trade with the EU. A second graduation criterion is the ratio of imports from a given country to total EU imports of a product and this country's share of total EU imports. See Hoekman and Ozden (2005).

Post-Uruguay Round implementation concerns

A subsidiary body of the WTO General Council, the Committee on Trade and Development is the focal point for trade-related concerns of developing countries. A Subcommittee on Least Developed Countries focuses on issues of interest to the poorest WTO members. A frequent agenda item for these committees after the Uruguay Round was implementation and participation-related concerns, in particular the need for technical assistance and improving the effectiveness and application of the almost 100 SDT provisions found in WTO agreements.[5]

Implementation concerns were of three types. One was to ensure that high-income WTO members would deliver on their market access commitments. A second related to the ability of developing countries to implement the many Uruguay Round agreements before the various transition periods expired. Here a problem was that implementation of agreements had not been made conditional on obtaining adequate financial and technical assistance. The third was to question whether the substantive disciplines of some of the WTO agreements were compatible with national development priorities.

Many developing countries were concerned about the way the US and the EU had implemented the first stage of integrating textiles and clothing products into the GATT. As discussed in Chapter 6, the first tranches of liberalization essentially excluded any product of significant export interest. The use of transitional safeguards under the ATC by the US also did little to encourage developing countries. As mentioned, two dispute-settlement cases were brought regarding such measures. Although both were won, the signal that was being received was worrisome.

The Uruguay Round and the establishment of the WTO changed the character of the trading system. The GATT was very much a market access-oriented institution—its function was to harness the dynamics of reciprocity for the global good. Negotiators could be left to follow mercantilist logic—the end result would be beneficial to all contracting parties. This dynamic worked less well for developing countries, for reasons explained above. For these countries the burden of liberalization rested much more heavily on the shoulders of governments—even if they wanted to, the scope to use the GATT was often limited because exporters had fewer incentives and were less powerful than in OECD countries. The reciprocal, negotiation-driven dynamic also worked much less well for issues that were 'lumpy' and where the terms of the debate revolved around what rules to adopt, not around how much of a marginal change was appropriate. Once discussions centre on rules, especially disciplines on domestic policy and regulations, it is more difficult to define intra-issue compromises that make economic sense. Cross-issue linkage becomes necessary.

[5] The various provisions are identified and discussed in a secretariat document prepared for the Committee on Trade and Development (WT/COMTD/W/66), available on the WTO website.

Views on whether the package that emerged from the round was a balanced one differ widely. Studies of the Uruguay Round suggest all regions gained, with the magnitude of the gains depending importantly on the extent to which governments reduced barriers to trade (see Martin and Winters, 1996). Others argue that the models miss many of the important dimensions of the WTO agreements, especially the rent transfers associated with the TRIPS agreement and the implementation costs generated by the various agreements (Srinivasan, 1998; Finger and Schuler, 2000; Ostry, 2002). Whatever one's view, it is clear that the approach taken towards ensuring and supporting implementation of WTO agreements by developing countries was not an effective one. Limiting recognition of this problem to the setting of uniform transition periods was clearly inadequate. Many would argue that what is needed is greater willingness to allow more flexibility in determining whether all rules should apply to all countries. The case for uniform application of agreements that involve reducing trade barriers—tariffs, NTBs—is very strong. But in other areas requiring minimum levels of institutional capacity—such as customs valuation—'one size fits all' is a bad rule of thumb.

In the run-up to the Seattle ministerial in 1999, both types of implementation concerns—holding high-income countries to their promises and dealing with the problems of complying with Uruguay Round agreements—were put forward by developing countries as priorities to be addressed. The ministerial virtually coincided with the five-year mark after which most transition periods were to expire for developing countries (non-LDCs). By then it had become clear that many countries were struggling to implement agreements such as customs valuation, standards and TRIPS.

Numerous submissions were made, both with respect to old issues and suggestions for topics to be negotiated during the first year of a new round. Developing countries sought immediate action to tighten antidumping rules and expand *de minimis* provisions, and relaxation of subsidy rules to allow for export-promoting policies. On SPS and TBT, it was proposed to make technical assistance mandatory and to devise mechanisms to ensure that the views of countries at differing levels of development would be heard in international standards-setting bodies. On clothing, commitments were sought by importing countries to accelerate the elimination of the MFA, and commitments that antidumping would not be applied on goods that were subject to QRs. On TRIMs many countries sought extension of transition periods, an opportunity for governments that had not notified illegal TRIMs to do so and to be granted a transition period to phase them out, and an exemption from the ban on domestic content requirements. On IPRs, the demands included acceptance that the TRIPS agreement does not prevent developing countries from issuing compulsory licences for drugs listed by the WHO as essential, an extension of transition periods, a prohibition on patenting of plant and animal life, and operationalization of TRIPS provisions for transfer of technology on fair and mutually advantageous terms.

Most of these demands were opposed by the US and many other OECD countries, who did not wish to reopen Uruguay Round agreements. Given the debacle in Seattle, no concrete results emerged from the ministerial meeting. However, it was clear to WTO members that absent progress on implementation concerns it would be very difficult to launch a new round. In the aftermath of Seattle, the Quad put together a 'confidence-building package'. They proposed a case-by-case consideration of requests for extension of transition periods, improved market access for LDCs (but allowing for exceptions, and without mention of antidumping), and a promise 'to undertake to work to devote adequate resources' for technical assistance efforts. All in all, this package did little, if anything, to 'build confidence' that implementation concerns were being taken seriously. The market access offer did not go much beyond the status quo, the technical assistance language was vague, and the case-by-case approach to requests for extension was already largely provided for in the various WTO agreements. Indeed, developing countries had already been seeking, and obtaining, extensions under certain agreements, in particular that on customs valuation.

In May 2000 the WTO General Council adopted a work programme to review implementation-related concerns. Although little resulted from this process, the implementation agenda and work programme was part of a pre-negotiation process, akin to what occurred after the failed 1982 ministerial in the area of services. The various questions and concerns became prominent agenda items in the Doha Round.

12.2. Doha: Special and Differential Treatment Revisited

The Doha Ministerial Declaration reaffirmed the importance of SDT, stating that provisions for SDT were an integral part of the WTO agreements and that negotiations were to 'take fully into account the principle of [SDT...] embodied in Part IV of the GATT 1994... and all other relevant WTO provisions' (para. 50). It also called for a review of WTO SDT provisions with the objective of 'strengthening them and making them more precise, effective and operational' (para. 44). Modalities for further commitments, including provisions for SDT were to be established no later than 31 March 2003 (para. 14). On implementation, para. 12 of the Doha Decision on Implementation-related Issues and Concerns instructed the CTD to provide a report to the WTO General Council 'with clear recommendations for a decision'.

Years of negotiation followed, revealing deep divisions between WTO members on the appropriate scope of SDT and how to achieve the Doha mandate.

Box 12.2. Summary of main SDT Doha proposals by WTO agreement

- GATT Article XVIII: greater freedom to restrict trade for infant industry protection/meeting development needs.
- GATT Article II: allow duties for fiscal purposes notwithstanding tariff bindings.
- GATT Article XVII: recognize importance of state-trading for developing countries.
- Part IV GATT: make improved market access (preferences) mandatory; hold developed countries responsible for achievement of Part IV objectives (e.g. growth in exports; diversification).
- WTO Article IX (waivers): commitment not to question benefits sought by developing countries and to grant LDC requests expeditiously or automatically.
- Agriculture: permanent exemptions in the calculation of the AMS for capital and input subsidies to resource poor farmers; raising the *de minimis* level of exempt AMS.
- Decision on Net Food Importers: developed countries to make specific, binding commitments to a revolving fund to provide grant aid.
- SPS: actions to reduce market access impediments, extension of transition periods, mandatory technical assistance.
- ATC: accelerated quota growth.
- TBT: create implementation fund; longer transition periods; impact assessments.
- TRIMs: longer transition periods for developing countries; exemption for LDCs.
- Antidumping: limit use by developed countries against developing economies; prohibition on use of duties as a remedy.
- Customs valuation: automatic extension of transition periods; right to use minimum prices for valuation purposes; mandatory provision of technical assistance for LDCs.
- Pre-shipment inspection: mandatory cooperation between customs authorities; technical assistance for price verification and fraud.
- Rules of origin: financial support for participation in WCO and WTO Origin Committee.
- Import licensing: preferential treatment for LDCs/developing countries; exemptions from reporting requirements.
- SCM: greater subsidy freedom.
- Safeguards: *de minimis* 3 per cent market share for every developing country; greater freedom to extend and repeat safeguards.
- GATS: establish and monitor benchmarks for technical assistance and market access; phase-out of mode 4 restrictions by developed countries; WTO to conclude agreements with other organization to address supply side constraints.
- TRIPS: increased flexibility in implementing the agreement as it concerns pharmaceuticals needed for eradication of endemic diseases; extension of transitional period; implementation of developed country commitments on technology transfer; increased technical assistance; compensation for indigenous knowledge; reconciliation of TRIPS with UN Convention on Biological Diversity.
- DSU: monetary compensation for losses to developing countries due to WTO illegal acts; panels to assess how developing country concerns and SDT requirements were addressed; longer time periods if defendant.
- Uruguay Round Decision on Measures in favour of LDCs: compliance with WTO to be at discretion of LDC; mandatory requirement that developed countries grant duty/quota free access and address SPS and rules of origin constraints.

Box 12.2. (*Continued*)

- Tokyo Round (1979) Enabling Clause: all LDCs to be given full duty-/quota-free access before Cancun ministerial; LDCs to be compensated for preference erosion through elimination of all NTBs on their exports, debt relief and financial compensation for erosion for products accounting for more than 50% of export earnings; credit for unilateral liberalization; reiteration of principle of nonreciprocity.
- Accession of LDCs: reduce requirements and burdensome processes.
- Transparency: establishment of a mechanism to monitor the implementation of SDT provisions; greater accountability of high-income nations in delivering SDT.

Some 88 proposals were made by developing countries, many of them by the African, LDC and 'Like-minded' groups. They break down into demands for: (1) better preferential access to markets; (2) greater freedom to use trade restrictions; (3) greater freedom to delay or refrain from adoption of WTO rules or policy principles; (4) proposals relating to development aid and technical assistance for implementation; and (5) calls for greater transparency and accountability on the part of the industrialized country membership of the WTO for achieving SDT objectives. Box 12.2 classifies proposals by major WTO agreement.

The discussion on SDT was plagued by procedural and substantive disagreements. In an effort to break the impasse in the run-up to the Cancun ministerial meeting, the Chair of the General Council suggested classifying proposals into three categories: a set to be agreed before or at Cancun (38 mostly agreement-specific proposals); another group of 38 proposals that should be addressed in negotiating groups dealing with the substantive issues in question as part of the Doha Round; and a residual set of 12 proposals where it was clear that consensus would be very difficult to reach.[6] The 'early harvest' set included 12 proposals on which agreement had already been reached during deliberations in 2002—mostly technical assistance and information/transparency-related—as well as a group that in the Chair's view were important in terms of having a development impact and in which agreement appeared possible. These included proposals relating to balance-of-payments and infant industry protection, monitoring of actions by developed countries, waivers and transition periods, notification requirements, transfer of technology and simplification of rules of origin. The Chair's Category 2 proposals spanned antidumping, subsidies, agriculture, GATS, dispute settlement, SPS, TRIMs, safeguards and TRIPS.

The proposals were of two main types: replacing the best-endeavours language of SDT provisions calling on actions by developed countries with binding obligations requiring them 'to deliver'; and weakening the reach of substantive WTO

[6] See *Bridges Weekly Trade News Digest* (2003: 7, (13 and 17); www.ictsd.org).

disciplines. Given that much of what is embodied in Part IV is outside the control of industrialized countries, it is not surprising that they objected to suggestions that SDT become a binding obligation. Economists could (and did) argue that insofar as the economics of the disciplines embodied in many WTO agreements are sound, many of the proposals to weaken their reach are unlikely to benefit developing countries. The substance and economics of the disciplines in each of these areas are discussed in other chapters of this book.

Economic arguments were not very prominent in the negotiations, however. From a development standpoint, the discussions on SDT were striking in that the focus was not on whether a particular proposal had developmental merit. Proposals were not objected to so much because they would not do much good to the country or group proposing them, but because they would impose negative externalities. This was perhaps clearest with respect to proposals for deeper preferences for LDCs. For example, Paraguay argued that waivers from Article I GATT (MFN) should not be used to accord advantages or privileges to developing countries where they clearly discriminate against other developing countries. Instead, privileges granted should abide by the spirit and the letter of the Enabling Clause and its provisions, i.e. apply to all developing countries. In cases where this is not done, Paraguay suggested that the preference-granting country provide excluded developing countries with compensation.[7] Insofar as little in the way of a negative spillover would result from a proposal, other members tended to be relaxed. Thus, in practice, industrialized countries are prepared to accept export subsidies from LDCs almost indefinitely because such subsidies are unlikely to cause serious problems to their own domestic industries (and because LDCs do not have the financial wherewithal to undertake significant subsidy programmes in any event), not because there is a strong belief that this makes sense from a development perspective.

To many observers the SDT negotiations pointed to a need for: (1) greater differentiation between developing countries; and (2) greater emphasis on economic analysis and argument of why and how a specific proposal would be beneficial from a development perspective (Stevens, 2002; Hoekman, 2005; Page and Kleen, 2005). Part of the problem was arguably the Doha ministerial mandate, which made it difficult to more fundamentally rethink the framework for SDT in the WTO. The suggestion by the Chair to address most of the substantive SDT proposals in specific negotiating groups made sense in terms of pragmatism. It also has an opportunity cost: if a good framework for SDT had been in place which ensured that poor and/or small countries would not be subject to significant downside risks from accepting to negotiate on the Singapore issues, the Cancun meeting might have ended more successfully.

[7] TN/CTD/W/5, /Add.1, /Add.2.

Several options have been proposed in the literature for a different approach to SDT (see Hoekman, 2005, for references to the literature):

- acceptance of the principle of 'policy space': flexibility for all developing countries as currently (self-)defined in the WTO whether to implement a specific set of (new) rules, as long as this does not impose significant negative (pecuniary) spillovers.[8]
- a simple rule-of-thumb approach: allow opt-outs for agreements that require significant investment to implement for all countries satisfying broad threshold criteria such as minimum level of per capita income, institutional capacity or economic scale. As countries come to surpass thresholds over time, disciplines automatically would become applicable;
- an agreement-specific approach: this would involve the *ex ante* setting of specific criteria on an agreement-by-agreement basis to determine whether countries could opt out of the application of negotiated disciplines for a limited time period. Criteria could include indicators of administrative capacity, country size and level of development, and implementation could be made conditional upon adequate financial and technical assistance being offered;
- a country-specific approach: this would make implementation of new rules a function of national priorities. World Trade Organization disciplines implying significant resources would be implemented only when this conforms with or supports the attainment of national development strategies. A process of multilateral monitoring and surveillance, with input by international development agencies, would be established to ensure that decisions are subject to scrutiny and debate;
- a combination of country- and agreement-specific approaches: conditional on acceptance of certain binding core rules (e.g. MFN, the ban on quotas and tariff concessions), countries would be able to invoke a consultative, 'pre-panel' mechanism if they did not implement an agreement (or are challenged to that effect). This would focus not just on the legality of a policy instrument but on assisting governments to attain their objectives through the use of more efficient instruments than trade policies, including development assistance and other forms of cooperation.

A common element of all these proposals is that implicit or explicit use is made of economic criteria to determine the applicability of resource-intensive rules. This is controversial, as it implies differentiation among countries, something that continues to be rejected by many developing countries in the WTO. As discussed above, whether SDT is invoked is left to individual members (i.e. whether or not to self-declare as a developing country) and a mix of unilateral action and bargaining by developed country members whether to accept this and provide SDT. Country

[8] As noted in Chapters 1 and 3, in practice small countries are less likely to be confronted with disputes, so the proposal would to some extent simply formalize the prevailing status quo.

classification inevitably creates tensions among governments as to which countries would be counted in and which out. Although a major advantage of simple criteria is that it is 'clean'—there is no need for additional negotiation—the disadvantage is that criteria imply *ex ante* differentiation, which is not acceptable to many countries in the WTO (notwithstanding that it is standard practice in other international organizations). The alternative case-by-case approach is more 'resource-intensive', but experience shows that agreeing on a rule- or agreement-specific set of criteria is feasible—witness the Subsidies Agreement per capita income threshold for the use of export subsidies or the net food importers group in the Agreement on Agriculture.

Proposals revolving around full 'policy space' (free discretion as long as it does not injure other developing countries) or the application of specific criteria—be it by country (e.g. per capita income) or agreement—do little if anything to engage governments and stakeholders, or to help them identify better policies or areas where complementary actions/investments are needed. Instead, the focus is purely 'legalistic': SDT is needed as a mechanism to prevent countries from undertaking investments or implementing rules they do not wish to and to avoid being confronted by the threat of DS. A more country-specific approach that involves a process that encourages policy dialogue and accountability on all sides could do much to enhance the development relevance of the WTO, while at the same time reducing the perceived downside risk of undertaking new commitments for developing countries.

Potential advantages include: (1) it would bolster the engagement with developing country governments on their policies—complementing the Trade Policy Review (which is arguably under-utilized because the WTO Secretariat is not permitted to form judgements regarding the WTO consistency of observed policies or their impacts within and across countries); (2) generate assessments of whether policy instruments are achieving development objectives; (3) allow discussion/identification of less trade-distorting instruments; (4) allow for inputs from other entities, including national think-tanks and the private sector; and (5) help improve communication/interaction between the development and trade communities.

The fundamental problem with SDT in the WTO is that the only instrument on which members focus is the one that they negotiate on: trade policy broadly defined. The approach taken by the GATT/WTO to address development concerns can be characterized as an effort to use 'trade as aid'. Although this is understandable, it is fundamentally incoherent. Whereas trade is better than aid—indeed, trade is a necessary condition for development—the problem with the WTO approach to SDT is that it distorts incentives; is often ineffective; if effective, is inefficient and inequitable; and has significant negative repercussions on the realization of a nondiscriminatory multilateral trading system. As discussed in the next two subsections, using trade policy as an instrument to promote industrial development has not had much success. There is also substantial evidence that

trade preferences are costly instruments, not just for excluded countries and the trading system as a whole, but also for the donor and recipient countries. But, most fundamentally, preferences do little to help countries deal with the domestic distortions that impede their competitiveness.

Infant industry protection

Industrial development is an integral part of any economy's development strategy.[9] The manufacturing sector is often viewed as the leading edge of modernization and skilled job creation, as well as a fundamental source of various positive spillovers. Accordingly, although many developing countries have scaled back trade barriers over the past 20 years, the industrial sector remains relatively protected, in part as a result of special tax concessions and relatively low tariff rates for importers of manufacturing machinery and equipment. Even when policies do not explicitly favour large firms, they may benefit relatively more from trade protection, both because their products compete more directly with imports, and because sectors with large, capital-intensive firms lobby the government more effectively. The bias against small entrepreneurs is exacerbated when financial repression is a problem, as credit rationing typically excludes the smallest borrowers first.

The infant industry argument, based on the existence of some type of market failure and dynamic positive externalities, is the main rationale underlying most advocacy of industrial policy. Kemp (1964) provides the first careful statement of the argument, identifying processes such as worker learning-by-doing as the source of the social benefits from intervention and distinguishing between learning processes that are internal to the firm and those that are external. As the former are appropriable by the firm, only the latter warrant government intervention, and then only if the reductions in cost over time compensate for the higher costs incurred during the period of assistance.

This argument does not provide a justification for blanket assistance to all firms in an industry or even a subindustry: the existence of an externality and the required cost-saving must be demonstrated in every case. Moreover, the tax-subsidy to be provided to firms should be temporary. Baldwin (1969) pointed out that a tariff or subsidy provides no incentive per se for a firm to acquire more knowledge. Because tariffs or subsidies are output-based (provide incentives for greater production), a firm will increase output by the least costly method, not necessarily by acquiring more technology. In theory, to capture the learning-related spillovers a subsidy related to knowledge creation is called for; e.g. a subsidy to those workers who learn by doing. Most knowledge or skill acquisition is

[9] For a more extensive discussion see Bora, Lloyd and Pangestu (2000) and Pack and Saggi (2005).

process-, job- or product-specific, so that the corrective subsidy should be targeted to the process, job or product.

These qualifications are examples of a more general conclusion emerging from the literature on government intervention. Any externality or market failure calls for a tax-subsidy, the base of which is the variable that generates the externality or failure, and the tax-subsidy rate will be that rate which gives the optimal effect (Bhagwati, 1971). Any policy other than the optimal tax-subsidy causes by-product distortions that will impose costs on the economy (Corden, 1974). In principle the tax-subsidy rate will vary across firms in an industry if the strength of the effect justifying intervention varies across firms. Even when an intervention is called for, a choice of a suboptimal instrument with by-product effects reduces the net benefits obtainable from the optimal instrument and may in fact be welfare-reducing. Finally, the economy-wide effects of intervention in one industry also need to be borne in mind—a tariff on an input will cause the effective protection of downstream users to decline.

A recent argument for 'infant industry' type intervention has been offered by Hausmann and Rodrik (2003), who emphasizes a specific type of learning externality: providing incentives for firms to invest resources so as to help discover where a country has a comparative advantage. The argument they make is that in the process of transformation investments need to be made in new activities. The private payoffs to successful investments are much lower than the social benefit because the private gains may get eroded very rapidly in those cases where investments prove to be profitable—through new entry into what has been revealed to be profitable businesses. Thus, there is a nonappropriability problem. Their analysis suggests a role for government to increase the incentive to undertake 'exploratory' investments in new (nontraditional) activities—in addition to standard public goods such as property rights, as well as a liberal trade regime that allows access to inputs and technologies. At the same time, appropriate policies to foster investment (self-discovery) must be complemented by policies which ensure that failed experiments result in the exit of firms that entered into activities where there is no comparative advantage. What is needed, therefore, is a mix of promotion and discipline. Although learning externalities certainly exist, achieving such a balance is a major challenge.

A more general argument for policies to support industry (entry into nontraditional economic activities) revolves around enhancing the competitiveness of firms. To a large extent arguments along these lines are second-best type arguments—other policies and/or the institutional environment are such as to impose extra costs on firms located in the developing country, direct action to remove these excess costs is not feasible, giving rise to a need for policies aimed at compensating for these costs. But, there are also market failure aspects of 'competitiveness' arguments for intervention. Often these revolve around credit constraints for small- and medium-sized firms—e.g. absence of financing for investment in new technology

or new business lines—that prevent upgrading and the production of higher value-added products, information asymmetries or externalities related to training to personnel. Insofar as such market failures exist, policy interventions need to be targeted at their source. In the case described above, moreover, the intervention will be horizontal or cross-cutting in scope, not sector-specific.

As mentioned, infant industry arguments may also be based on the presence of policies that are used to attain specific objectives—such as revenue collection—but which give rise to distortions in the economy. Assuming that the underlying policies cannot be changed in the short to medium term, this gives rise to the so-called theory of the second-best. In the context of international trade, there may be a second-best case for trade restrictions. For example, if imports of certain goods are subject to tariffs, welfare can be improved if tariffs or subsidies are levied on some or all of the remaining goods. Second-best rationales for protection are not a strong foundation for intervention as it is often not clear why in practice the policies that cause distortions cannot be changed. Moreover, determining the second-best policy requires a great deal of knowledge on the determinants of the behaviour of agents in the economy, which often does not exist. Third-best interventions made in ignorance of the true values of some behavioural parameters may be welfare-reducing.

There are also political economy and moral hazard problems associated with protection of infant industries. The prospect of protection can give rise to rent-seeking behaviour with associated scope for (legal) lobbying and (illegal) corruption. Moral hazard problems can easily arise as the reward for doing well is the removal of protection. This can generate perverse incentives for firms never to perform 'too well' so as to retain protection. In practice there are many examples of 'infants' that never 'grow up' and become able to compete internationally (Pack and Saggi, 2005).

Changes in the preferential trade landscape

The inability to conclude the SDT negotiations did not mean that nothing happened during the Doha Round in this area. One result of the insistence on SDT and the need to address Uruguay Round implementation concerns was that LDCs were not expected to make any market access commitments in the Doha Round. This 'Doha Round for free' decision was formalized at the Hong Kong ministerial in 2005. In addition, LDCs were granted better preferential access to major OECD markets. The EU's 'Everything But Arms' duty- and quota-free initiative for LDCs, the US African Growth and Opportunity Act, and the 2003 duty-/quota-free access programme for LDCs implemented by Canada, as well as similar schemes adopted by other OECD members, all provide better access than their GSP programmes by expanding product coverage and completely removing tariffs. Moreover, at the

Hong Kong ministerial agreement was reached to extend such duty-free access as a permanent WTO commitment for at least 97 per cent of the exports of LDCs. In addition to better access for LDCs, initiatives were launched to do more to assist countries to improve their competitiveness in export markets (the latter are discussed below).

The deepening of preference regimes for LDCs can in part be seen as a response to the increasing pressure being exerted by Latin American and Asian countries that did not benefit from the EU's ACP regime to reduce the extent to which they confronted trade diversion costs. As the WTO allows deeper preferences for LDCs, and almost by definition these are countries with limited supply capacity and thus not a major threat as competitors, other developing countries supported these LDC initiatives.[10] A corollary of deeper preferences for LDCs is that preferences for other developing countries are eroded. As already mentioned, such erosion was particularly significant for countries and products that had benefitted from guaranteed access to the EU market.

Much of the extensive economic literature on this subject concludes that preferences do little good to recipients and may do harm (Grossman and Sykes, 2005; Hoekman and Ozden, 2006). The reasons for this include the following:

The rules determining eligibility are defined by granting countries. Such criteria include rules of origin and product coverage. Rules of origin may be so strict (constraining) that it is cheaper for countries to pay the MFN tariff. Research suggests that the 'tariff equivalent' of rules of origin averages between 3 and 5 per cent (Francois, Hoekman and Manchin, 2006). This figure has remained remarkably constant over time—the first quantitative estimate ever made in the literature for EEC-EFTA trade in the early 1980s by Herin (1986) concluded that the 'tariff equivalent was in the 5 per cent range.

The importance of rules of origin as a constraint to utilization of preferences was revealed by the export supply response to AGOA. A number of African countries saw exports to the US explode in product categories in which they already had duty-free access to the EU. The more liberal rules of origin under AGOA allowed imports of yarn and fabric from anywhere in the world, whereas the EU did not. Given the absence of an efficient textile industry in African countries, they were unable to utilize the EU preferences (Brenton and Hoppe, 2006). Exports of apparel from African LDCs to the EU and US were almost equal in 2000, but the value of exports to the US in 2004 was almost four times greater than the value of exports to the EU (Figure 12.1). In the context of the 2007 Economic Partnership Agreements the EU relaxed its rules of origin for textiles and clothing significantly,

[10] An exception is Bangladesh, a significant exporter of textiles and clothing. The fact that Bangladesh is an LDC does much to explain why in Hong Kong it was not possible to obtain agreement to grant LDCs duty- and quota-free access for 100 per cent of LDC exports.

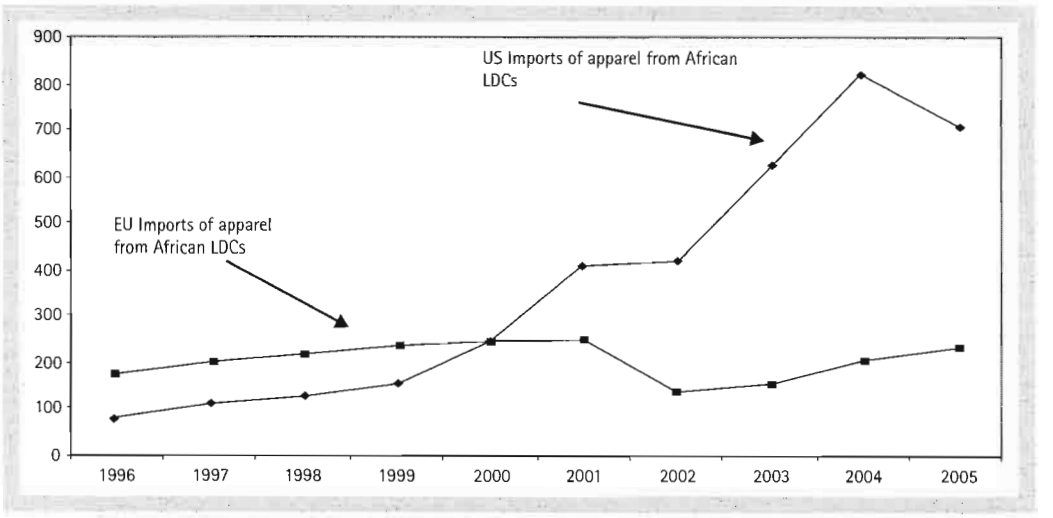

Fig. 12.1. Liberal rules of origin matter: EU and US imports of apparel from African LDCs (US$ million)

Source: Brenton and Hoppe (2006).

adopting a 'single transformation' rule (as in AGOA). However, this only applies to partners that have signed EPAs—it does not apply to countries with GSP or EBA status.

Product eligibility. Often goods in which developing countries have a comparative advantage are 'sensitive' products that have the highest tariffs. Preferences for these products have frequently been limited. Related to this is that recipients may not produce the relevant goods. The low level of industrialization and diversification in many low-income countries has contributed to low utilization.

Preferences are uncertain. The granting country is free to change eligibility, the administrative rules, and can erode the value of preferences granted by engaging in unilateral liberalization, undertaking MFN liberalization as a result of a MTN, or, as is increasingly the case, conclude PTAs with countries that compete directly with those who have preferential access (Box 12.3). One reason for the decline in exports to the US in 2004 shown in Figure 12.1 was that there was uncertainty regarding renewal of the liberal AGOA rules of origin in 2004 (they ended up being extended). There is very little scope to use WTO litigation to reduce the extent of uncertainty as granting countries are permitted to determine the rules of the game. In any event, recipients are unlikely to see it in their interest to litigate as that may increase the prospects of being excluded from benefits altogether.

Box 12.3. Unilateral preferences are uncertain

To benefit from preferential access, exporters must be able to document that products originate in countries that have been granted preferences. The rules of origin applied by a donor country can easily greatly reduce or nullify the benefits of preferences. To give an example, in 1983, the US adopted the Caribbean Basin Initiative, which granted Caribbean countries duty-free access to the US for many products. To determine whether a product was eligible for preferential treatment, at least 35 per cent of the value of the good imported into the US must have been generated in the Caribbean. The preference scheme induced foreign investment in the Caribbean, including companies that established operations in Costa Rica and Jamaica to convert surplus European wine into ethanol, which was then exported to the US. This production process met the 35 per cent value-added test. Two years later, with production and exports doing well, the exporters were hit with a rule change: a US congressman introduced an amendment to a tax bill raising the value-added requirement for ethanol to 70 per cent—an impossible requirement to meet for the Caribbean producers. The US industry that had lobbied for this rule change was never threatened by the imports, which never exceeded 3 per cent of US consumption (Bovard, 1991: 22).

The repercussions of the changes that have been implemented over time by the EU with respect to the preferences granted to ACP countries for sugar and bananas also illustrate that preference programmes are subject to exogenous shocks—in this case stemming from other countries invoking their WTO rights.

Nontrade conditionality. Preferences may be subject to (nontrade) conditionality (satisfaction of labour rights, environmental requirements, etc.). That is, there may in fact be significant reciprocity, but in areas not subject to WTO disciplines.

Importers will capture part of the benefits. Even in cases where preferences have value (are used), applying to highly protected sectors in donor countries and thereby generate rents, in practice these rents will not accrue completely to the recipient country. Instead, a share of the rents will be captured by importers (distributors, retailers). Ozden and Sharma (2006) estimate that Caribbean exporters capture only two-thirds of preference margin in the US market, whereas Olarreaga and Ozden (2005) conclude that the share of rents captured by exporters under AGOA are even lower.

Perverse specialization. If the sectors for which preferences are granted are not the ones in which a country has a comparative advantage, firms may be induced to invest in activities that can only survive *because* of the preference. If the preference induces such investment—that is, it is effective—it automatically creates a future adjustment burden as well as current resource misallocation distortions. Moreover, the preferences can result in countries not exiting a sector or not upgrading facilities and improving productivity because they have no need to.

Perverse political economy effects. Ozden and Reinhardt (2005) find that US GSP recipients implement more protectionist trade policies than countries that are

removed from the GSP programme. They explain this apparently perverse effect of preferences by noting that preferences decrease the incentives for domestic exporters to mobilize in favour of more liberal trade policies. As own trade policies are more important for developing countries' growth prospects than barriers in export markets, the perverse incentive effect of unilateral preferences may be quite damaging. This last line of argument has not gone unchallenged (see Box 12.4). If a (transitional) SDT regime is required to help developing countries to successfully liberalize their economies, Ozden and Reinhardt may be finding evidence that preference programmes are working as intended. Clearly for some countries—the

Box 12.4. A theoretical foundation for preferences?

Conconi and Perroni (2004) develop a theoretical framework that provides a possible economic rationale for what is observed by Ozden and Reinhardt. They argue that preferences are premised on inter-temporal reciprocity, and that the fact that recipients lower their trade barriers once they have graduated from GSP may simply reflect a temporal lag between reciprocal concessions, rather than GSP graduation directly inducing countries to liberalize.

The stylized facts that inform their analysis are: LDCs get deeper preferences than other developing countries; as (very) small price takers LDCs should in principle pursue unilateral liberalization, but do not; and preferences are granted on an explicitly temporary basis. These stylized facts are argued to indicate that the (political) constraints on trade liberalization faced by LDC governments are viewed by all parties as transitory, and that the apparent gap between short-run protection incentives and long-run liberalization incentives reflects a commitment problem for LDC governments. This time-consistency problem reflects the power of import-competing lobbies. This commitment problem can then explain both the scope for SDT-based trade cooperation with a large developed country, and the temporary nature of SDT.

Given the commitment problem and allowing for adjustment costs, a self-enforcing dynamic agreement will necessarily feature higher protection in the small country in comparison with the long-run equilibrium tariff (i.e. delayed implementation); and, lower protection by the large country (i.e. temporary GSP concessions). In the Conconi and Perroni model, the market access (to the North) and the protection component of SDT (in the South), even though not formally tied, are linked by conditionality both within and across periods. In each period, cooperative policies are sustained by the threat of future punishment; at the same time, concessions are exchanged across different time periods—with the large country offering temporary preferences in exchange for future market access, and the small country's determination to disentangle itself from its commitment problem being shored up by the prospect of facing future punishment by the large country for failing to succeed.

Whatever the case may be regarding the rationale for preferences, what matters is that the domestic economy 'works'—that there are no major distortions. In practice, as has been documented extensively, and as discussed in other chapters, domestic distortions are the major bottleneck impeding efficient production and economic growth.

successful ones that were 'graduated'—GSP may have played a role in generating the initial export expansion and then breaking a domestic political deadlock that precluded opening up the economy. Major exporters such as Hong Kong, Taiwan, South Korea and Singapore all benefitted from US and EU preferences in the 1970s, and subsequently to being removed from eligibility continued to do very well on the export front.

The duty- and quota-free initiatives put in place since 2000 help address only some of the problems that affect preference programmes. A key remaining factor is the rules of origin, which are still at the discretion of granting countries. The basic problem of supply capacity and lack of competitiveness of firms in the LDCs remains, as do the political economy downsides just noted. Finally, it is important to recognize the systemic effects of the continued use of preferences. These include trade diversion and the eventual adjustment costs as preferences are eroded. Preferences can give rise to detrimental trade diversion as the set of goods that beneficiary developing countries produce and trade will tend to overlap with other developing countries that are not beneficiaries. Borchert (2008) finds that the absolute magnitude of diversion caused by the EU GSP programme is economically significant, affecting large Asian countries in particular. Prospective adjustment costs may be particularly important in that they can impede further multilateral liberalization by creating a bootlegger-Baptist situation: beneficiaries are induced to support trade-distorting policies in donor countries that primarily benefit domestic producers in those countries—at the expense of the rest of the world (nonpreferred exporters) and domestic consumers/taxpayers. It is not surprising that many ACP countries often supported the EU in the Doha agricultural talks.

Some of the downsides of preference programmes for beneficiaries identified above can be addressed, but only at the cost of potentially making matters worse for excluded countries. For example, in 2008 the EU had plans to replace the different rules of origin that applied in its trade agreements—based on value added, change of tariff classification, or technical requirements—with a single criterion referred to as a maximum foreign content. This would define the degree of transformation required to confer origin to a product in terms of the maximum amount of value that can come from the use of imported parts or materials. The principal advantage of applying a 'maximum foreign content' principle is that it is transparent and can readily be applied across products. The adoption of such an approach would be somewhat akin to the tariffication of NTMs in the agriculture negotiations in the Uruguay Round. Future WTO negotiations could then focus on gradually reducing the restrictiveness of the rule (Cadot and De Melo, 2007). From a SDT perspective, an advantage is that it would allow for maximum foreign content levels to be set lower for LDCs, helping these countries to utilize duty-free access.

However, making preferences more effective will at the same time increase the costs of trade diversion and raise the incentives to oppose further MFN

liberalization because of fears of preference erosion. The research by Nuno Limão (see Chapter 10) demonstrates that such diversion effects prevail in the US and the EU—both liberalize less in products that are important for preferred partners. The significance of erosion as a constraint on further liberalization depends very much on how large the benefits of preferences are (see Annex 2 for an illustration of the economics of preferential trade and erosion). Research on this question has shown that preferences are most valuable when they guarantee access through quota-like policies. Increasingly, that type of preferential access has disappeared in favour of tariff preferences only. An implication is that much of the erosion that could occur has already taken place—examples are the implementation of the ATC, which removed rents for less efficient exporters that had specific quota-protected access to major markets, and the unilateral reforms that were implemented by the EU for sugar and bananas.

Although there is a case to be made in favour of complete duty-free and quota-free access to major markets for the poorest countries, with liberal rules of origin that allow inputs to be imported from the most competitive sources of supply, such preferences should be seen as a transitional instrument. One rationale is that such preferences can help offset some of the competitive disadvantages firms LDCs operate under, and may help focus attention on the supply capacity and infrastructure investments that are needed in order to engage in global production networks (Hoekman, Ng and Olarreaga, 2002). That said, in absolute terms, most poor households in the world do not live in the poorest countries; preferences for some come at the cost of poor people in nonpreferred developing countries.

A large body of research has shown that discriminatory trade policies have been of limited use to many developing countries. Although a number of countries benefitted from such programmes as a result of being granted quota rents on traditional commodities such as sugar and bananas, this arguably has worked against their export diversification. Moreover, the plethora of preferential access programmes has encouraged the proliferation of reciprocal trade agreements, further distorting world trade flows and moving the trading system away from nondiscrimination. The fact is that despite preferences and SDT, many of the poorest WTO members have seen their share of world trade stagnate or decline since the 1970s.

All in all, both experience and extensive research suggests that shifting away from SDT as traditionally pursued in the WTO, in favour of an approach that focuses directly on the reasons developing countries cannot compete on world markets would have much higher payoffs. This is mostly a domestic reform agenda that revolves around facilitating trade, lowering trade and operating costs, and improving the productivity of firms and farmers. Shifting to other instruments that provide more direct assistance to realize these objectives would improve policy coherence by marrying greater overall *nondiscriminatory* access to

markets to an enhanced ability on the part of low-income countries to exploit such access (Hoekman, 2002). Aid for trade also offers a potential mechanism for addressing preference erosion. For example, Limão and Olarreaga (2006) show that shifting from tariff preferences to a system of equivalent import subsidies (i.e. a form of development assistance) in OECD countries might encourage additional tariff liberalization and reduce distortions created by preferential trade.

As discussed further below, such considerations helped to put aid for trade on the agenda of international policymaking and the WTO.

12.3. Beyond SDT: Aid for Trade (Reform)

From the very beginning the third plank of SDT has been technical assistance to help firms exploit export opportunities—this motivated the establishment of the ITC in 1964. Over time, the connection between the ITC and its parents (UNCTAD and GATT/WTO) became rather weak. The WTO itself had virtually no capacity to assist its members. In 1999, when developing countries had raised the profile of implementation as a priority matter of concern, the WTO budget provided for only US$470,000 for technical cooperation activities by the secretariat. All of this was used for travel and subsistence expenses of staff, mostly in connection with training seminars and workshops.

At the 1996 Singapore ministerial conference, ministers committed themselves to addressing the problem of increasing marginalization of LDCs in world trade, and to work towards greater coherence in international economic policymaking and improved cooperation among agencies in providing technical assistance. Ministers agreed to a Plan of Action for LDCs. It envisaged closer cooperation among the WTO and multilateral agencies assisting LDCs in the area of trade.

To implement the plan, an Integrated Framework (IF) for trade-related technical assistance for LDCs was established. The Framework was endorsed in October 1997, at a WTO High Level Meeting for LDCs, where it was decided that six agencies—ITC, IMF, UNCTAD, United Nations Development Programme (UNDP), World Bank and WTO—would take joint responsibility for the implementation of the framework for identifying trade-related technical assistance to LDCs (Box 12.5). The idea was that needs would be addressed as part of the regular delivery of assistance by the agencies and/or bilateral donors. Essentially an unfunded mandate established by trade ministers, the IF achieved little in its early years. Over time its functioning was improved as the development community (see below) began to devote greater attention to the trade agenda.