Designing the UK trade preferences scheme for developing nations

Response from the UK Trade Policy Observatory

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1. Introduction

We welcome the opportunity to reflect on the details of the UK's Developing Countries' Trading Scheme. In this note, we comment on the four main changes that are currently being evaluated by DIT. In each case, we set out the arguments to consider, and for three of them, we identify future analysis that would enhance the quality of the final decisions. Our discussion is not oriented towards specific commercial objectives, but rather towards helping to achieve the ultimate aim of stimulating the development of poorer nations through the expansion of trading opportunities.

2. The analytical context

The UK has offered unilateral preferential market access to several developing countries since it joined the EU, with the 1975 Lomé convention disciplining the regime applicable to former colonies of the African, Caribbean and Pacific (ACP) states, and the EU GSP extending similar trade preferences to other developing countries (Hoekman et al., 2016). As of January 2021, the UK has created its own UK Generalized System of Preferences (GSP), whose structure and functioning are largely similar to that of the EU GSP.

Although the evidence on the trade impact of unilateral GSP-type preferences is mixed (Herz and Wagner, 2011; Gil Pareija et al, 2014), with WTO membership interacting with the effect of the preferences (Ornelas and Ritel, 2020)[2], recent studies exploiting detailed product level data tend to agree that GSP schemes affect trade between donors and beneficiaries positively (Frazer and Van Biesebroeck, 2010; Gasiorek et al, 2010; Thelle et al, 2015, Borchert and Di Ubaldo, 2020; Hakobyan, 2020).

The GSP scheme of the EU has been of great relevance for developing countries, with utilization rates being high, especially for members of the more preferential GSP+ and EBA sub-schemes (Gasiorek, 2010; Borchert and Di Ubaldo, 2020; Hoekman et al, 2017) [3]. This high preference utilization, in excess of 90%, is good news in light of the notorious complexity of the rules determining the origination status (henceforth Rules of Origin – RoOs) of products shipped by GSP countries, and their eligibility

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[2] GSP preferences affect exports of beneficiaries when they are WTO members *and* very poor; for less poor GSP beneficiaries, preferences have an impact on exports only for non-WTO members. Relatedly Tobin and Busch (2018) find that while GSP boosts the *imports* of non-WTO members, it reduces those of members. Imports matter for the gains from trade.

[3] The share of trade using GSP preferences out of the total of trade eligible for GSP preferences.

for the preferential treatment. A factor explaining this high utilization is likely to be the simplification of the EU GSP RoOs for LDCs in 2011 (Hoekman et al, 2016).[4]

More evidence that preferences encourage trade comes from the observation that while GSP utilization rates by LDC countries have increased, the share of EU imports from LDCs that pays zero MFN tariffs (i.e. trade that faces no tariffs but attracts no preferences) has been declining (Hoekman et al, 2017). This hints at the relevance of the competitive advantage created when preferences are offered only to some trade partners: lower (or zero) MFN rates erode the preferential margin offered to LDCs, thereby reducing their ability to compete on international markets (Winters et al, 2020).

3. Lower tariffs on some products in the General Framework (GF) and Enhanced Framework (EF)

The number of products, defined at the 8-digit Combined Nomenclature level, facing positive tariffs in the GF and EF of UK GSP is currently low (about 9% and 8%, respectively), due to several MFN-zero tariffs in the UKGT schedule, and the GSP-zero rates that were rolled-over from the EU GSP. Increasing the number of products eligible for preferential rates, as well as reducing further the rates of products already eligible for GSP tariffs, is likely to stimulate exports from the affected GF end EF countries. This increase in trade will, however, most likely come at the expense of lower imports from LDCs. A simulation exercise performed in Winters et al. (2020) sheds light on the expected effects.

Winters et al. (2020) calculate the effect of post-Brexit UK tariffs on imports from GSP members. This exercise was performed before the announcement of the UK GSP tariff schedule and based on the assumption that the UK would replicate the EU GSP tariffs exactly. The main source of change, with respect to the pre-Brexit regime, is therefore represented by the switch from the EU MFN to the UKGT schedule, the latter being on average slightly lower than the former.[5] The exercise of Winters et al. shows that while, on the one hand, a few countries such as India, Vietnam, and Indonesia, are expected to gain from the lower UKGT rates on non-GSP eligible products, on the other, the UKGT seems not to erode GSP preferences too much, especially for LDC countries, whose trade with the UK is not expected to be very affected. This latter result is of relevance because tariffs for LDCs are already zero on all products except arms, so LDCs can only lose from lower multilateral tariffs. The lower UKGT rates affect products scarcely traded by LDCs, thus limiting their losses.

It is against the backdrop of the exercise of Winters et al. (2020) that the proposal to extend the list of GSP eligible products, and further lower tariffs on products still facing positive rates, can be discussed. The benefit of wider and deeper preferences is likely to be accrued by countries in the GF and EF, and more so if the tariff reductions affect products with substantial trade between the affected countries and the UK, such as textiles. The elimination of nuisance tariffs will produce similar, albeit probably quantitatively lower, effects. It will be important to "protect" preferences for LDCs, however, and to focus the tariff reductions on those products not exported by the poorest countries. To this end, Winters et al (2020) show that there are about 1000 tariff lines, the removal or reduction of which would benefit GF and EF countries, reduce costs for UK consumers and businesses, but not harm LDCs. Repeating Winters et al's exercise with the UK's current policies based on the UKGT schedule, and several possible reforms, would be a very useful contribution to this policy decision.

[4] The EU GSP RoOs for LDCs shifted from a *minimum local content* rule of 60% to a *maximum foreign content* rule of 70%.

[5] This setting implies that a positive trade impact must be ascribed to lower tariffs on products not eligible for GSP treatment, while on the remaining 66% of products eligible for GSP there might be negative trade effects due to higher competition from non-GSP countries, which benefit from the lower UKGT rates.

4. Simplification of Rules of Origin (RoOs) and extension of cumulation possibilities

The simplification of RoOs for LDCs in order for them to be able to claim GSP concessions more easily appears a very sensible and welcome intervention. As Hoekman et al. (2016, 2017) show, the 2011 reform of the EU GSP RoOs for LDC, whereby the *minimum local content* rule of 60% was replaced with a *maximum foreign content* rule of 70%, led to a significant increase in utilization rates – from about 85% to 95% (i.e. a reduction of the imports which were unable to claim the preferences by around two-thirds). A further increase in the *maximum foreign content* rule to 75%, as well as the possibility to choose alternative rules to prove a product's originating status, is likely to increase utilization rates further, and could induce increases in trade through changes at either the extensive or intensive margin.

The extension of the possibility to cumulate inputs originating in all LDCs, or all GSP members, is expected to have qualitatively similar effects to those of more liberal RoOs. It would be even more impactful to allow for cumulation from all the countries with which the UK has a Free Trade Agreement, especially the block of ACP countries in the same regional blocks as the GSP beneficiaries. Inference based on the results in Montalbano et al (2020) suggests that trade in intermediate goods between low income countries is not large, but attractive cumulation may be able to encourage it. Thus, before determining UK policy, it would be useful to research the extent of such trade and the possibilities of extending it.

5. Amendments to the graduation mechanism

The re-definition of the rules for preference removal based on the competitiveness of GSP beneficiaries requires balancing several conflicting objectives and possibilities.

The change of the goods categories used to compute the import-shares that determine graduations, from the GSP *sections* to narrower groups, can have both positive and negative impacts on developing countries. While assessing pros and cons, it is important to remember that what currently determines the graduation is the *relative* competitiveness of a country in a certain section of imports, i.e. the share of a that country in UK imports in that section from all GSP beneficiaries together.

First, even without any changes to the rules determining competitiveness-related graduations (i.e., the import-share thresholds and product groupings), the separation of the UK from the EU-27 block is likely to determine a number of new country-section graduations in the UK. This is a consequence of the uneven distribution of GSP countries' exports between the UK and the EU-27, and it will mostly affect India (Di Ubaldo, 2019) [6]. In this respect, the use of narrower product groups to determine graduations, for instance, 4-digit sub-sectors instead of sections, will not avoid the loss of preferences, but could focus the preference removal on the 4-digit sub-sectors which are internationally very competitive (relative to the same 4-digit groups in other GSP members). This will focus the pain of graduation on specific products and as such may place greater strains (and uncertainty) on small firms with limited product ranges than on larger, more diversified, ones. Firms in other 4-digit groups within a GSP section *might* instead be able to maintain GSP preferences, although it is hard to predict any

[6] More specifically, sections whose trade is relatively more oriented to the UK than to the EU-27, relative to other GSP members, are at risk of graduating in the UK.

effect, as the graduation is determined by the *relative* competitiveness, and by the import-share thresholds which will be adopted.

Two possible adverse effects can be identified from the fragmentation of the graduation groups. First, an unambiguously negative outcome of using narrower groups is that the preferential treatment will become more uncertain. Import-shares computed out of narrower groups are going to be more volatile, as changes (in either direction) in trade by one GSP member can result more easily in preference losses (or not) for other GSP members. So, the uncertainty of the preferential treatment is likely to increase substantially. Work for the Horizon 2020 RESPECT project (http://respect.eui.eu/) by Borchert and Di Ubaldo (2020) shows that preferences uncertainty can severely depress trade from beneficiary countries, hence any intervention that can make trading conditions more uncertain should be avoided[7].

Second, although with less certainty, fragmentation means that there are likely to be fewer eligible developing country exporters within each graduation group and hence a greater chance that any one of them exceeds the threshold. Thus, the number of firms and countries affected by graduation seems likely to increase. Exactly how to trade this off against the smaller scope of each individual graduation is a complex task analytically that requires both theoretical and empirical research.

The increase in preferences uncertainty could be made less severe by reducing the frequency at which graduations are decided. Firms needing to make (sunk) investments to enter the export market, or expand their activity, might be more willing to do so if the tariff rate that applies to them is fixed for the next 5-10 years, instead of just three. So, if narrower product groups are going to be used to determine graduations, to focus the preference removal on the more competitive producers in a section, a complementary intervention might be to make graduation decisions at longer time intervals, to offset somewhat the higher uncertainty introduced using narrower groups.

The case against less frequent graduation calculations is that it increases the probability that in any year a product is dominated by one super-competitive supplier. This would possibly reduce the probability of other countries starting to export a particular product. How one trades off these considerations depends at least somewhat on what graduation is intended to achieve – is it to share around the benefits of the preferences or to ensure that rapidly developing countries do not 'take unfair advantage' of a preference that they no longer need.

Finally, another potential issue with using narrower groups is that this might imply the de-graduation of sub-sectors that are currently graduated. This would be good news for the firms re-obtaining the preferential treatment, but it might result in increased competition for firms in other GSP members. It is difficult to predict whether the increase in competition would outweigh the gain of better market access, but the possibility to de-graduate certain sub-sectors should be considered.

6. Simplification of the reporting requirements for EF countries, and of the conditions that could lead to the suspension of preferences.

Reporting requirements for Enhanced Framework countries

We do not know how much of an economic burden these are for the beneficiaries, but, subject to the required information being revealed, any simplification would certainly appear welcome. We also

[7] The removal of competitiveness related graduations for GSP+ countries of the EU GSP scheme led to an increase in trade of approximately 45%, on average.

believe that there might be a burden on the donor side, with the UK having to verify that (at least some of) the conditions to obtain the Enhanced Framework treatment are fulfilled. Again, subject to the same condition, simpler monitoring would be an advantage.

The decision about how much of a burden is warranted economically, hinges crucially around how much influence such conditionality has on beneficiaries' behaviour. Acting independently, the UK is a large enough trading partner to have leverage in only a few cases, and small ones at that. Moreover, what beneficiaries sell to the UK probably has alternative markets in Europe and elsewhere in OECD and so might be easily circumvented. As Winters (2016) observed, significant leverage is likely to become possible only by acting in concert with the European Union. We believe that the UK Government should consider that option.

Conditions that could lead to preference suspension

We do not believe this to be a major source of concern. GSP preferences have been revoked so rarely that the conditions that can lead to this do not appear to be a big impediment to beneficiaries enjoying their preferential market access. The EU has generally adopted a gradual process of engaging with the countries suspected to have violated any of the conditions and has revoked preferences only as a last resort. The UK should adopt the same kind of approach.

A potential improvement could be to ensure the transparency of the process, to avoid the suspicion that some countries, due to their size or their political like-mindedness, are subject to a different treatment. We recognise, however, that this might cut across the diplomatic processes associated with this sort of conditionality.

Our overall conclusion is that, while trade policy may possibly affect partners' non-economic policies, it is difficult to establish a strong link – see the many papers for the RESPECT project (http://respect.eui.eu/working-papers-and-reports-by-topic/), notably Ferrari et al (2021). Thus it should be used for such objectives only with a very clear-headed view of the UK's objectives and the likely effectiveness of tariffs on UK imports as an instrument for achieving those objectives.

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