PREFERENTIAL TRADE AND DEVELOPING COUNTRIES

Bad Aid, Bad Trade

Prepared for

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Rural Industries Research and Development Corporation
Level 1, AMA House, 42 Macquarie Street
Barton ACT 2600

PO Box 4776 Kingston ACT Australia 2604

Telephone	+61 2 6272 4539
Facsimile	+61 2 6272 5877
Email	rirdc@rirdc.gov.au
Internet	http://www.rirdc.gov.au

Prepared by
Andrew Stoeckel and Brent Borrell
Centre for International Economics
Ian Potter House, Cnr Marcus Clarke and Edinburgh Avenue
Canberra ACT 2600

GPO Box 2203 Canberra ACT Australia 2601

Telephone	+61 2 6248 6699
Facsimile	+61 2 6247 7484
Email	cie@thecie.com.au
Internet	http://www.thecie.com.au

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FOREWORD

World agricultural markets remain highly distorted and protected. The disparities between world prices and internal prices in protected markets, principally in Europe, the United States, Japan and Korea, are higher for most agricultural products than for manufactured goods except perhaps for textiles. When countries give preferential access to their protected markets, they create a wedge between those countries that have access and those that do not. Granting preferences to developing countries can therefore add to the distortions in world agricultural markets and lead to an inefficient use of the world's resources.

Preferences do not even achieve their aims. They end up encouraging high cost production and transfer little benefit to developing countries.

The Cairns Group includes 15 developing countries, all of which are efficient agricultural producers. The Cairns Group can be an effective voice to highlight the importance of non-discriminatory trade around the world and promote the better working of agricultural markets.

This study is the tenth in a series of studies by RIRDC into the problem of agricultural protection. This issue of preferential trade and developing countries was one of the issues identified in the RIRDC commissioned study *Solving the Problem: A Look at the Political Economy of Agriculture Reform* released last year.

FOREWORD

This publication forms part of our Global Competitiveness R&D Program, which aims to identify important impediments to the development of a globally competitive agricultural sector and support research that will lead to options and strategies. Most of RIRDC's 700 publications are available for viewing, downloading or purchasing online through our website:

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Peter Core
Managing Director
Rural Industries Research and Development Corporation

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SUMMARY

- Addressing the interests of developing countries is one of the pressing economic and moral issues of our time. Some have labelled the proposed round of nego tiations that trade ministers hope to launch at talks in November 2001 'the development round'. Over three-quarters of WTO members are developing count ries.
- Faced with the desire to do something 'special' for developing countries, trade preferences have the potential to become a big issue for a new WTO round.
- There are two sets of 'special treatments' for developing countries currently permitted under the WTO agreement. The first is related to implementation issues. Countries with weak institutional capacity are offered more lenient implementation schedules and lower commitments.
- The second set of special treatments — non-reciprocal, preferential access for developing countries to industrialised countries' markets — are addressed in this study.
- Granting preferential access to developing countries is intended to assist their development through giving higher than world prices and/or more access to restricted markets. The money so transferred is supposed to contribute to development — a form of aid.
- However well intentioned, preferences make bad aid. Aid delivered through preferential trade is wasteful. In

the case of EU banana preferences, it can cost up to $13 to transfer $1 of aid to the developing country.

- Moreover, because EU preferences lower the world banana price, the $1 of aid to one group of developing countries costs another group of developing countries $1. Net aid is zero.
- Little aid from preferences reaches its target because resources must be used up to produce goods to qualify for the aid. Many countries receiving preferences are high cost, uncompetitive producers of those products. They use up a lot of resources to qualify for the aid. The net value of aid may be a small fraction of the gross aid given through preferences.
- Even worse, some studies show trade preferences for particular commodities to be a 'kiss-of-death' for the recipient developing country. Preferences encourage wasteful use of resources and cause costs to rise and industries to become uncompetitive.
- Further, economic rents created by preferences can end up in the hands of wholesalers and importers rather than the exporting countries for whom they were intended as aid.
- Extending preferences creates additional vested interests (rent seekers) with the incentive to oppose trade reform.
- Preferences are a distraction from the main issues in development. They send the wrong message about what is holding developing countries back. The attention of policymakers is diverted from the real issues. The path to prosperity in developing countries lies mostly in tackling difficult domestic reforms such as secure property rights, a well functioning finan cial and legal system, better governance, open trade and investment and better education.
- To take advantage of expanding trade opportunities — regardless of whether access is preferential or not —

developing countries need to confront difficult domestic economic reform and institution building issues.

- Modelling analysis demonstrates developing countries stand to gain much more from their own unilateral liberalisation of trade barriers than from preferential access to protected markets in rich countries.
- Another major concern about preferences is that they threaten the basis of the GATT. The most-favoured nation or non-discrimination clause is the cornerstone of the GATT. It is the basis for an open, competitive system of world trade based on enforceable rules that is to the benefit of all nations, big and small.
- Preferential trade arrangements, including regional trade agreements, are discriminatory and weaken the cornerstone of the WTO. It sends the wrong message — that discriminatory trade is acceptable. The non-discrimination principle is also in danger of erosion by the extension of environmental and labour standards in trade agreements and wider use of anti-dumping. But preferential trading arrangements are among the main offenders.
- The world, including developing countries, would be better off discarding preferences by liberalising trade and working towards an open trading system based on non-discrimination. All regions, both rich and poor, stand to benefit from global trade reform.
  - Free trade encourages competitiveness and specialisation in all countries. It spurs cost savings, innovation and more rapid adoption of new technologies. It causes rationalisation of resource use among regions and between sectors within an economy. More efficient resource use increases incomes.
  - Open trade provides an easy, effective and valuable way to ensure that competition in domestic markets is on world best terms. Without this, resource use

tends to become wasteful, lowering incomes and wealth.

- What is needed is a two pronged approach to this issue: trade liberalisation and direct aid. Since aid delivered by preferences is wasteful, distortionary and vulnerable to change, developing countries could benefit more from development assistance given directly rather than by receiving trade preferences.
- Direct aid is superior to preferential trade for assisting development because:
  - the equivalent gross value of preferences is worth considerably more to the recipient country than the net value of aid through preferences, therefore donor countries could transfer more aid at less cost;
  - resources would no longer need to be used up producing goods to qualify for aid;
  - direct aid could be targeted to essential development needs on a country-by-country basis such as education, health and infrastructure; and
  - direct aid could be targeted to particular countries without harming other developing countries as can occur with discriminatory preferences.

In short, preferential trading arrangements for developing countries are not in their own best interests, they are not in the best interests of countries that grant the preferences, they are not in the best interests of other developing countries that do not receive preferences and they are not in the interests of an open, non-discriminatory rules based trading system. More efficient alternatives exist.

1 INTRODUCTION

Trade ministers are due to meet in Doha, Qatar in November this year. They hope to launch another round of trade talks following the failure to do so at the Seattle Ministerial Meeting in 1999.

Developing countries make up three-quarters of the World Trade Organisation's (WTO's) 142-strong membership. The plight of many of these developing countries is certainly one of the pressing moral and economic issues of the time. The growing anti-globalisation movement seen vividly in Seattle also demonstrates the political sensitivity of this issue. The political imperative to do something special for developing countries through trade is superficially compelling. It has led to the notion that developing countries can be helped through preferential trading arrangements. The question in this study is: is preferential trade an effective way to help?

It turns out that there are much better alternatives to using preferential trade to help developing countries. In chapters 4 and 5 we show that in some cases preferences are actually harmful to the recipients.

But there is a larger point than this. There is strong evidence that developing countries have much to gain from an open and liberal trading system. Under the General Agreement on Tariffs and Trade (GATT) and now the WTO, such a system requires adherence to the principle of non-discrimination. Preferences violate this principle and thus weaken the system. The non-discrimination principle aims to eliminate differences in economic and political weight between nations and dispenses with favouritism, while preferences do the opposite.

This study does not aim to 'solve' the development problem, but rather to analyse and explain why preferential trade is not a likely route to development, and is a damaging outcome for world trade.

The study first describes special and differential treatment for developing countries — the who, what, when and why of preferential access and the state of play of protection. Next, the role of trade in growth and development is analysed. Third, static analysis shows why preferential trade is not the best trade initiative to help developing countries. Fourth, case studies explore the dynamics of why and how preferential access has failed to deliver development to poor countries, and may be making matters worse. Next, more efficient and effective ways to deliver development assistance are presented. The study concludes by emphasising the importance of the non-discriminatory basis of the GATT, which is weakening under attacks from many fronts, not least, preferences.

2 PREFERENCES AND DEVELOPING NATIONS

There are two types of treatment under the WTO granting special provisions to developing countries: special and differential treatment, and preferential market access. This study focuses on preferential access.

Special and differential treatment

Special and differential treatment is in effect leniency for developing countries. Developing countries have smaller commitments or longer transition periods to implement WTO agreements compared to developed countries — see table 1 for agriculture. Special and differential treatment provisions also include assistance to developing countries in some areas such as technology transfer under intellectual property protection. The General Agreement on Trade in Services (GATS) also allows developing countries some preferential treatment. Special and differential treatment provisions are based on the principle that developing countries do not need to reciprocate. This is complex stuff — the WTO agreements are riddled with over 100 provisions giving developing countries special treatment.

1 Developing countries liberalise agriculture less and more slowly Numerical targets set by Uruguay Round for cutting subsidies and protection

	Developed countries	*Developing countries (except LDCs)*	*Least developed countries*
	6 years: 1995–2000	*10 years: 1995–2004*	
	%	%	%
Tariffs (average cut)	-36	-24	0
Domestic support	-20	-13	0
Export subsidies	-36	-24	0

Source: World Trade Organization, 1999. WTO OMC Seattle 99 Press Pack, World Trade Organisation 3rd Ministerial Conference Seattle, 30 November to 3 December 1999, issued 28 November.

Preferential access

The focus of this study is preferential access for developing country exports to OECD markets. There are different forms of preferential access. First, countries may obtain waivers from the WTO rules to set up non-generalised preferential schemes, such as non-reciprocal preferential agreements involving developing and developed countries. The waivers are required because preferences are a contravention of the GATT's and WTO's main principle of non-discrimination[1] — see box 2. Examples of non-reciprocal preferential arrangements are the CARIBCAN agreement whereby Canada offers duty-free non-reciprocal access to most Caribbean countries, and the *US–Andean Trade Preference Act*.

[1] World Trade Organisation 2001, 'Development: Legal Provisions, Main legal provisions', http://www.wto.org/english/tratop_e/ devel_e/d2legl_e.htm, Accessed 16 August 2001.

2 How preferences contravene the main principle of the WTO

The General Agreement on Tariffs and Trade (GATT) is an agreement between 142 contracting parties which governs trade in goods. There are also agreements on trade in services (GATS) and intellectual property (TRIPS). These agreements set out the principles and rules governing trade.

The cornerstone of the GATT since its establishment has been the most-favoured-nation (MFN) principle.[2] This implies a country should not discriminate between its trading partners. 'Concessions' granted to one trading partner should be extended to all. It also dictates countries should not discriminate between its own and foreign products — the so-called 'national treatment' clause. So important is this MFN principle that it is the first article of the GATT.[3] This is a principle of non-discrimination.

A limited number of clearly defined circumstances were exempted from the MFN principle at the creation of the GATT because a number of preferential trading arrangements were already in effect. These largely governed the British Commonwealth system of imperial preferences. Also, customs unions and free trade areas were exempted from the most-favoured-nation clause under Article XXIV.

Ironically, the attempt to outlaw preferences in the creation of the GATT had the effect of writing a permanent exemption into the general agreement for most existing preferential systems.[4]

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[2] MFN is also a priority in GATS and TRIPs although in each it is handled slightly differently.

[3] World Trade Organisation, 'Trading into the Future — Principles', http://www.wto.org/english/ thewto_e/whatis_e/tif_e/fact2_e, Accessed 1 August 2001.

[4] Dam, K. W., 1970. *The GATT: Law and the International Economic Organization*, University of Chicago Press.

Under the non-reciprocal Generalised System of Preferences (GSP), developed countries offer non-recip rocal preferential treatment (such as low duties) to imports from developing countries. The preference-giving countries — generally the OECD countries — unilaterally determine which countries and products to prefer. [5]

Other non-reciprocal preferential access, but not in the ambit of this study, are arrangements between developing countries. The WTO's Enabling Clause permits developing countries to set up regional arrangements, and for those developing countries which are members of the Group of 77, to exchange trade concessions among themselves under the Global System of Trade Preferences. Developing countries may also grant preferences to those among their group that are least developed.

Preferences are also present in other guises, such as regional free trade areas under Article XXIV of the GATT. The essence is the same: one country's exports receive preferential access to a market. The main difference is that unlike GSPs, free trade areas require reciprocal obligations. The European Union is now promoting trade with regional free trade areas under the Cotonou Partnership Agreement, to replace its non-reciprocal preferential trade with former colonies of Africa, the Caribbean and the Pacific (ACP) under the Lomé Convention, which was not compliant with WTO rules. However, the change essentially just shifts preferences from one group of developing countries to another.

[5] World Trade Organisation 2001, 'Regionalism: Notified Regional Trade Agreements, Regionalism: the WTO's rules, http://www.wto.org/-english/tratop_e/region_e/regrul_e.htm, Accessed 16 August 2001.

Who grants preferences? Who receives them?

Any country can grant preferences, as long as the arrangement conforms to WTO rules. The preferences that really matter are the GSP preferences into the European Union, Japanese and US markets. Other OECD countries also extend preferences to developing countries.

All developing countries are eligible for preferential access to developed markets and special and differential treatment. About 100 of the WTO's 142 members are developing countries. While this group of developing countries is diverse, many are rich in labour and/or land or natural resources, which makes agriculture and textiles central to many of these economies. Thus preferences on agriculture and textile exports are of great interest to the developing countries.

There are also additional provisions and waivers for the countries defined by the United Nations as 'least-developed countries' (LDCs). LDCs include 49 of the world's poorest countries representing 10.5 per cent of the world's population. These countries face many challenges to development. Structural rigidities, low skill capacity, poor infrastructure, weak institutions, debt burdens and weak private sectors complicate efforts to develop human and economic capital.[6]

LDCs are exempted from the tariff and subsidy reductions on agriculture shown earlier in table 1. They are also the focus of special preferential arrangements such as the European Union's new 'Everything but Arms' Initiative. This eliminated all duty and quotas on all products bar arms imported from the 49 LDCs. Strictly it should be called the 'Everything but Anything that Matters plus Arms' Initiative

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[6] OECD 1999, 'Developing Countries and Multilateral Trade Liberalisation: A Background Note on Some Key Issues' TD/TC (99)18, Paris, 21-22 October, p.18.

since the sensitive goods of rice, sugar and bananas — the highly protected goods that really matter for poor countries — are exempted from the agreement until, for some, as late as 2009.

Preferences are getting more preferential

In 1979 the Enabling Clause inserted preferences permanently into the general body of GATT law. The GSP permits developed countries to bypass the MFN clause for an indefinite time by granting three principles of 'generalised, non-reciprocal, non-discriminatory' preferences to developing countries. However divergence from these three principles has grown over time.

The crucial GATT principle of non-discrimination, or the MFN principle, is supposed to be applied to preferences for developing countries. That is, when a preference is granted, preference-giving countries are not supposed to discriminate between developing countries but to apply the concession to all. However, the extra measures available to LDCs, while fully allowable under the waivers and clauses in the WTO agreement, violate the spirit of this principle.

The principle of generality should ensure all preference-giving countries apply the same scheme to all developing countries. In practice however, GSP schemes differ in product coverage, depth of tariff cuts, safeguards and rules of origin. Non-reciprocity is likewise ignored by some preference-giving countries that place conditions on eligibility (some of which may be purely political, such as cooperation on drug control). [7]

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[7] UNCTAD, 'The Generalised System of Preferences', http://www.miti.gov.my/gsp.htm, Accessed 7 August 2001, p. 4-6.

Why preferences?

Preferences are around today partly due to inertia in policymaking — colonial preferences were in the GATT from the start. And as will be seen later, once a country receives a preference it creates players who have a vested interest in opposing reform.

Preferences are increasingly used as a vehicle for delivering development assistance. This notion underlies the European Union's 'Everything but Arms' preferences to LDCs. The simple idea is that developing countries will be paid more for their products, or will be able to expand their exports into lucrative developed markets. Part of the higher price that consumers in Europe pay for, say, bananas, is transferred as aid to the banana producers in the ACP country. However, this is not effective aid in practice. The reasons why will be discussed in the following chapters.

The preferences that matter: agriculture and textiles

It is a persuasive idea to use trade to help developing countries. There is no doubt that poor countries are being hurt by the trade restrictions of the rich countries, particularly in agriculture and textiles — the two most important exports of developing countries and the most highly protected by developed countries.

Developing countries contribute a sizeable and growing part of world trade. Developing countries' share of international merchandise exports rose to 28 per cent from around 20 per cent in 1973.[8] However, this growth was far from evenly distributed. The pace of trade development in

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[8] World Trade Organisation 2000, 'Participation of developing countries in world trade: Recent developments, and trade of the least-developed countries', WT/COMTD/W/65 15 February, p. 1.

East Asia far outstripped that of Africa and Latin America, and trade in manufactured goods grew faster than agricultural and textile exports. And LDCs' exports are not even one per cent of world exports. [9]

To some extent this disparity reflects resource endowments, industrial policies and domestic conditions. However, most developing countries that diversified to non-textile manufactures gained trade share while most economies tied to agricultural products or raw materials lagged in trade development. The simple explanation for the difference is that agriculture and textiles remain the most heavily protected despite the preferences granted. Countries that could take advantage of trade liberalisation in the 1980s and 1990s gained trade share. The others were held back by the slow pace of liberalisation in agriculture, minerals and textiles and clothing sectors. [10]

Agricultural protection

The ratio of agricultural protection to manufacturing protection, or the *relative* assistance to agriculture, determines the cost of the distortion from protection. [11] This ratio is far higher in high income than low income countries (chart 3). This implies most of the distortion to

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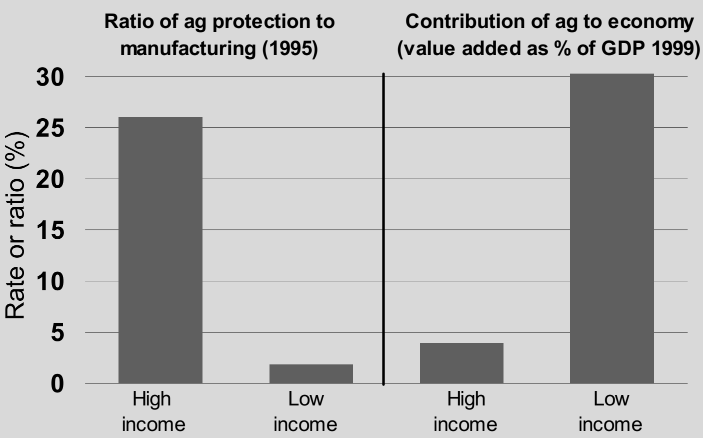
[9] World Trade Organisation 2001, WTO News: 2001 Press Releases, Press/227, 14 May 2001, 'WTO Director-General describes United Nations conferences as opportunity to help 'poorest of the poor'', http://www.wto.org.english/-news_e/pres01_e/pr227_e.htm, Accessed 9 August 2001.

[10] World Trade Organisation 2000, 'Participation of developing countries in world trade: Recent developments, and trade of the least-developed countries', WT/COMTD/W/65 15 February, pp. 1-3.

[11] Strictly, it is the effective rate of protection that best represents the cost of distortions but in the absence of data the ratio of protection of agriculture to manufacturing is a good proxy.

3 The distortion from protection to agriculture hurts developing countries the most



Source: GTAP Version 4 Database, World Bank, *World Bank Development Report 2000–01*.

world agricultural markets is caused by the high income OECD countries.[12]

If high income countries impose the cost, who pays the price? High income countries lose from agricultural protection by paying more than they need to for agricultural products. But low income countries are also big losers. Agriculture is much more important to low income countries than to high income countries — chart 3. The distortion of world trade by high income countries therefore hurts low income countries the most. It is tempting to conclude that extending the system of preferences to developing countries will solve the problem. As discussed later, this is not the first-best solution and is not ultimately in the interest of developing countries.

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[12] Stoeckel, A., 2000. *Solving the Problem, A Look at the Political Economy of Agricultural Reform*, Banff 2000, Rural Industries Research and Development Corporation, Canberra, p. 11.

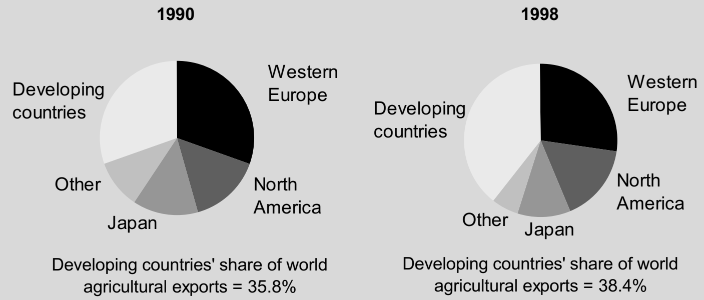
South-south agricultural trade

Developing countries impose high protection on their agriculture but the economic cost of the distortions as a proportion of GDP is not as large as in high income countries. Many countries argue protection is necessary to ensure food security and to support their large agrarian populations, including preventing migration to already congested cities. Also revenue raising can be important. Because of the non-reciprocal clause of the GSP and other preferential trade arrangements and special and differential treatment provisions in WTO agreements, developing countries are under less pressure from the WTO than developed countries to reduce their protection.

The markets of the developing countries themselves are becoming increasingly important for their own agricultural exports. Chart 4 suggests that even where preferences have been given, developing countries have not expanded exports greatly to those markets. They lack the capacity to make use of the preferences, and encounter other hurdles such as quota restrictions, standards and quality issues in developed markets that are less prevalent in other developing countries. The European Union's impact statement on its 'Everything but Arms' deal for LDCs notes structural problems may prevent these countries fully exploiting the preferences.[13] These figures also underscore the potential for stimulating agricultural trade *among* developing countries by them liberalising as a group in the absence of preferential non-reciprocal deals with developed countries.

[13] EU Trade Concession to Least Developed Countries, 'Everything but Arms Proposal: Possible Impacts on the Agricultural Sector', http://europa.eu.int-/trade/miti/devel/eba.htm, Accessed 9 August 2001.

4 Developing countries are exporting more agricultural products to each other Destination of developing countries' exports



Source: World Trade Organisation, 'Market Access: Unfinished Business, Post-Uruguay Round Inventory and Issues, Special Study No. 6', http://www.wto.org/english/res e/booksp_e/spec_e.htm, Accessed 20 August 2001.

Protection in the textile industry

The Uruguay Round attempted to integrate textiles and clothing — major exports of developing countries — fully into WTO rules. It chose however a prolonged and back-loaded programme. After six years it has not delivered significantly more market access to developing country textile exporters. Although 33 per cent of trade has been integrated as committed, only a few quotas have actually been removed. The trouble with back-loading is all the difficult adjustments can be avoided until the final years.

So far the developed countries have been able to delay real liberalisation. They have restricted growth of textile exports and left the distribution of textile and clothing exports between major regions unchanged.[14] Unfortunately, the Agreement on Textiles and Clothing offers no real guarantee that complete liberalisation will happen by 2005. The

[14] Business Line, 'With less than 100 days left to go for the WTO ministerial meeting at Doha, Qatar', 7 August 2001.

failure of developed countries to increase market access for textiles during the last round makes it hard to see that they will open their markets to developing countries any more with preferences than they would under full multilateral liberalisation.

What are the interests of developing countries in the next round?

The interests of developing countries in a new round of trade talks are diverse. Some call for more preferences, concessions and non-reciprocal arrangements. Others want to eliminate preferential arrangements in favour of free trade.

Special arrangements: the 'like-minded group'

Some developing countries are still experiencing difficulties implementing Uruguay Round agreements, now seven years old. They lack the financial and human resources and technical abilities to fulfil some complex requirements, such as the intellectual property (TRIPS) agreement, the Trade-Related Investment Measures (TRIMS) Agreement, and meeting sanitary and phytosanitary (SPS) standards.

On the other hand, developing countries argue special and differential provisions are insufficient, too vague or too often ignored by developed countries. Many want to see concrete special and differential commitments for developing countries that are generalised, non-discriminatory and non-reciprocal. Developing countries' market access in agriculture and textiles also fell below their expectations. Many call for lower barriers on their agricultural exports in the face of continuing high tariffs, tariff quotas and subsidies and tariff escalation (for example, on processed goods). Many also argue their access to textiles and clothing markets has not improved under the Agreement on Textiles and Clothing and want to see the conditions, particularly on anti-dumping, tightened up. They also argue for more implementation time on TRIMS, TRIPS and SPS standards.

These concerns have developed into a comprehensive list of demands by the 'like-minded group' of countries led by India, Egypt, Pakistan and Malaysia. They argue a new round is not warranted until such implementation issues from the last round are resolved. Some agreements have been reached already, with some countries granted an extension on TRIMS compliance.

Food security is also high on the list of concerns of developing countries. However, net food importing developing countries stand to gain from agricultural liberalisation. Although the world price of agricultural pro ducts would rise if subsidies by dev eloped nations were removed, this would be outweighed in many cases by gains from expanding agricultural exports. It is possible that net food importing countries may improve their food trade balance under greater access to world markets, as their agricultural exports would expand. The Finance Minister for Egypt, which is a net food importing country, recently lobbied to liberalise agricultural trade as the 'only sustainable way' of addressing the problems of net food importing countries. [15]

Developing countries in the Cairns Group

The Cairns Group is a group of 18 mostly large agricultural exporting countries primarily composed of developing countries (15 members). The Cairns Group has two interests: a specific interest; and a general one. The specific interest is the lowering of barriers to the highly protected agricultural sector and distortions to commodity markets. The second more general interest is for a more prosperous

[15] Boutros-Ghali, Y., Egyptian Finance Minister, speech addressing the Cairns Group, Banff Canada, October 11, 2000.

and stable world with which to trade. That means a world where there are far fewer barriers to trade and investment and where a set of enforceable rules exists to give some certainty to that trade. It means open competition in markets free of politically granted preferences. It implies a world where developing countries are also focused on the real causes of the lack of development and where aid is efficient and effective in achieving its aims. As the following chapters show, that is not happening now.

3 ROLE OF TRADE IN DEVELOPMENT

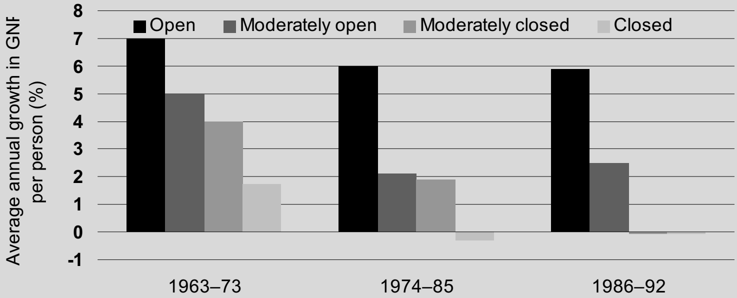
Granting preferences to help developed countries is based on the premise that trade is good for development. It is an appealing idea, since protection for agriculture and textiles in particular hurts developing countries. Granting preferences to give them duty-free or quota based access to markets should help their growth. Unfortunately it is not this easy. The relationship between trade and growth is based on the benefits of *imports*, not only exports.

One of the drivers of growth and poverty reduction has been the reduction of tariff and non-tariff barriers to trade. Through multilateral and unilateral reductions in barriers to trade, the world has become more integrated and globalised. Nowhere is this more important than for the developing countries. Work undertaken by the OECD shows that from 1963 to 1992, those developing countries which had open policies typically achieved higher rates of growth than those with closed economies. This difference is shown in chart 5. The difference between those open economies and those closed economies can amount to growth of 5 percentage points difference.

More recent work shows that globalisation leads to faster growth and poverty reduction in poor countries.[16] This

[16] Dollar, D. and Kraay, A., 2001. 'Trade, Growth and Poverty', The World Bank, Washington, June.

5 The rewards of openness in developing economies are higher rates of growth



Data source: OECD, *Agricultural Policies in OECD Countries, Monitoring and Evaluation 2000: Agriculture and Food*, Paris, 2000

work confirms the link also established by two researchers, Frankel and Romer, which showed that for every 1 percentage point increase in the ratio of trade to GDP, income per person is 2 – 3 per cent higher.[17]

The key point made by this recent research is that there has been a major change in the trade policy regimes of a group of developing countries from the mid-1980s. As described by Sally, since 1990 three-quarters of the countries in transition have liberalised trade and payment regimes in one of the 'most dramatic episodes of economic liberalisation the world has ever seen'.[18] The conclusion from World Bank researchers[19] is that the post-1980 developing country globalisers are catching up to the rich countries while the rest of the developing world is falling far behind. Trade has a strong positive effect on growth, even allowing for

[17] Frankel, J. and Romer, D., 1999. 'Does trade cause growth?', *The American Economic Review*, vol. 89, no. 3, pp. 379-399.

[18] Sally, R., 2000. 'Developing country trade policy reform and the WTO', *Cato Journal*, vol. 19, no. 3, pp. 403–22.

[19] Dollar, D. and Kraay, A., 2001. 'Trade, Growth and Poverty', The World Bank, Washington, June.

changes in other policies and endogeneity. That research shows the increase in growth rates that accompanies expanded trade leads to proportionate increases in incomes of the poor.[20]

The message from all these studies is clear: open policies to trade and investment and embracing globalisation can enormously improve the living standards of people in developing countries. Most important for this study is that the benefits come from a country *reducing its own barriers to trade and investment,* not the fact that other countries have reduced their barriers to developing country exports. The gainer from trade liberalisation is the country doing the liberalising. This fact is seen quite clearly in research that shows the potential gains in welfare for two developing countries, Indonesia and the Philippines, under two conditions: multilateral and unilateral trade reform. This is seen in chart 6. When there is full multilateral liberalisation around the world there is the greatest gain. But the bulk of the potential gains can come from each country liberalising its own barriers.

This result turns out to be quite robust. Countries stand to gain far more from reducing their own barriers to trade than by waiting for some other country in the world to remove barriers to their exports. On this reasoning, priority number one is to confront the challenge to 'get your own house in order'.

The message is that poor countries that have not done well have missed out because they have *not been able* to globalise, not because they have globalised. The politics of globalising are never easy, and countries face many constraints. But the rewards from success are high.

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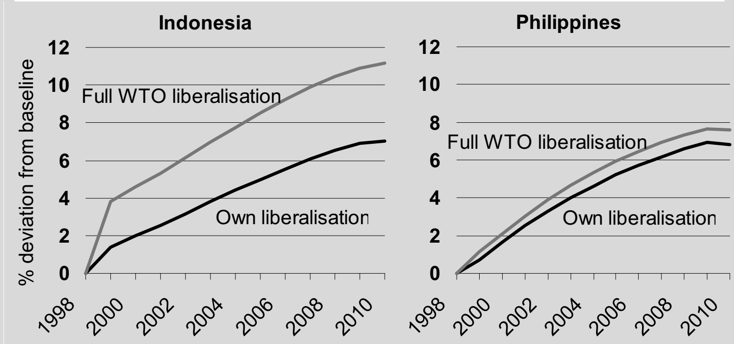
[20] Dollar, D. and Kraay, A., 2001. 'Trade, Growth and Poverty', The World Bank, Washington, June and also substantiated in Commonwealth Treasury of Australia 2001, *Economic Roundup Centenary Edition 2001,* Canberra.

6 Potential gains in consumption from trade liberalisation in Indonesia and the Philippines



Source: McKibbin, W. and Stoeckel, A., 1999. East Asia's response to the crisis, Paper presented the ASEM Regional Economist's Workshop, Denpasar, Bali, 15–17 September.

World trade is enormous and tends to grow at a faster rate than economic growth generally. Most developed countries have very low barriers to trade. Average tariff rates are 6 per cent in the United States, 10 per cent in the European Union and 10 per cent in Japan. Small devel oping countries need only obtain a tiny fraction of the world market to achieve substantial trade growth. But to capitalise on those opportunities they must be competitive. Becoming competitive is a big challenge but it is a *domestic* one. A country that is unable to achieve domestic economic reforms to become competitive can gain little from increased access to export markets — regardless of whether this access is preferential or not.

Other ingredients for trade and development

Trade liberalisation is not the only ingredient for successful development. Much literature on development highlights that developing countries need secure property rights, since they secure the basis for trade. Those rights need to be formally integrated into the legal and financial system of the country — a point made by Hernando de Soto in *The Mystery of Capital*.[21]

Development also requires good governance and institutions, or 'rules of the game' — the formal and informal rules that shape incentives, transaction costs and hence behaviour.[22] The development literature also focuses on the importance of knowledge and human capital formation through good education.[23] In addition, developing countries need good health systems and social safety nets that work well to look after the disadvantaged.

Trade encourages a domestic political economy more conducive to making the domestic changes needed for development. Opening to trade creates competition and, once trade protection is ruled out, forces import competing industries to argue for the 'shackles' to their success to be removed. Allowing imports encourages exports and makes those industries more competitive. Exporters too argue for more shackles to be removed and so the country proceeds on a path of development.

Again, note the benefits and favourable dynamic process of domestic policy reform comes from a country removing its own barriers to trade. Preferential trade arrangements offered by others do not achieve this — in fact they can hinder it. By deflecting attention from domestic economic issues, development is potentially held back.

Although it is not the only thing that matters for a developing country, trade is good for growth and poverty alleviation. Hence it is understandable why preferential

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[21] De Soto, H., 2000. *The Mystery of Capital, Why Capitalism Triumphs in the West and Fails Everywhere Else*, Bantam Press, London.

[22] North, D., 1990. *Institutions, Institutional Change and Economic Performance, Political Economy of Institutions and Decisions*, Cambridge University Press.

[23] The World Bank, 1999. *World Development Report Knowledge for Development, Including Selected World Development Indicators, 1998/99*, Oxford University Press.

access has been granted — it should help create trade. But it works on the export side of the economy, whereas historical experience with development shows us that the fastest growing developing countries are those that have reformed access to their own markets, not access to someone else's markets. Establishing preferences has static effects on resource allocation and the pattern of trade as well as dynamic flow-on effects for policy. We analyse the static effects first.

4 ECONOMIC EFFECTS OF PREFERENCES

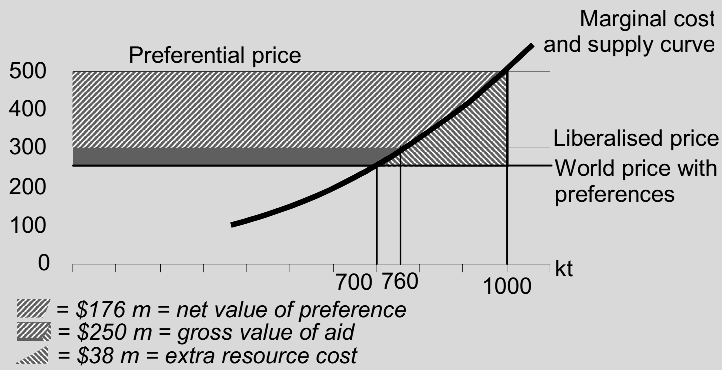
Granting trade preferences to a developing country changes the volume and pattern of trade. Some trade that did not exist before can now arise but this can occur at the expense of trade between third countries. To illustrate these effects it is worth describing what happens to the developing country receiving the preference, what happens to the country granting the preference, and finally what happens to third countries that may have been producing a competing product. Here we deal with the static and immediate effects of preferences. In the next chapter we consider the dynamic and longer-term effects.

Effects of preferences on receiving country

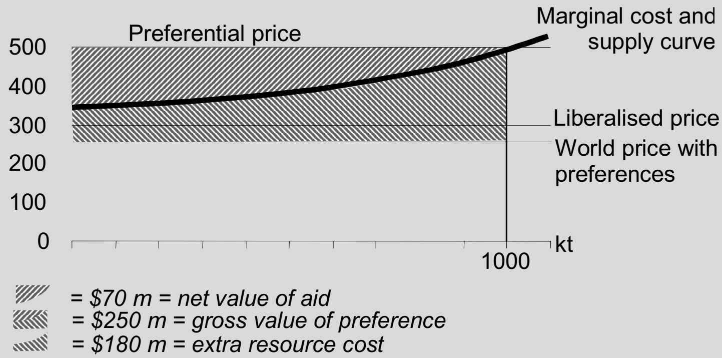
When a developing country receives a preference to a market its exporters gain a higher price for the goods on which the preference applies than they would selling to a non-preferential market. The extra price these exporters receive provides a notional windfall gain. Exporters may also respond to this higher price and put more effort into increasing production and sales. Example 1 in box 7 shows producers receive \$500 per tonne instead of the world price of \$250 per tonne, worth \$250 million in gross aid terms, and in response expand production from 700 kt to 1000 kt.

7 Net value of preferences

Example 1: reasonably efficient producer



Example 2: inefficient producer



Example 1: a reasonably efficient producer uses 15 per cent of the value of gross preferences in extra resource costs to qualify for aid, and loses another 15 per cent due to lower world prices.

Example 2: an inefficient producer uses 72 per cent of the value of gross preferences in extra resource costs to qualify for aid.

Source: Centre for International Economics.

However, this extra production, while of some benefit, does not come for free. It involves using up real resources — resources that could have been used elsewhere. If the developing country receiving the preference happened to be one of the world's reasonably efficient producers there can be a significant net gain ($176 million in example 1 of box 7). But if the developing country is an inefficient producer of those extra exports, the extra cost involved can be substantial ($180 million in example 2 of box 7). So the net aid may be very small — in our example, $70 million of $250 million gross.

Moreover, preferential access by definition implies access to an import protected market. Import protection reduces export demand and lowers the world price. This makes the value of the preference appear higher, in the example $250 ($500-$250) instead of $200 ($500-$300).

Effects on granting country

Protection is costly to the protecting country. In the next chapter, Borrell[24] shows that in the case of the EU banana market, it costs EU consumers $13 to transfer a dollar of aid to ACP countries via preferences. However, to the extent that preferences may increase imports, the country granting the preference may make itself relatively better off — compared with a situation of full protection — in two ways.

With preferences, consumers in a protected market may receive imported products at a lower price than before — a gain in welfare. Sometimes, the particular workings of the distorted market in the rich country do not allow the full

[24] Borrell, B., 1999. 'Bananas: straightening out bent ideas on trade as aid', prepared for the Conference on Agriculture and New Trade Agenda from a Development Perspective: 1–2 October, 1999, Geneva, Centre for International Economics, Canberra.

flow through of those price reductions in which case part of the potential consumer gain is lost — more on that later. The second area of gain for the country creating the preference is that prices will be slightly lower and the imports may displace some of the protected local production. Protected industries are wasteful of a nation's resources, so as producers cut back they free up resources that can be used more productively elsewhere — another gain.

Third country effects

The third effect is what happens to other countries that also export their products also to the country granting the preferences. Countries excluded from preferences will be relatively less competitive in that market compared with recipient countries. Hence their sales drop — an obvious cost to the exporting country. Because these countries can now export less, it follows ultimately that they can also import less — another cost to world trade. The problem for the efficient allocation of the world's resources is that export sales from these third countries may fall even if they are lower cost producers. Some of the world's efficient trade has been displaced.

In the extreme case, the trade creation by the granting of a preference is fully matched by trade diversion and there is no overall gain. The gain to one developing country can be fully offset by losses to another developing country. Borrell[25] shows that EU banana preferences that deliver about $151 million a year in aid equivalent to ACP banana producers cost Latin American producers $149 million a

[25] Borrell, B., 1999. 'Bananas: straightening out bent ideas on trade as aid', prepared for the Conference on Agriculture and New Trade Agenda from a Development Perspective: 1–2 October, 1999, Geneva, Centre for International Economics, Canberra.

year. The example of bananas demonstrates net aid may be zero, but how likely is this more generally?

A global scenario: preferences for non-Cairns Group developing countries

To see whether there can be significant trade diversion and how important preferences might be compared to the opening of trade by developing countries we take a hypothetical but not unrealistic scenario of the granting of preferences using actual trade data and preferences as they existed in 1997. The scenario is one where high income countries in the world grant preferences to a group of developing countries. Because most of the distortions in world trade now lie in agriculture and textiles we are most likely to see trade diversion for groups of countries that have one or both of these interests. One group with clear agricultural interests are the developing country Cairns Group members. Therefore, we perform the experiment of extending full preferential access to developing countries other than the Cairns Group. Cairns Group countries are efficient agricultural exporters.

Since we are trying to capture the effects of trade creation and trade diversion, we use a global trade framework. The particular model here is a global trade model called GTAP. The version and description of this trade model, which is widely used for such analysis, is described in appendix A. The important feature is that preferences, barriers and trade data relate to 1997. The model identifies some 42 developing countries/regions out of a total of 66 countries/regions.

The scenarios

Scenario 1: removal of all trade barriers facing non-Cairns Group developing countries

The first experiment is to take the world's high income countries (largely Europe, Japan and the United States plus other OECD countries) and remove all trade barriers to those developing countries who are not members of the Cairns Group. Note that some of these developing countries who are not members of the Cairns Group already receive some preferences in agriculture and textiles (and some other goods). These existing preferences are taken into account. All scenarios assume no other policy distortions.

Scenario 2: unilateral reform

Earlier, it was seen that trade is valuable for creating growth and alleviating poverty. So a second experiment is also conducted. This scenario is where the same group of non-Cairns Group developing countries unilaterally re move their existing barriers to trade of all goods and services but all other countries continue with the same policies.

Scenario 3: multilateral reform

The intention of the WTO is to remove barriers to trade around the world on a multilateral basis. So here a third experiment is conducted whereby all barriers to trade by all countries are removed.

Results

The results from these three scenarios are summarised in chart 8 as scenarios 1, 2 and 3.

Scenario 1

The results show in chart 8 that both high income and developing countries that are not members of the Cairns Group expand GDP by about US$8 billion when preferences are extended by selectively removing barriers. Developing countries can gain because they receive a higher price for their product. There is an additional gain, net of extra resources to supply more product to the market. The total gain to developing countries could be nearly US$8 billion of GDP. This represents nearly 0.2 per cent additional gain to their GDP. High income countries granting the preferences also gain because they are now receiving some lower priced products and some resources can be freed up to be used in more efficient and productive uses.

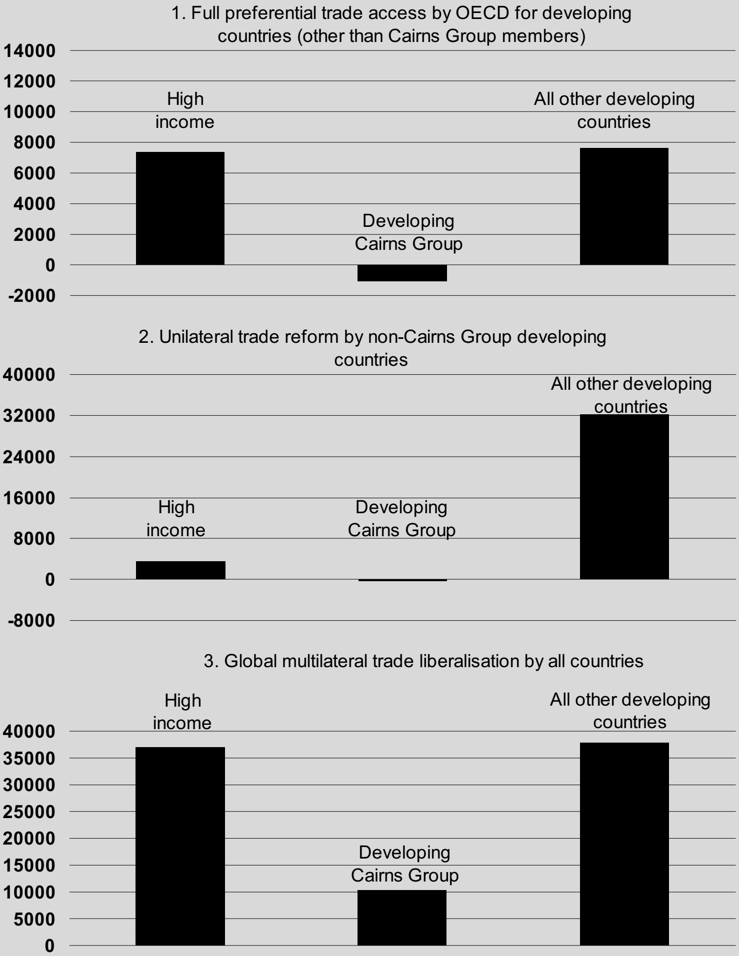
From panel 1 of chart 8, it can be seen that some of the gain comes at the expense of developing Cairns Group members due to trade diversion. Devel oping Cairns Group members are worse off to the tune of US$1.1 billion of GDP.

The possibility of trade diversion is confirmed by other World Bank research, which predicts the 'Everything but Arms' deal will divert trade from other developing countries not included in the least developed list.[26] Other researchers though have argued that preferences for 37 sub-Saharan African countries would cause diversion but it would be negligible given the small value of trade from the sub-Saharan group.[27] Yet another study on tariff peaks (largely agriculture and textiles) in QUAD countries

[26] *The Economist* 2001, 'Zero-sum?', 3 March , p. 75.

[27] Ianchovichina, *et al.* 2001. 'Unrestricted market access sub-Saharan Africa: How much is it worth and who pays?' Development Research Group, World Bank, Washington DC, February.

8 Effects of trade policy options (1997, $US million)



Source: Centre for International Economics simulations with GTAP 5.

(Canada, European Union, Japan and the United States) found that removing these peaks by QUAD countries to LDCs would see exports rise but nearly half the increase would come from falls in other developing countries' exports.[28]

The assumptions underlying these results are scrutinised in the next chapter but first it is instructive to compare the value of preferences to developing countries to the effect of removing their own trade barriers.

Scenario 2

In chapter 3 it was seen that most gains from trade come from a country removing its own barriers rather than seeking removal by others. The middle panel of chart 8 shows the impact of unilateral trade reform by non-Cairns Group developing countries. The result is consistent with other research and theory — the developing countries stand to gain handsomely from the removal of their own trade barriers. The gain is *four times* the increase in GDP from receiving full preferential access to rich country markets. High income countries stand to gain a little as well because they get to trade with a now more pros perous group of developing countries. But the high income countries miss out on the main part of the gain because they do not remove their own protection. They do not get lower prices for their consumers and more efficient and productive use of their resources at home.

There is very little effect on the developing Cairns Group members because their main product — agriculture — is still not permitted to the markets that matter most, the high income protected markets, particularly Europe, Japan and the United States. Also, under this scenario the Cairns Group countries are not liberalising their own trade barriers. This result highlights another effect — those

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[28] Hoekman, B., *et al.* 2001. 'Tariff peaks in the QUAD and least developed countries exports' Development Research Group, The World Bank, Washington SC, July.

countries that liberalise first get the new investment capital first. They get the 'first mover' advantage.

Scenario 3

The third simulation is the experiment whereby all countries remove their barriers to trade in goods and services. Also, domestic subsidies are removed in this scenario because it is not possible to remove a domestic subsidy on a preferential basis. The welfare (as measured by GDP) of the high income countries is now more than seven times higher than when they grant preferences to a select group of developing countries. The reason is they are now undertaking a more substantive liberalisation. More distortions are being removed, such as domestic subsidies, and markets are opened to more countries. Agriculture is a very large component of this additional gain. Developing Cairns Group members also gain as do all other developing countries. Developing countries (other than the Cairns Group) could gain nearly *five times* the gain from that of receiving full preferential access. If high income countries wanted to do the developing countries and themselves a favour they would remove their own barriers to trade and convince others to do likewise. Clearly, full global multilateral trade liberalisation is a win-win result. That should be the priority of trade negotiators.

To summarise, the following can be deduced:

- preferential trade can result in trade diversion and can make some countries or groups of countries worse off;
- unilateral trade reform by developing countries, that is removing their own barriers to trade, can be four times more beneficial than receiving preferences;
- multilateral, non-discriminatory trade liberalisation is a win-win situation and first best policy; and

- the above results and other studies referred to are from static analyses and ignore political economy dynamic effects.

It is shown in the next chapter that when these dynamic effects are considered the differences between these various options are even more stark.

5 THE 'KISS OF DEATH': SOME CASE STUDIES

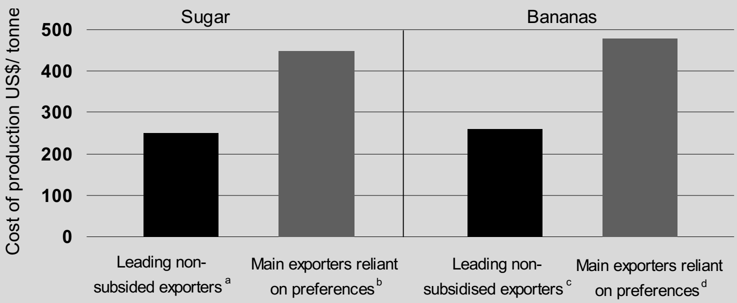
Competition spurs innovation and cost savings. But trade preferences insulate producers from competitive pressures and weaken disciplines to control costs. This can be a kiss of death for many producers. Through time, insulated producers tend to:

- adopt new cost reducing technologies at a slower rate than producers who are fully exposed to global competition; and
- see their costs rise due to other pressures in their economies — chart 9.

Moreover, preferences require policies in the recipient country that allow for the equitable distribution of the economic rents earned from preferential access. Typically, preferential access is restricted by quotas and rules of origin to limit how much economic rent any one country can extract. Often very complex domestic policies are required to match domestic production to the quota-restricted access. One of the unintended consequences of such policies is that they can create economic rigidities and incentives that:

- slow down innovation and economic adjustment over time; and
- create political incentives that cause costs to rise.

9 Preferences are not worth much if producers' costs of production are high



a Australia, Brazil, Thailand. **b** Mauritius, the Philippines, Dominican Republic. **c** Ecuador, Costa Rica, Columbia. **d** Cameroon, Caribbean, Canary Islands, Martinique and Guadeloupe

Source: Borrell 1996 (see footnote 43), Borrell et al. 1994 (see footnote 31) and Borrell 1999 (see footnote 24).

Through time, the production costs of competitive producers will influence the world price. As their costs fall, so will the world price, making producers with preferences increasingly uncompetitive and reliant on their preferences. Ironically, the net result seems to be that countries that receive economic rents from their preferential access lose most of the economic advantage this affords. This is due to inefficient resource use that preferential access tends to encourage. Their costs rise to match or even exceed the high prices they receive. They are forced to use up valuable resources to qualify for the preferences and so they become highly uncompetitive. They struggle to make a living in an industry which for them has little potential for expansion. Resources that could have been used to develop other more profitable industries are wasted.

Analytically, what happens is that a reasonably efficient producer, such as that shown in example 1 of box 7, can become inefficient and uncompetitive as shown in example 2 of box 7. 'Protected' by preferences, and in the absence of competitive pressures, costs rise, shifting the marginal cost curve upward.

Case study: preferences harm Mauritius

Chart 10 and 11 show the nominal value of trade preferences granted by the European Union and the United States through preferential access to their protected domestic sugar markets. Mauritius is clearly the biggest recipient of preferences, a form of aid, from the European Union. The preference costs EU consumers nearly US$200 million a year. Access to the EU market allows Mauritian producers to receive prices that are, on average, more than double the world price of sugar. Over 70 per cent of Mauritius's sugar is sold to the European Union.

Despite the huge subsidies received through preferential access to the European Union, the Mauritian sugar industry is struggling. Its costs are at least double those of efficient sugar exporters. In 1999, the costs exceeded revenue by 17 per cent.[29] The industry imposed a loss on the Mauritian economy.

Preferences have prevented cost savings

Insulated from world market competition for many decades, the industry's structure and organisation have ossified. There are pronounced economies of scale in sugarcane milling. In the past four decades leading sugar exporters in Australia, Brazil and Thailand have rationalised milling and built massive mills with very low costs.

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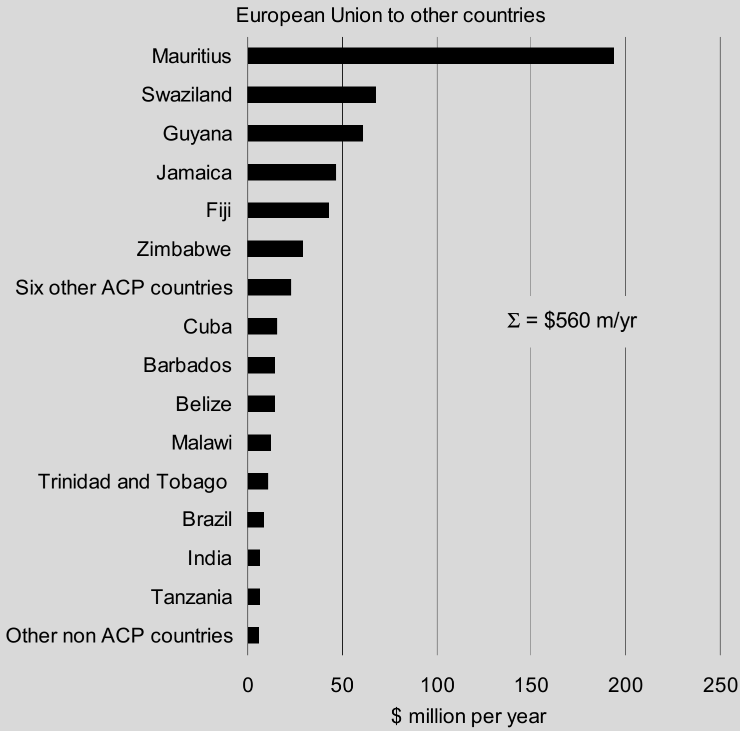
[29] Mauritius Sugar Producers Association 1999 Annual Report, Estimated Revenue & Expenditure Account of Sugar Estates with FAC, http://www.-prosi.net/mspa/estim.htm, Accessed 9 August 2001.

10 Nominal value of EU trade preferences: sugar

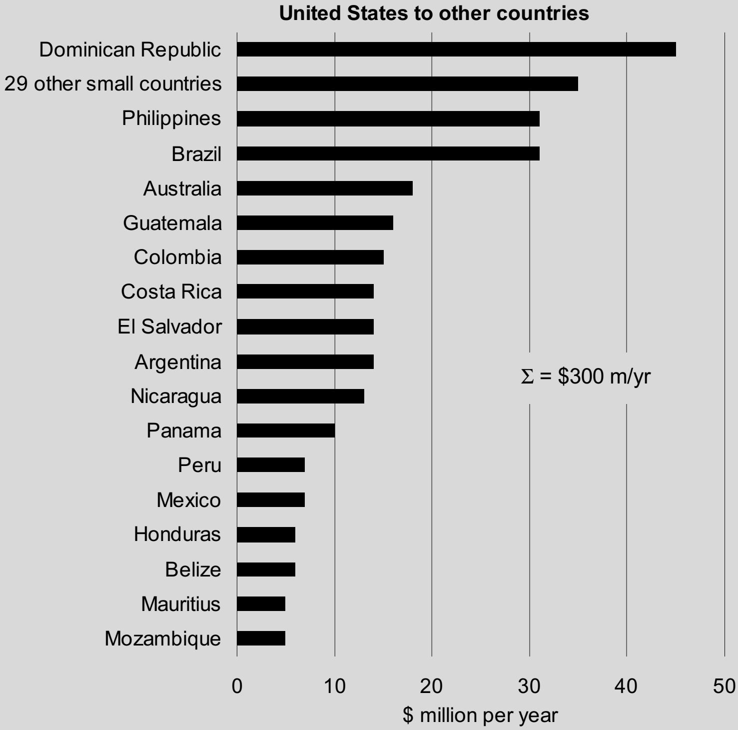


Source: Borrell, B. and Pearce, D., 1999. 'Sugar: the taste test of trade liberalisation', prepared for the Conference on Agriculture and New Trade Agenda from a Development Perspective: 1–2 October 1999, Geneva, Centre for International Economics, Canberra.

Mauritius has retained tiny mills, less than a tenth of the size of the efficient mills operated by competitive exporters. It uses too much capital and labour in sugar milling. Without economies of scale, its milling costs are likely to be double those of large efficient mills.

To equitably distribute the economic rents from preferences, Mauritius has enacted several policies that limit

11 Nominal value of US trade preferences: sugar



Source: Borrell, B. and Pearce, D., 1999. 'Sugar: the taste test of trade liberalisation', prepared for the Conference on Agriculture and New Trade Agenda from a Development Perspective: 1–2 October 1999, Geneva, Centre for International Economics, Canberra.

competition for sugar industry resources.[30] Land is allocated to each mill, preventing competition among mills. Land is also zoned for use in sugarcane growing, limiting competition for land from other industries. Labour laws introduced in the 1970s prevent the industry from reducing surplus labour except by attrition. Labour laws also provide

[30] Larson, D. and Borrell, B., 2001. 'Sugar Policy and Reform', in *World Bank Regional and Sectoral Studies, Commodity Market Reforms, Lessons of Two Decades*, Washington.

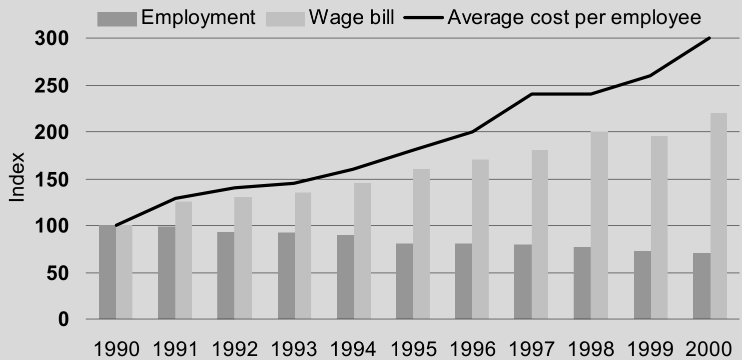
other special conditions to workers relating to housing, health, schools, and social, cultural and sporting amenities.

Land allocation, zoning and labour laws limit the ability of mills to rationalise their operations and reduce incentives for investment in new technology. As the Mauritian economy has grown, labour costs and the opportunity costs of land, water and capital have all increased — see chart 12. However, sugar industry policies have locked resources into the industry, preventing it from adjusting by substituting new technological solutions to reduce resource use and costs. As a result the industry uses up more costly labour, land, capital and water than is warranted.

Policies fashioned around preferences now harm other sectors of the economy

Locking land, labour and water into the industry imposes costs on other sectors of the economy by limiting their

12 Cost per employee is rising sharply in the Mauritian sugar industry



Source: Mauritian Chamber of Agriculture, Mauritius Sugar Syndicate, Mauritius Sugar Producers' Association, Joint Memorandum on 2000–20 National Budget, PROSI Magazine, June 2000, No. 377, Sugar Industry, http://www.prosi.net/mag-2000/377june/memo377.htm, Accessed 9 August 2001.

opportunities for growth. The sugar industry commands many of the island's critical resources. It commands 93 per cent of the island's arable land, much of its managed water resources and over 10 per cent of its labour force.

Its special labour arrangements look particularly incongruous given Mauritius's high rates of employment and a need to recruit guest workers from overseas. Its land laws and land prices also indicate the magnitude of costs being imposed on other sectors. One indicator is that the rest of the economy values land at 10 times what it is worth as a sugar growing resource. Indicators such as these suggest that sugar policies, put in place as a result of preferences, are having costly unintended consequences on the Mauritian economy. Indeed, despite the economic rents received, the preferences and the industry itself are imposing a net cost on the economy. The real value of preferences is therefore negative.

Admittedly, the industry pays a special turnover tax of around 8.0 per cent and so contributes around US$16 million to government revenues. Some may also argue that in providing employment for around 35 000 workers, it provides a benefit to the economy. However, if Mauritius is recruiting guest workers and facing a labour shortage this benefit is likely to be very small. Moreover, by Mauritian standards nowadays, sugar workers are low-paid. They remain locked into the industry by the housing, health and other special benefits offered.

Preferences appear to be killing the industry

Preferences appear to have lulled the Mauritian sugar industry into having a false sense of security. Sugar industry policies have been fashioned around these preferences, but they insulated the industry from competitive developments within its own economy and within the world sugar market.

Through time, the industry has not adjusted to competitive pressures domestically or internationally, so that today it is hopelessly uncompetitive. It is doubtful the industry can be restored to be internationally competitive.

Sugar preferences have damaged Cuba, the Philippines and others

Until 1960, the Cuban sugar industry had preferential access to the high-priced US sugar market. After 1960, the former Soviet Union offered Cuba similar preferences. At that time Cuba was the largest exporter of sugar in the world. Prices received by Cuba were over double the world price and the Soviet Union took almost all of Cuba's sugar.

The Soviet legacy in Cuba

The collapse of the Soviet Union in 1990 revealed how internationally uncompetitive Cuba had become while insulated by preferences. Exposed to world prices, Cuba's production declined by more than 50 per cent. Cuba now struggles to meet its production targets and is only a minor force in the world sugar trade.

As part of the preferential arrangements it had to import Soviet sugar milling machinery. The legacy of Cuba's dependence on Soviet preferences is that of a poorly structured industry reliant on obsolete and unreliable machinery. Part of the legacy is also a poorly structured and undiversified agricultural industry, with most arable land being used for sugar production. Other opportunities have not been developed and much of the Cuban economy is reliant on an industry it has little hope of being restored to international competitiveness. Cuba's story highlights another point: preferences can make a country vulnerable to their removal. Preferences do not offer a country stability.

The US legacy in the Philippines

Historically, the instruments of Philippine sugar policies were largely designed to distribute the premiums received from preferential access to the US market, which were first established in 1898. Indeed, the US Government played a big part in establishing the policies. One of these policies was a market sharing arrangement (known as the Quedan system) designed to give cane growers and millers equitable access to premium markets. However, under the system producers are penalised for increasing productivity and production. This greatly reduces incentives to invest in technology to increase productivity.[31]

The policies appear to have constrained increases in yields of sugar per hectare, limited sugar recovery rates at the mill, and prevented economies of scale being exploited. All this has contributed to raise Philippine sugar production costs by over 30 per cent.[32] Yet agronomically the Philippines is suited to growing cane and historically it was a major force in world sugar trade. By contrast with Thailand, the Philippine industry has stagnated and declined over the past two decades, while Thailand has emerged as one of the major efficient exporters of sugar. Thailand has virtually no trade preferences in sugar. In 1983, the Thai and Philippine industries were roughly the same size. Since then the Thai industry has more than doubled in size and expanded exports aggressively without preferences, while the Philippine industry has decreased exports by 80 per cent and now imports sugar to meet domestic needs.

Like Cuba, the Philippines has had preferences removed. In the 1980s the Philippines lost much of its access to the US market, another example of the risk inherent in preferences.

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31 Borrell, B., Quirke, D., de la Pena, B., and Noveno, L. 1994. *Philippine Sugar: An Industry Finding Its Feet*, Centre for International Economics, Canberra.

32 Borrell *et al.* 1994.

In the United States increased production of a substitute sweetener, fructose corn syrup, led to a marked reduction in US imports of sugar in the late 1970s and 1980s. In response, the US Government reduced preferential access.

The US legacy in the Dominican Republic

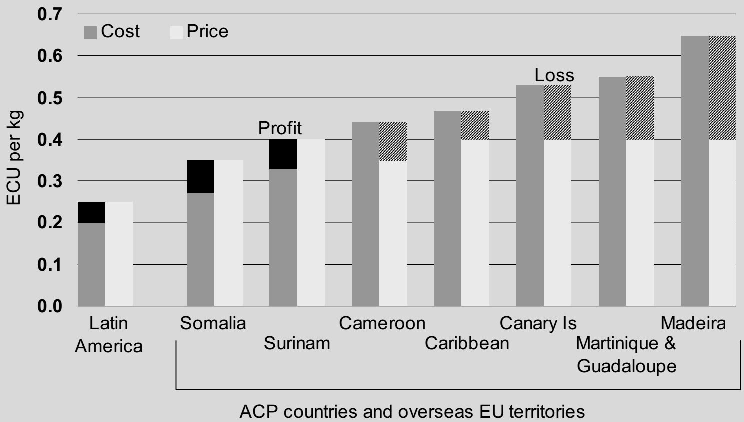
In the Dominican Republic the story seems to be much the same. The Republic has adopted domestic policies to deal with preferences. These policies distort incentives and lead to inefficient growing and milling practices. Fry [33] argues that in the Dominican Republic, high returns from preferential access to the US market caused the costs of factors such as labour and fertilizer to be bid up and encouraged inefficient growing and milling practices. Since the reduction of US preferences in the 1980s, the Dominican Republic sugar industry has struggled and been unprepared for the increasingly competitive world market.

A similar story emerges in bananas

ACP and EU territorial producers receive preferential access to the high-priced EU banana market. Despite prices being over double the world price, most producers with preferential access appear to be making big trading losses — chart 13. Preferences have become a burden rather than an economic windfall. Although hundreds of millions of dollars are paid to ACP banana producers by the European Union, the value of this to recipient nations may be zero or negative because of the inefficiencies created.

[33] Fry, J., 1982, 'The Costs of Production of Sugar and HFCS', in *F.O. Licht 1982 Yearbook*, Ratzeburg, Federal Republic of Germany.

13 Most ACP and EU territories appear to be suffering big losses



Source: Borrell, B. 1999, 'Bananas: straightening out bent ideas on trade as aid', prepared for the Conference on agriculture and new trade agenda from a development perspective: 1–2 October, 1999, Geneva, Centre for International Economics, Canberra.

The UK/EU legacy in the Windward Islands

A Cargill Technical Services Ltd[34] study on the Windward Islands highlights some of the inefficiencies that have arisen behind banana preferences.

- Windward Island bananas are perceived to be low yielding, high cost and of inconsistent quality relative to Latin American fruit.
- Costs of production are twice those of production in Latin America.
- Guaranteed access to the UK market until 1993 (and subsequently the EU market) was a disincentive to solving fundamental quality and cost inefficiencies.

[34] Cargill Technical Services 1995, *Proposals for Restructuring the Windward Islands Banana Industry, Draft Final*, United Kingdom.

- Poor management at all levels is a bigger problem for the industry than inherent climatic, topographical or structural weaknesses.
- The industry has the capacity to function competitively in a free market if the necessary organisational and technical changes are made.
- Despite good support prices and conditions between 1989 and 1992, the industry’s marketing bodies were accumulating debt.
- When prices fell in 1993, debt of marketing bodies blew out to Euro 113 million, putting the industry in an unsustainable financial position.
- The industry is financially unsustainable without massive increases in productivity and competitiveness, substantial debt write-offs and infusions of equity.

The EU banana story highlights the inefficiencies of using preferences for aid

The European Union imports around 40 per cent of all internationally traded bananas. The EU banana policy restricts access to Latin American producers, which raises the EU domestic banana price but provides preferential, quota-restricted access to former colonies and EU overseas territories. EU banana prefer ences are the largest distortion in the world banana market.

Ostensibly the EU banana policy operates to deliver aid to several developing nations by raising the prices these countries receive for their products in the EU market. In reality, it costs EU consumers a fortune ($2 billion a year), with only a small proportion ($150 million a year) reaching the intended developing country targets. Banana importers and wholesalers with import quotas extract most of the rest. In other words, it costs consumers $13.25 to transfer $1.00 of aid. This is a ridiculously inefficient form of aid. [35]

Worse still, as stated earlier, for every dollar of aid reaching its target, collateral damage of a dollar is caused to other developing countries that export bananas, namely the efficient Latin American producers. This occurs because export opportunities and the world price are reduced. The net benefit to developing countries is therefore zero. Banana preferences are a lose-lose situation.

The loss of so much of the $13.25 paid by consumers to importers and wholesalers highlights another problem. The rents created by preferences end up being captured by groups they were not intended to help.

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[35] Borrell, B., 1999. 'Bananas: straightening out bent ideas on trade as aid', prepared for the Conference on Agriculture and New Trade Agenda from a Development Perspective: 1–2 October, 1999, Geneva, Centre for International Economics, Canberra.

6 DIRECT AID IS BETTER THAN PREFERENCES

The whole purpose of aid is to make a developing country better off. Based on the evidence in the previous chapter, preferential trading arrangements do not achieve this despite it being the sole justification for their existence.

To receive the 'aid', the developing country has to commit resources to producing a commodity it may not be good at (like bananas) and hope some of the benefit might flow through to better education or better infrastructure. Sadly, the benefits get siphoned off into someone else's pockets. Spending $13 to transfer $1 of aid as we saw in the banana example is very expensive and ineffective aid.

The story is even worse than this, because to transfer $1 of aid not only costs $13 but imposes a $1 cost on another developing country. For the welfare of the developing world as a whole, it is obvious this is not a good aid strategy.

Furthermore, the longer term effects of granting preferences tends to lock countries into the wrong industries, and makes them vulnerable to policy changes which threaten to remove their preferences. This creates a political economy resistant to trade reform. In the extreme, examples discussed in the previous chapter indicate some countries may be made worse off because of preferences.

A preference is only useful where there is a wedge between the world and protected market price. As all agricultural tariffs gradually come down through ongoing talks, the value of this aid will fall — it is not a sustainable source of aid.

Preferential trading arrangements can be used selectively to buy the acquiescence of another country on other international issues. Even when preferences are granted they often have conditions attached. Recipient countries are sometimes required to import some proportion of their imports to make the preferentially treated good from the 'donor' country — a bit like tied aid. Sometimes, the country is required to implement certain labour standards or assist with drug control or other policies.

Perhaps the worst effect of preferences is that they distract developing countries — and the developed countries and organisations that want to help — from the main game. Gaining access to another country's market is seen as the panacea for the developing country's ills, which diverts attention and resources away from the more fundamental need — to address the domestic constraints and dynamics underlying their poor economic performance. As discussed in chapter 3, focussing on domestic reform will have a far better developmental outcome than seeking preferences.

The effect of granting preferences by the rich countries is to create a sense of complacency of having done enough for poor countries. More seriously and deleteriously, it enables the rich countries to persist in maintaining trade barriers that are detrimental to developing countries as a whole.

Direct aid is more consistent

Aid delivered via trade preferences is inconsistent with the EU commitment to direct, well-targeted aid. The European Commission[36] appears to recognise that:

> '... many ACP states have really not benefited from their preferential access...', that '... the Uruguay Round...' will mean '... access to the European market will mainly be determined by the differences in competitiveness between competitors...', that '... the new Lomé IV Convention should be enriched with a series of new arrangements aimed at improving the competitiveness of ACP states...' and that '... new elements should not only focus on reforming the trade policies of ACP countries, but also on other economic policies within carefully conceived structural adjustment programs.'

The European Union has a comprehensive direct aid program with several well-established mechanisms for delivering well-targeted aid to ACP countries. In 2000, the European Union provided nearly Euro 2.6 billion in direct aid to ACP countries — chart 14. Direct well-targeted aid is likely to be far more efficient than aid given via preferential access.

Through its direct aid program, the European Union places a great deal of emphasis on planning, selecting, implementing, coordinating, avoiding inconsistencies with other activities, evaluating and monitoring aid transfers and the effectiveness of their use. Many factors are considered in assessing the worthiness of aid. All this is in recognition of the difficult task involved in making aid effective. Providing quality aid is a major objective of the European Union's direct aid program.[37] By comparison, the aid it provides as

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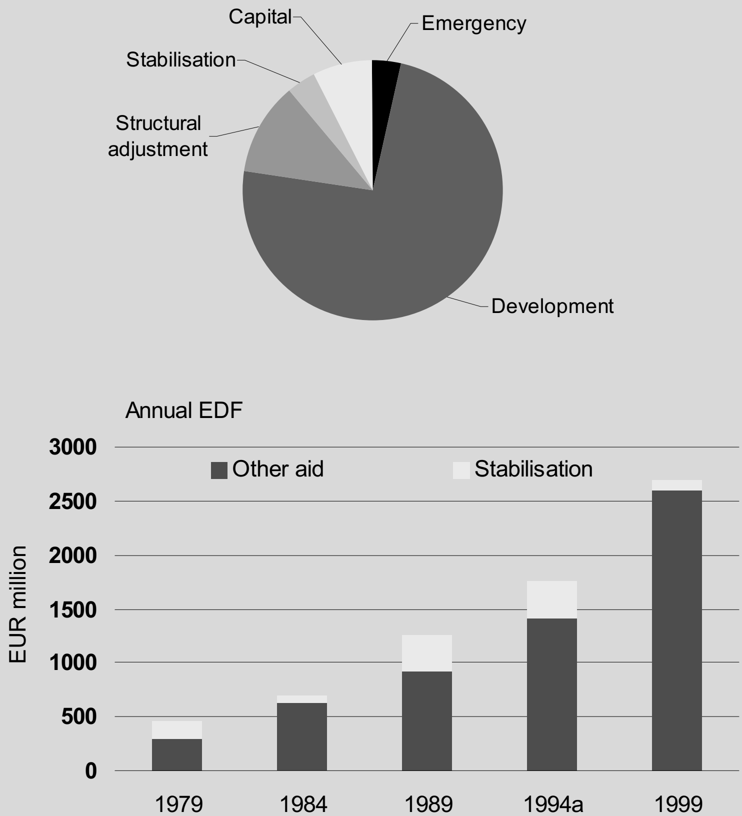
[36] Commission of European Communities 1995, *Financial Cooperation under the Lomé Conventions: Review of Aid at the End of 1994*, Geneva, pp.55 and 57.

[37] Commission of European Communities 1995.

14 The EU already gives direct aid to ACP countries



Source: Borrell, B., 1999. 'Bananas: straightening out bent ideas on trade as aid', prepared for the Conference on Agriculture and New Trade Agenda from a Development Perspective: 1–2 October, 1999, Geneva, Centre for International Economics, Canberra; European Commission 2000. *Community Budget: The Facts in Figures 2000.*

banana aid (or preferential aid) is entirely haphazard. In this regard it appears to be inconsistent with the European Union's aid strategy.

More aid and more effectiveness

By shifting from delivering aid via preferential trade to direct aid, rich countries could afford to give more effective aid to developing countries. In the examples given previously for bananas and sugar, where very little or even no net benefit is actually transferred, very little direct transfer of aid would be required to compensate developing countries if preferences were removed. But more to the point, because preferences cost rich countries' consumers so much to deliver so little benefit, the potential exists to both lower the cost to rich countries and increase the aid to developing countries.

The task is to first assess what the gross value of preferences for all other commodities amounts to. Then OECD countries should transfer at least the equivalent amount directly, as part of their official development assistance (already worth US$56.4 billion in 1999[38]).

As direct aid, the equivalent gross value of preferences will be worth considerably more to the recipient country than the net value of aid through preferences. Resources will no longer need to be used up producing goods, at high cost, to qualify for aid. Rather, the aid can be targeted directly to boost education, health, infrastructure and other essential development needs on a country-by-country basis. Additionally, direct aid can be targeted to particular developing countries (for example LDCs) without harming others as discriminatory preferences do.

The organisation best equipped to devise and deliver development assistance is not the WTO but the institution set up for this purpose — the World Bank. Turning the WTO into an aid organisation only weakens that institution's main role, discussed in the next chapter.

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[38] OECD 1999. http://www.oecd.org/dac/images/ODA99amo.jpg, Accessed 7 August 2001.

7 EROSION OF THE MFN CORNERSTONE

Preferential trade further weakens the non-discrimination principle of the GATT. The GATT (now the WTO) was established at the Bretton Woods agreement along with the World Bank and IMF in the wake of the Second World War. The Bretton Woods agreement aimed to establish a financial architecture for the world, the means to promote development assistance and a framework for expanding trade. The bitter memories of the Great Depression, the beggar-thy-neighbour protection polices and the trade implosion that followed prompted the move to establish an international agreement to provide a set of rules governing trade and a framework by which countries could reduce barriers to trade. The non-discrimination principle is the only principle in the GATT consistent with the more efficient use of the world's resources. Without this clause there is little point in having the WTO.

Mercantilism, reciprocity and non-discrimination

To appreciate the central role of the MFN clause in the GATT it is important to understand how the multilateral trade system works, how political forces are brought into play in a negotiating round, how the rules are 'policed' and how negotiations are to be conducted efficiently.

The bargaining game played out under the WTO is based on maximising your access to others' markets while giving away as little access to domestic markets as possible. This concept — 'exports are good but imports are bad' — is inherently flawed. People choose to buy imports because they add to their welfare. Imports increase choice and provide 'value for money' goods and services. Because people can purchase cheaper things they can afford to spend more on other things, both local and imported, which enhances their welfare. There is one difficulty though — the person supplying the imports wants to be paid in foreign currency. This foreign exchange can only be earned by selling exports. Hence exports are good but *only* because imports are good. Indeed, were a country to stop all imports, eventually it would stop all exports. That proposition was worked out by economists over 200 years ago and is well understood by any good economist today. So why is this so misunderstood generally? It is due to history, politics and self-reinforcing messages that perpetuate the myth of 'exports good, imports bad'.

Mercantilism sprang out of the idea that accumulating gold increased wealth. It followed that selling exports in exchange for gold was good. The problem is that accumulating gold, in itself, is no use — like being marooned on a desert island with a bucket of gold.

Once the 'exports are good' idea took hold, it generated its own powerful political economy. The idea is that countries negotiate to reduce each others' trade barriers, whereby an offer to reduce a barrier on a product is treated as a 'concession'. That is the economic nonsense part — countries that reduce barriers to imports are doing themselves a favour!

The request and offer negotiations under the principle of reciprocity, plus the principle of non-discrimination or MFN, meant that a deal struck on access between the majors was to be offered to all other members on an equal basis. For these reciprocal negotiations to work on a world scale requires the principle of non-discrimination.

The point is that, having established a political game based on faulty logic, the system effectively required the principle of non-discrimination to work. It is the only principle compatible with a competitive and efficient open trading system.

Non-discrimination is also required to 'police' the system. The WTO framework consists of a set of rules agreed to by members of the 'club'. For this to work requires penalties for those who do not follow the agreed rules. The WTO does not have an international police force so rules are enforced through the threat of retaliation. A country can impose sanctions on a offending party. They can legally discriminate against their exports and so hurt their interests. Again note the economic nonsense here — the country that stands to lose the most is the country imposing the retaliatory import barriers! But once discrimination is allowed through various guises of preferential trading arrangements it weakens the policing power by the majors of the system and its rules. As Martin Wolf notes:

> 'Once discrimination has become a norm, further and progressive increases in protection are virtually inevitable, for the system tends to lose its one effective sanction, retaliation by the major established powers against each other. Discrimination then acts as a sort of meat slicer on existing commitments.'[39]

Mercantilism then tends to undermine the commitment to non-discrimination. Preferential or discriminatory arrangements weaken the whole multilateral trade system.

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[39] Wolf, M., 1986, 'Fiddling while the GATT burns' *Cato Policy Analysis No. 78*, 25 September, p. 9, http://www.cato.org//pubs/pas/pa078.html, Accessed 1 August 2001.

Weakening the MFN, weakening the system

The GATT's key principle of non-discrimination embodied in the MFN has been gradually eroded since its inception. While non-discrimination was never universally adopted, rhetoric and reality have moved further away from this principle as decades progressed. Today a high proportion of international trade is conducted on a discriminatory basis, and disputes are increasingly settled by discriminatory protection outside the GATT framework. [40]

The main offenders are the preferential trading arrangements, the focus of this paper. The essence of preferential access is discrimination. Preferences are a clear exception to the WTO's principle of non-discrimination, therefore their proliferation or extension weakens the cornerstone of the WTO.

The principle of non-discrimination is being eroded gradually on other fronts besides the preferential arrangements for developing countries. Free trade areas (or more correctly, discriminatory trade areas) are allowed under Article XXIV. The way anti-dumping works makes such policies in effect discriminatory protection. And the world is edging towards more formally including environmental and labour standards in trade agreements. These will end up discriminating against some countries. Pressure to extend the WTO's mandate to include development, environment and labour issues, by strengthening discrimination, would weaken the organisation. That is not in the interests of anyone, least of all developing countries.

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[40] Wolf, M., 1986, 'Fiddling while the GATT burns' *Cato Policy Analysis No. 78*, 25 September, p. 7, http://www.cato.org//pubs/pas/pa078.html, Accessed 1 August 2001.

The rise of regionalism

Regionalism is an erosion of the non-discrimination principle. These agreements are not free trade — they are discriminatory. One country's imports are given preferential access over another. Well-known trade economist Jagdish Bhagwati has described the proliferation of what are preferential, not free, trade agreements as a 'spaghetti-bowl' that clutters up trade with discrimination depending on the 'nationality' of a good.[41] These agreements, like the preferential arrangements for developing countries, need rules of origin to work. These rules are arbitrary and difficult to police. Out of the complexity comes opportunity for an industry of lobbyists to 'fiddle' with the adoption of the rules for protectionist intent. However well intended, preferential regional trading arrangements are weakening the multilateral system by further eroding the principle of non-discrimination. Efforts to transform the non-WTO compliant Lomé Convention into regional arrangements allowable under Article XXIV do not change the basic fact that the arrangements are still discriminatory.

Anti-dumping

Yet another erosion of the MFN principle is the increasing resort to anti-dumping to prevent cheap imports from entering a country. Low cost imports have two effects: a beneficial effect on consumers and other industries using the low cost import, and a deleterious effect on domestic producers who find the competition tough. But anti-dumping determinations measure only one side of the equation. They focus on the costs, not the benefits. And even then they do not measure economic cost, using a technical measure instead. Little wonder that with this

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[41] Bhagwati, J., 2000. *The Wind of the Hundred Days: How Washington Mismanaged Globalisation*, MIT Press, Cambridge, Mass., p 243.

biased view, anti-dumping runs the risk of becoming a new source of protection. The other danger is that anti-dumping policies are effectively preferential in nature because they are mostly targeted at a particular country — often a developing country.

Trade and environment and labour standards

As if the erosion of the non-discrimination principle through developing country preferences, proliferation of regional trade agreements and wider use of anti-dumping policy were not enough, there also looms the prospect of yet more discrimination creeping into the system through the extension of environmental and labour standards in trade.

Activists at the Seattle meetings of the WTO grabbed attention with demands to make trade preferences dependent on certain environmental and labour standards. The added complexity of factoring in environmental and labour standards into an already discriminatory preferential system moves the world further from multilateral liberalisation and will end up discriminating against developing countries the most.

For the purposes of this study, two problems exist with incorporating environmental and labour standards in trade agreements. They can give countries the excuse to impose protection against imports they may not like and they will end up discriminating against developing countries, which tend to score low on both environment and labour standards. Imposing trade barriers against developing countries will not help workers in those countries — it will slow down growth and keep people poor. And poor countries do not have the popular demands from residents to care for the environment or the technologies, institutional arrangements and resources to enact environmental protection to the standards of industrialised countries. These come later once incomes rise. Linking environmental standards with trade sanctions runs the risk of reduced trade, slower growth, and poor environmental outcomes.

The ways to help the environment are to liberalise trade, remove subsidies that end up harming the environment in agriculture, energy and fishing sectors[42] and removing trade barriers to facilitate cheaper access to environmentally-friendly technologies. Environmental and labour standards can be addressed in many other ways, such as improving governance and accountability, property rights and the rule of law. It should not be done by mixing objectives and abandoning the MFN principle.

Preferential trade and competition policy

Special or preferential deals also work against effective competition policy. Many governments around the world have recognised the power of competition as the discipline of the market on producers to provide safe, best value-for-money products for consumers. More important, many governments have recognised that competition acts as a spur for innovation, which leads to productivity and growth. One of the essential ingredients of an effective competition policy is the contestability of the market. Imports provide an easy, effective and valuable way to ensure that competition in domestic markets is on world best terms. Discrimination and limiting import competition from some countries in favour of others weakens the competition and discipline on domestic producers. As Borrell[43],

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[42] Myers, N. and Kent, J., 1998. *Perverse Subsidies, Tax $s Undercutting Our Economies and Environments Alike*, International Institute for Sustainable Development, Canada.

[43] Borrell, B., 1996. *Beyond EU Bananarama 1993: The Story Gets Worse*, Centre for International Economics, Canberra, June.

for example, has shown, preferential arrangements on imports of bananas violated the European Union's own internal competition policy rules set out in the Treaty of Rome.

Preferences are a distraction

The modelling analysis demonstrated that preferential access does relatively little for the proposed beneficiary, even using static analysis. But potentially the biggest cost can be that preferential access reinforces the message, 'We are poor because our exports are kept out of your markets'. While others' trade barriers certainly compound the problems of poor countries, preferential access distracts attention from the actions developing countries can take to enhance their own economic performance, as discussed in chapter 3. By deflecting attention away from domestic reform, rich countries' preferential trade offers are doing a disservice to developing countries.

Also, because preferences are contentious they divert attention away from the main issue of wealth crea tion and poverty alleviation in international fora like the WTO. The case of the banana disputes and the resources devoted to *seven* WTO rulings is a case in point. Somehow the issue was lost that the European Union should remove its protection for bananas, that the ACP countries should remove their own barriers to trade, and the European Union and ACP countries could be better off if aid was channelled directly.

Turning the WTO into an aid organisation is a corruption of that organisation's chief role. Far better that aid is left to the World Bank and other aid agencies specialising in development. That will also free up resources for the WTO to do some more useful things for developing countries like devising capacity building programs to enhance the ability of developing countries to implement WTO agreements and comply with the rules. Turning the WTO into an aid organisation only muddies the message of the benefits of free trade.

8 BETTER AID, BETTER TRADE

Preferences don't work. Although justified by claiming to deliver aid, in practice they deliver little and certainly less than they cost. They impose costs on non-preference receiving counties, so there may be no net benefit to the developing world. Even for the preference recipients, preferences distort much and deliver little. They encourage rent-seeking behaviour, create vested interests that block reform, hinder competition policy and distract policy attention from the main game of development.

Seen from the perspective of the world as a whole, preferences weaken the fundamental principle of the WTO, non-discrimination, and in so doing weaken the international trading system. The world, including developing countries, would be better off discarding preferences by liberalising trade and working towards an open trading system based on non-discrimination, and delivering un-tied aid directly to countries that need it. The evidence is there — both developed and developing countries alike stand to gain from non-discriminatory trade liberalisation. Doing so makes markets contestable, increases competition, allows countries to concentrate on using their resources most efficiently, spurs innovation and best practice and so lifts growth.

At the same time, developing countries can benefit more, and at less cost, from development assistance given directly rather than through preferences. Aid delivered by preferences is not only wasteful and distortionary but risky and vulnerable to change for developing countries.

Developing countries do have special needs for integrating into the world trading system. They lack the resources, expertise and institutional capacity to implement, and sometimes even comply with, WTO rules. Helping these countries develop the capacity to implement effective trade regimes is one area of assistance.

Although it is an appealing idea to assist poor countries' development through preferential trade, the evidence presented here indicates it is not in their best interests. Instead it seems their interests lie in non-discriminatory trade liberalisation by developed countries, and placing high priority on unilateral liberalisation of their own economies. Developing countries have much to gain by participating fully and as equal partners with developed countries in a non-discriminatory, liberal world trading system.

The Cairns Group, which includes fifteen developing country members, is one group that could inject some more rational thinking into this debate. Clayton Yeutter, the former United States Trade Representative, has noted that the Cairns Group is the 'third force' in international trade negotiations. Time and again, he notes, the Cairns Group provided balance to the debate over trade reform, especially agriculture, and nearly always led to a constructive outcome.[44] It is now time again for some clear thinking on the potentially damaging role of preferential trade and focussing on issues that might make a difference for developing countries.

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[44] Yeutter, C., 1999. 'Critical role of the Cairns Group in liberalising farm trade' in Stoeckel, A. and Corbet, H. (eds), *Reason versus Emotion: Requirements for a Successful WTO Round*, RIRDC Publication No. 99/167, Canberra, pp. 1–20.

A GTAP MODEL

GTAP is the global modelling framework developed as part of the global trade analysis project described in http://www.agecon.purdue.edu/GTAP. GTAP is a fully documented, publicly available general equilibrium model. It is based on comparative statics and models the activities of economic agents — consumers, producers and government — according to othodox economic theory. Consumers maximise utility and producers maximise profit, and production has constant returns to scale.

A key feature of trade determination in GTAP is that of product differentiation. Textiles produced in South Korea, for example, are modelled as a separate product from textiles produced in the United States. GTAP explains trade flows at the bilateral level between all products and regions as well as the level and composition of economic activity in each region.

The version of the model used here is GTAP Version 5 based on 1997 data.

The aggregation used in this study follow:

- High income: EU, Canada, Australia, New Zealand, USA, Japan.
- Developing Cairns Group: all Cairns Group members other than Canada, Australia and New Zealand.
- All other developing countries: all other countries.