The Future of Agriculture Trade Preferences Granted by the EU to Developing Countries

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Content

1 Introduction

The EU has notified the WTO of 21 bilateral trade agreements that are currently in force with nonmember countries (WTO, 2005). Under these agreements, the EU grants almost unlimited access to its industrial markets, but only limited preferential access to its agricultural markets for various countries and country groups. In addition, the EU grants preferential access to its agricultural markets under nonreciprocal schemes: the General System of Preferences (GSP), the Everything but Arms Initiative (EBA) and the Cotonou Agreements. In 2002, 47% of dutiable agricultural imports entered the EU market under preferential schemes (OECD, 2005). EU imports of agricultural and food products under preferential arrangements are thus the rule rather than the exception, and imports that occur under most favored nation (MFN) conditions are the least favored ones. The EU is not the only country which engages in the establishment of complex bilateral trade policies; Bhagwati (1995) has described the resulting multilateral trading system as a "spaghetti bowl".

From the "trade rather than aid" point of view, preferential market access to developing countries has some appeal. Indeed, improved access to developed countries' markets can enhance economic development in exporting developing countries. Nonetheless, preferential market access arrangements have a number of drawbacks: they may work in the direction of slower multilateral agricultural trade liberalization, they may conflict with WTO rules, they imply high transaction costs for negotiations and administration, they may encourage developing countries to establish unsustainable production structures, and the distribution of benefits is ambiguous, especially if quantitative restrictions or the EU entry price system are in place.

Furthermore, the "perceived benefit" from trade preferences is decreasing over time, from a developing country as well as an EU point of view. For various reasons, it is likely that protection for agricultural products in the EU will continue to decline, and hence margins of preference will erode in the future. While valuable in the short run, the potential economic benefits resulting from trade preferences for the preference recipients will thus be of a transitory nature. For the EU, on the other hand, the detailed preferential trade barriers still in force become less relevant due to the decreasing domestic EU price level.

This paper aims to analyze the scope and relevance of agricultural trade preferences granted by the EU to developing countries and discusses the future development of those preference schemes. Section 2 provides a short overview of agricultural preferences granted by the EU to developing countries. Section 3 reviews methods of analyzing the significance of preferences with a focus on the concept of the preference margin. In Section 4, the quantitative significance of preferences is analyzed by drawing on the literature, focusing in particular on the distribution of preferences among products and recipient countries. Section 5 presents an overview of the empirical evidence on various kinds of drawbacks of agricultural trade preferences. Section 6 discusses the future of EU agricultural preferences against the background of the preceding sections.

2 Overview of EU Agricultural Preferences for Developing Countries

From a WTO point of view, trade preferences are a deviation from the MFN principle. Two kinds of provisions allow for such a deviation: preferential treatment in the framework of a customs union or a free trade agreement (reciprocal preferences), and nonreciprocal preferences which are exclusively granted to developing countries.

About two-thirds of EU preferential agricultural imports are under nonreciprocal preferences (OECD, 2005). Such preferences are provided for in the WTO by the Enabling Clause which was established in the GATT in 1979 (GATT, 1979). Preferences under the Enabling Clause must be nondiscriminatory among developing countries with the exception of special preferences for the group of least developed countries (LDC).

The most important nonreciprocal preferences granted by the EU to developing countries in terms of country coverage are granted under the Generalized System of Preferences (GSP), which was established in 1971.[1] The EU GSP includes tariff exemptions and reductions for 142 beneficiary countries. A graduation mechanism excludes sectors from some countries from GSP preferences if their export shares exceed certain thresholds with respect to total EU imports of those products from GSP eligible countries or total imports from the respective country. As a result, about 27% of imports that would be eligible for GSP preferences in the absence of a graduation mechanism are graduated (own calculations based on OECD, 2005).

In 2001, the EU introduced the EBA, under which imports from all 49 LDC are tariff free. The only exemptions are rice, bananas and sugar, for which tariff-free access is phased in within tariff rate quotas (TRQs) and there will be no unrestricted market access before 2006 for bananas and 2009 for sugar and rice.

Furthermore, the EU grants nonreciprocal preferences for certain subsets of developing countries since 1998 under GSP incentive schemes, conditional on the compliance with certain environmental and labor standards or the implementation of anti-drug campaigns (European Commission, 2004). Whether such differentiation may be considered consistent with the Enabling Clause is somewhat controversial (WTO, 2004).

Clearly not covered by the Enabling Clause, however, are the nonreciprocal preferences granted by the EU to the African, Caribbean and Pacific (ACP?) countries under the Cotonou Agreement. These preferences and their predecessors under the Lomé Convention have been covered by a waiver in the WTO. However, this waiver has not been extended. Thus the nonreciprocal preferences under the Cotonou Agreement will turn into reciprocal preferences from 2008 on under the EU/ACP Economic Partnership Agreements. A special feature of the ACP preferences are the protocol preferences granted to selected ACP countries for sugar, bananas and beef and are limited by TRQs.

[1] During the first years of the GSP, a waiver was granted to the EU and other industrialized countries for similar systems by the GATT parties. This waiver became part of the GATT in 1979 as the above mentioned Enabling Clause.

Reciprocal preferences, which make up about one-third of preferential agricultural imports in the EU (OECD, 2005), are not covered by the Enabling Clause. They are subject to the conditions defined in GATT Article XXIV on the formation of customs unions and free trade areas. The EU has notified the WTO of a customs union with Turkey, and free trade areas with South Africa, Chile, Mexico and the North African and Near East countries in the framework of the Euro-Mediterranean Partnership. Agriculture is excluded from the customs union and free trade areas, but is subject to detailed positive lists of products for which preferences are granted. These preferences include tariff cuts as well as reduced entry prices, which the EU applies to certain fruits and vegetables. Preferences are often restricted seasonally and limited by bilaterally defined TRQs in hundreds of cases. The legal WTO status of these agreements is unclear, mainly because they lack clarification of the requirement of GATT Article XXIV that free trade areas or customs unions should include "substantially all the trade" between the members, which raises the question of whether the exclusion of large parts of agricultural sectors is in conformance.[2]

In addition to the complexity of heterogeneous preferences among beneficiary developing countries, sophisticated rules of origin differ dependent on the respective agreement, and far reaching safeguards are usually part of the agreements. Bhagwati's spaghetti bowl thus seems an apt metaphor.

3 Quantitative Methods of Analyzing the Significance and Impact of Trade Preferences

Three strands of quantitative analysis of the significance of agricultural trade preferences and preference erosion can be distinguished. First, several studies attempt to analyze the impact of regional trade integration ex post applying econometric methods such as the estimation of gravity models or other regression techniques (e.g. Romalis, 2003; Nilsson, 2002). Pohl Nielsen (2003) reviews the empirical literature and finds that results are heterogeneous.

In a second strand of analysis, several authors analyze the significance of preferences by relating them to observed trade flows (e.g. Grethe et al., 2005; Nolte, 2002; Yamazaki, 1996). Main indicators derived from such an analysis are product coverage and preference margin. The preference margin gives a rough indication of the value of preferences, although its interpretation is subject to many limitations. Large parts of Section 4 of this paper are based on such analyses and the concept of the preference margin is therefore discussed in some detail below. Finally, various types of quantitative simulation models are used for the analysis of changes in preferential trade regimes. A thorough review of such model analyses is provided in Pohl Nielsen (2003), and only some summarized findings, which largely support findings from the analysis of preference margins, are reported in Section 4.

[2] For a detailed discussion of the WTO-conformance of EU free trade agreements with Article XXIV see Grethe and Tangermann (1999). For a recent EU position see European Commission (2002).

When relating preferences to observed trade flows, an indicator of the depth of tariff cuts is the simple or weighted average of the preferential reduction in tariff rates, expressed in percentage *ad valorem* terms.[3] An alternative approach is to express the depth of tariff reductions in absolute monetary terms, taking into account the value of trade in individual products and the respective magnitudes of tariff reductions. Essentially this indicator is a variant of a weighted average tariff reduction, with trade values used as weights and the result expressed in money terms rather than as a percentage tariff rate. Such an indicator of the depth of tariff cuts is the preference margin, which also indicates the extent to which the donor country was willing to forego (potential) tariff revenue by granting preferential access to its markets.

Estimation of the preference margin starts with the assumption that both MFN exporters and preferential exporters of a given product earn the same price on the importing countries' domestic market, which implies homogeneous goods. The relationship between the export prices received by the MFN supplier (p_w) and the preferential supplier (p_p) is described in equation (1):

$$p_w (1 + t_{MFN}) = p_p (1 + t_p) \qquad (1),$$

where t_{MFN} is the (*ad valorem*) MFN tariff rate for exports to the preferential market, and t_p is the preferential tariff rate. The value of the preference margin (VPM) for the product concerned is then the difference between p_p and p_w, multiplied by the quantity exported to the EU under preferential conditions ($Q_{ex,p}$), as depicted in equation (2):[4]

$$VPM = \qquad (2).$$

The VPM is not necessarily equivalent to a direct economic gain to the exporting country. The preference margin essentially is equivalent to a price difference, which can take either of two forms (or some combination of them). One possibility is that the preferential tariff reduction can be used to sell at a lower price on the domestic market of the EU, in an effort to expand the quantity of exports. Alternatively, a given selling price on the domestic market of the EU can mean that the preference margin can result in an increase of the price received for a given quantity. However, even in the latter case, which underlies the concept of the VPM, it is not necessarily clear who captures the higher price. Depending on the distribution of negotiating power between the export and import side, which depends heavily on the institutional framework, e.g. license allocation in case of TRQs (Skully, 2001), or the existence of minimum import price systems, the price differential may accrue to the exporting

[3] The following paragraphs draw on Grethe et al. (2005).

[4] Alternatively, the VPM can also be expressed as a percentage of the export value (e.g. in Grethe et al., 2005; Nolte, 2002), which should not be confused with the preference margin defined as the difference between MFN and preferential tariff in percentage points (e.g. in Alexandraki and Lankes, 2004; WTO, 2003).

or to the importing companies, and hence to the exporting preference recipient or the importing country.

For two other reasons the economic gain accruing to the exporting country can differ from the VPM. First, the MFN tariff may be prohibitive, in which case part of the preference just reduces the redundant part of that prohibitive tariff, and the potential economic gain to the exporting country is less than the preference margin. In cases of deep preferential tariff cuts for products for which MFN tariffs are prohibitive, some studies take this into account and calculate the difference by using the EU market price as the relevant variable instead of the world market price plus MFN tariff (for example for sugar and bananas, see both Nolte, 2002, and Alexandraki and Lankes, 2004). Second, tariff preferences usually result in an expansion of the quantities traded (i.e. if not subject to TRQs or minimum import price systems). Therefore the potential economic gain tends to be somewhat higher than the preference margin, if the preference margin is calculated using trade figures prior to the implementation of the preferences concerned. If, on the other hand, the preference margin is calculated based on trade quantities after implementation of the respective preferences, the preference margin would overestimate the potential economic gain because it would not take into account increasing marginal cost of additional exports induced by preferences.

So the main drawback of the preference margin as an indicator for the benefits resulting from trade preferences is its static nature. Any quantity changes induced by preferences (or preference erosion) are not explicitly covered. Especially with large changes in donor countries' MFN policies, this may bias results. For example the reform of the EU sugar market regime may force some preferential suppliers to leave the EU market, and thus lose their surplus on the EU market at all. The static nature of the preference margin concept also implies that effects on world market prices, and thus on exports of nonpreferential exporters, which may be displaced by those of preference recipients, cannot be analyzed in this framework.

To cope with this drawback, behavioral economic simulation models can be used to estimate the response of donor, recipient and third countries to changes in bilateral trade restrictions. For such an analysis, various difficulties must be overcome: preferential trade conditions are often fixed at a very disaggregated tariff line level far below the usual aggregation level of widespread simulation models, limited to certain calendar periods and limited by TRQs. Moreover, some countries enjoy different preferential conditions in different markets and sophisticated rules of origin apply.

A first step followed by some authors in departing from the static preference margin approach is to establish a system of bilateral import demand and export supply functions for the products concerned which are solely dependent on the respective own prices (Alexandraki and Lankes, 2004; WTO, 2003). A more comprehensive partial approach would be the depiction of agricultural sectors of countries concerned including relevant cross relationships. Finally, the analysis may be performed in a general equilibrium framework to include effects on factor markets, sectors other than agriculture, and macroeconomic variables (e.g. Yu,

2005; Harrison et al., 2003). For the analysis of effects on developing countries, a general equilibrium analysis may be preferable because of the typically considerable size of their agricultural sectors, yet this approach clearly conflicts with the aim of depicting preferential trade arrangements in some detail.

Whether partial or general equilibrium models, a relevant question is how to depict international trade. The options for including aspects of preferential trade regimes in net trade models are extremely limited.[5] The prevailing approach is to model bilateral trade based on the Armington assumption of constant elasticities of substitution between domestic and foreign products as well as between different foreign origins. This approach, however, has a major drawback, especially in modeling changes of bilateral trade policies in highly protected markets, sometimes referred to as the Small Shares Stay Small (SSSS) property (Hanslow, 2001). A situation in which preferential access is granted to a highly protected market, for example one on which MFN barriers are prohibitive, is not that uncommon for some products in the EU (e.g. sugar). For sugar the expectation is that market liberalization and the respective preference erosion would lead to a massive "backward trade diversion" of EU sugar imports from ACP countries to more competitive suppliers, mainly Brazil. This, however, cannot be depicted in a standard Armington framework, as in the base situation Brazilian sugar exports to the EU are very small and can never become large with any realistic change in relative bilateral trade prices under an elasticity approach. Hanslow (2001) has addressed this problem with an alternative functional form which displays non-constant elasticities of substitution. Witzke et al. (2005) present a modified Armington approach which also allows for positive trade in cases of zero trade in the base situation. Abler (2005) discusses spatial equilibrium models as an alternative in modeling preferential schemes. One advantage of such models is that bilateral trade can be depicted for homogeneous products, a product characteristic which may fit some agricultural raw products such as sugar quite well.

4 Significance of EU Agricultural Preferences for Developing Countries and Preference Erosion: Empirical Evidence

4.1 Static Analysis: Preference Margins from Agricultural Preferences Granted by the EU to Developing Countries

Various studies have analyzed the percentage preference margin or the VPM resulting from preferential EU market access for different groups of developing countries. The results are summarized in Table 1. For those studies which only report a percentage preference margin, results are converted into the VPM by relating them to preferential trade flows.

[5] See Banse and Grethe (2005) for an approach to include bilateral TRQs in a net trade model.

Table 1: Size of the Value of the Preference Margin for Developing Countries under EU Preferential Schemes

	Value of preference margin		
	in mill. €	**% of agr. ex. to EU**	**% of GDP**
Yamazaki (1996), 1992 trade data			
Developing countries under all preference schemes	1,160.3	3.2%	0.02%
of which sugar	535.3		0.01%
Nolte (2002), 2000 trade data			
Non LDC ACP	1,047.8	16.6%	1.44%
of which non-protocol prod.	314.9		0.34%
of which beef protocol	73.6		0.24%
of which sugar protocol	434.3		2.07%
of which banana protocol	225.0		0.32%
LDC under EBA	151.3	6.4%	0.09%
of which non-protocol prod.	118.0		0.07%
of which sugar protocol	33.2		0.02%
LDC under EBA for sugar after full phasing in			
export 0.9 mill. tons	341.0		0.19%
export 2.7 mill. tons	1,023.1		0.58%
Non LDC ACP under GSP	54.6	0.9%	0.06%
LDC under GSP	113.4	4.8%	0.06%
Grethe et al. (2005), 2001-2003 trade data			
Total MC under EMA	225.5	7.35%	0.06%
WTO (2003), own calculations, 2000 trade data			
		% of total exp. to EU	
LDC for all products (also non agricultural) to EU	560.8	6.5%	0.30%
		% of total exp. to Quad	
LDC under all Quad schemes (also non-EU) and for all products (also nonagricultural)	1,779.1	9.8%	0.96%
Alexandraki and Lankes (2004), own calculations, 2001 trade data			
		% of total exp. to Quad	
Middle Income Countries under all Quad schemes (also non-EU) and for all products (also nonagr.)	43,148.1	4.7%	0.52%
of which sugar	18,122.2		0.22%

Sources: Grethe et al. (2005), Nolte (2002), Eurostat (various issues), World Bank (2005), WTO (2003), Alexandraki and Lankes (2004), Yamazaki (1996), own calculations.

Yamazaki (1996) assesses the VPM resulting from EU preferences under the GSP and the Lomé arrangements for all developing countries based on 1992 trade data. The VPM is estimated at about €1.2 billion which is equivalent to about 0.02% of the developing countries' GDP. About 50% of the VPM is found to result from sugar, and thus these figures concentrate on the 18 countries which are subject to the sugar protocol.

Nolte (2002) assesses the VPM for ACP countries under the Cotonou and EBA arrangements. In doing so he distinguishes between non-LDC ACP, which are only subject to the Cotonou preferences, and LDC ACP, which enjoy free market access under the EBA initiative. In order to account for future trade flows which may be induced by EBA sugar preferences, Nolte also

carries out a separate calculation of the preference margin for sugar after full phasing in under the two scenarios projected by the European Commission (2000). Nolte finds the VPM for non-LDC ACP countries to be about €1 billion, of which about 41% is for sugar alone and 70% is for the three protocol products combined. Related to the GDP of non-LDC ACP, the VPM is equivalent to 1.44%. For the LDC ACP, the VPM is estimated at €151 million which is equivalent to 0.19% of their GDP, 70% of which is for sugar. It could increase significantly with full phasing in of free market access for sugar, but even then would remain at less than 1% of GDP of these countries.

Grethe et al. (2005) estimate the VPM under the Euro-Mediterranean Agreements at €226 million which is equivalent to 0.06% of the recipient countries' GDP. Also these preferences are highly concentrated in terms of countries (Morocco, Tunisia and Israel account for more than 90% of the preference margin) as well as products, although on a differing product set per country: "for all MCs, four or fewer products at the 4-digit CN level account for more than half of the VPM" (Grethe et al., 2005).

Subramanian (WTO, 2003) assesses the preference margin for LDCs for total trade with the EU as well as to the Quad, also including nonagricultural sectors. Relating these preference margins to the respective trade flows, the resulting VPM is at €561 million to the EU and almost €1.8 billion to the Quad, which would be about 1% of GDP of the respective countries. The author considers this a clear upper bound, because, among other factors, the full MFN tariff is considered the preference margin, which is not yet fully the case in the EU and not the case in other Quad countries. Subramanian also shows that the VPM is highly concentrated: Bangladesh accounts for about 42% and the top 6 LDC account for about 80%.

Alexandraki and Lankes (2004) calculate the preference margin that results from preferences by the Quad for total imports, including nonagricultural imports, from middle income countries. The resulting VPM is at about €43 billion which is much higher in absolute terms than others reported above. This, however, reflects the fact that this country group includes large agricultural exporters like China, Mexico, Brazil and India. In relative terms, the VPM is equivalent to not more than a half percent of GDP of the middle income countries. Alexandraki and Lankes also show that the preference margin is highly concentrated on a few products and that more than 40% is for sugar.

In the interpretation of Table 1, one should keep in mind that the VPM is an overestimation of the gain accruing to the preference recipients for various reasons. First, in all cases, except parts of Grethe et al. (2005) and Nolte (2002) for non-sugar preferences under EBA, preferences are evaluated at trade flows which include those generated by the respective preferences. These trade flows, however, may be generated at higher marginal cost than trade flows which would be generated under MFN conditions. Thus part of the preference margin reflects additional costs. Second, all studies assume full utilization of preferences, which in reality does not occur (OECD, 2005). Finally, it is very unlikely that the full VPM accrues to the exporting country (see above).

4.2 Simulation Model-Based Analyses

Pohl Nielsen (2003) has reviewed the empirical literature on preferential trade agreements and comes to the conclusion that "the overall impact of preferential trade arrangements on welfare and trade is non-negligible and generally positive, but also relatively small" (74). Conversely, it follows that if the impact of preferential trade arrangements is small, the effect of their erosion should be small, too. Also Subramanian (WTO, 2003: 10) reviews a few studies and concludes that "in aggregate the losses – in terms of reduced exports – from preference erosion are likely to be very small." This section does not attempt to review the relevant literature systematically, but rather presents summaries of results from a few new studies which address the topic of preference erosion explicitly and are not covered by Pohl Nielsen (2003), although they generally confirm her findings.

Subramanian (WTO, 2003: 11) applies a simple partial equilibrium model which tends to overestimate the loss in preference erosion for various reasons. He concludes that the loss in LDC export value resulting from a 40% reduction of MFN tariffs in the Quad would be $530 million at maximum, which is 1.8% of their export value or 0.3% of their GDP. Only for five countries (Malawi, Mauritania, Haiti, Cape Verde and Sao Tome and Principe) would the loss exceed 5% of their export value. For another 17% the loss in export revenue would exceed 1% of export value, for the remaining 24 LDC this loss would be less than 1%.

Alexandraki and Lankes (2004) estimate the loss in export value under a similar scenario and using a similar model but for the group of middle income countries. They conclude that the loss in export value would be between 0.5 and 1.2% of total export value of middle income countries, depending on the export supply elasticities applied. For only 17 out of a total of 76 countries would the loss in export revenue be larger than 2% in case of an export supply elasticity of zero. Only for one country (Mauritius) would this loss exceed 10% (resulting largely from the sugar preference to the EU), and for another six countries it exceeds 5%. Generally, preference erosion is highly concentrated on a few product groups: "sugar and/or banana preferences are the source of the vulnerability for the ten most exposed countries, with the exception of Seychelles, whose vulnerability is associated with preferential access to the EU market for fish-related products" (Alexandraki and Lankes, 2004: 26).

Yu (2005) estimates the effect of the implementation of the Harbinson proposal on exports of African LDCs in the GTAP framework. The African LDCs' exports are found to decline by $311 million, which is equivalent to 0.52% of their total exports.

5 Drawbacks of Preferential Trade Agreements: Empirical Evidence

Preferential trade agreements have a number of drawbacks. They may negatively impact efficient resource allocation, they may negatively affect progress in the development of the international trading system, and they may have undesirable distributional effects. Furthermore, benefits to recipient countries may be uncertain in the long run.

From an efficiency point of view, preferential trade liberalization requires much higher transaction costs than multilateral trade liberalization which accrue at many stages: in bilateral

trade negotiations, in the administration of innumerable TRQs and high geographical and seasonal variations of preferential tariffs, and at the level of trading companies which have to act in a rather nontransparent field of complex bilateral trade policies. For example the need to design, enforce and deal with often sophisticated rules of origin (RoO) may substantially reduce the potential benefits from bilateral trade liberalization. Empirical analyses are rare. Mattoo et al. (2002) use a partial equilibrium model to assess the impact of restrictive RoO under the US Africa Growth and Opportunity Act for textiles (for which RoO play a more pronounced role than for agriculture) and conclude that the benefits to the African countries could be almost fivefold if they were not restricted in sourcing their yarn and fabric for exported apparel. Gallezot and Bureau (OECD, 2005) estimate the cost of compliance under EU nonreciprocal schemes between 2.9% (GSP) and 10.9% (EBA) based on utilization rates. These costs of compliance also include costs resulting from sourcing according to the respective RoO.

Also problematic from an efficiency point of view is the existence of policies which may result in economic rents, such as numerous TRQs or the EU entry price system for certain fruits and vegetables. Part of such rents may dissipate in various rent-seeking activities such as overinvestment in transportation or storage capacity in order to be "first", or bribing the relevant institutions in order to get import/export rights in the form of the respective licenses. Furthermore, the existence of economic rents may keep extramarginal actors in the respective sector, compared to a competitive situation under which supply comes from the lowest cost source. The existence of economic rents is not only problematic from an efficiency point of view, but also from a distributional perspective. It is often the well-established interest groups who manage to get hold of the relevant rights (licenses) and thus the resulting rents, which may not be optimal from a development perspective. The degree to which economic rents dissipate and how they are distributed greatly depends on the mechanisms of quota allocation.

The general mechanisms and the potential distribution of the resulting rent have been discussed in detail (Skully, 2001; Abbott, 2002; Chau et al., 2003), as well as their relevance for specific country groups, e.g. for the countries covered by Euro-Mediterranean Agreements in Grethe et al. (2005), based on theoretical considerations. Unfortunately, theoretical analyses usually remain rather inconclusive with respect to specific cases; empirical analyses of the existence and distribution of such rents are rare. Trela and Whalley (1991) provide an overview of quota allocation mechanisms in 17 textile exporting countries under the Multi-Fibre Arrangement (MFA). Taking the country-specific analysis as a basis, they model the abolition of the MFA in a CGE framework. They conclude that welfare losses that result from rent dissipation and the "lock-in" of extramarginal producers as a consequence of domestic quota allocation schemes exceed those from restricted market access by orders of magnitude. Chemnitz and Grethe (2005) analyze the dissipation and distribution of the economic rent which results from an EU TRQ for tomatoes originating in Morocco. They conclude that as a result of the EU license distribution mechanism, as well as the organization of the Moroccan export sector, a large part of the rent ends up at the Moroccan side. Due to a rather flexible organization of the distribution of the EU quota within Morocco, the long term incidence of

extramarginal producers seems limited. Some rent dissipation, however, seems to result from the fact that part of the EU quota is allocated based on past exports, including those to unrestricted markets.

Another efficiency effect is the trade diversion which may result from preferential trade rules. Although irrelevant to preference recipients in the short run, trade diversion affects more competitive MFN suppliers, many of which are developing countries, and may also negatively affect the importing country. Whenever preferential trade is based on trade diversion, this may also negatively affect preference recipients in the long run. This is because an erosion in preferences renders an enormous need for structural adjustment, as can be observed for some ACP sugar suppliers to the EU. Deep preferences for highly protected markets may draw countries in production structures which are not sustainable in the long run.

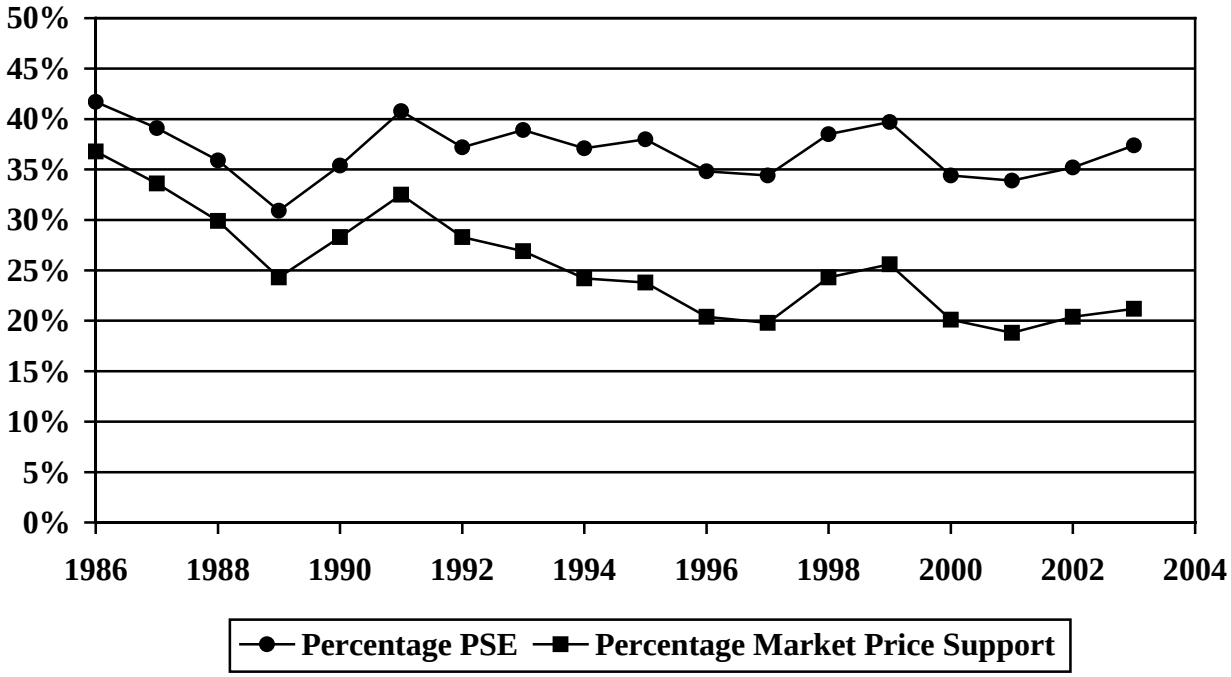
This leads to the aspect of non-reliability of preferences: they may be eroded due to MFN policy liberalization or through preferential agreements with other suppliers, they are usually not bound in the WTO and can thus be unilaterally withdrawn, and they may be subject to graduation, e.g. under the EU GSP system. In particular they may be subject to the pressure from domestic interest groups in the importing countries. Hoekman and Kostecki (2001) discuss an example, in which domestic pressure in the US led to changes in RoO in response to successful imports from Jamaica.

Finally, preferential trade agreements may hamper the development of multilateral trade liberalization. Whether this is the case has long been subject to discussion (e.g. Bhagwati, 1991; Bhagwati and Panagariya, 1996; Baldwin, 1997). Deep preferences for noncompetitive preference recipients, such as EU preferences for sugar and bananas under the ACP protocols or future preferences under the EBA for these products, seem in clear conflict with the goal of multilateral liberalization. This is documented by the opposition that ACP and LDC countries display in the context of current reform plans of the EU sugar market policy. These countries are included under the protectionist umbrella of the EU sugar market policy and therefore have the same interest in nonreform as EU sugar producers. More generally, some authors argue that preferential market access increases the probability of developing countries applying import protection, as the balance of political support from exporting and import-competing sectors shifts towards import competing sectors (Hudec, 1987; Özden and Reinhardt, 2003). Özden and Reinhardt (2003) establish empirical evidence for this hypothesis based on an econometric time series analysis of 154 countries between 1976 and 2000. They show that countries which were removed from the US GSP during this period were more likely to adopt liberal trade policies than countries remaining eligible for GSP.

6 The Future of EU Agricultural Trade Preferences: Erosion and Simplification?

The future erosion of agricultural trade preferences granted by the EU logically follows from the path of the reduction of agricultural price support which the EU has pursued since the early 1990s. Graph 1 displays the total PSE as well as market price support of the EU as a percentage of total agricultural production value, including direct payments to producers.

Graph 1: EU Percentage PSE and Market Price Support 1986-2003



Sources: OECD (2004), own calculations.

Although the percentage PSE was rather constant, around 35 to 40% between 1986 and 2003, the percentage market price support declined from more than 37% in 1986 to about 20% in recent years. This process, which mainly reflects the ongoing process of the replacement of price support by direct payments since the McSharry reform in 1992, is likely to continue. Some reforms not yet reflected in the figures in Graph 1 are already implemented such as the abolishment of rye intervention and the reduction of the intervention price for rice by 51% in 2004. Others are already decided upon and are in the process of implementation, for example the reduction of the intervention prices for butter and skim milk powder until 2007. Furthermore, a proposal for a substantial cut in the intervention price for sugar by 39% is on the table. Finally, a successful conclusion of the Doha Round will probably lead to further cuts in MFN access to the EU's agricultural markets.

In addition to the preference erosion which results from the reduction of the EU's domestic price level and of MFN market access barriers, preference erosion may also result from the EU granting additional preferential market access to countries that did not previously enjoy preferential treatment. For example, in the negotiations over a Regional Trade Agreement between MERCOSUR and the EU, MERCOSUR countries are pushing for the inclusion of substantial parts of the agricultural sector.

Thus, for both the preference-granting as well as the preference-receiving countries, the perceived advantages which result from preferential trade agreements are diminishing. For the preference recipients, it is the welfare effects resulting from higher export revenues than those that would prevail under MFN conditions that are diminishing. For the EU, the incentive to narrowly control preferential market access through a system of seasonal tariff and entry price

preferences, TRQs, sophisticated rules of origin and safeguard clauses is declining. After all, such systems are costly to negotiate and to administer, and with decreasing MFN barriers there is less and less of a domestic market price level to protect.

A further point along this line is that for preference-recipient countries, it is mainly the comparative static welfare gains from trade that are reduced through preference erosion. But these gains may not be at the forefront in determining welfare gains from RTAs (Robinson and Thierfelder, 1998). Some of the dynamic or non-traditional gains from trade, however, may be as well or even better realized for developing countries in a multilateral framework. Certainly this holds for the effects resulting from own market liberalization in case of reciprocal preferences: efficiency gains from increased competition as well as locking in domestic reforms do not depend on opening an exclusive market under a RTA. The greater predictability of the future potential of export sectors due to secured market access would be even better served under multilateral liberalization: market access would be more secure and not subject to erosion. Other dynamic gains, such as the attraction of FDI or the realization of economies of scale and increased productivity through trade, however, may be more exclusive and thus an incentive exists to realize them under RTAs or nonreciprocal preferences, as well as it exists for the realization of comparative static welfare gains.

In summary, in light of diminishing perceived benefits from preferential trade agreements, coupled with persistently high costs of such agreements, from a rational perspective the incentive to invest in the spaghetti bowl should decline. This, however, is not observed in reality: the number of RTAs the EU is involved in is increasing and the agricultural parts of these agreements continue to be highly complex and detailed in structure, even increasingly so in some cases (Grethe et al., 2005).

What are the alternatives? A strong simplification of the EU preference system seems a worthy alternative to consider compared to the current ever-increasing complexity of preferential trade arrangements. Such a system could basically consist of two layers: one EBA-like layer with unrestricted market access and a second GSP-like layer with relatively shallow preferences. The unrestricted market access layer could be extended to include, in addition to the LDCs, other vulnerable developing country groups.[6] Furthermore, all developing countries with reciprocal RTAs with the EU could be included in this layer. The effect on EU markets may be limited for many reasons. Natural resources, especially water, are rather scarce in many developing countries and therefore limit production and additional exports. In addition, transportation costs and increasing quality standards applied by EU importers limit the competitiveness of many developing countries' products on EU markets. Garcia-Alvarez-Coque (2002: 408) states, for preference recipients under the Euro-Mediterranean Agreements, that "only a few countries … are able to export the quality products demanded by high-income consumers". Grethe (2004) arrives at a similar conclusion

[6] Tangermann (2001) proposes such an extension of the Enabling Clause.

for Turkey where, in contrast to a priori expectations, full abolishment of EU market access barriers for fruits and vegetables would lead to only small gains in exports.

Such a simplified preference system would also allow for a much simpler system of RoO, as origin could be cumulated within each of the two layers.

Two conditions would probably be required to implement such a system. First, it would be necessary to substantially reduce MFN tariff peaks. This is because tariff peaks constitute a strong incentive to maintain old-fashioned, deep and controlled preferences. Extending free market access to highly protected markets to new developing countries, as envisaged under the EBA initiative, without a previous reform would therefore be irresponsible as those countries could be drawn into unsustainable distortions of production in conflict with their long term comparative advantages. This problem currently exists for sugar and bananas in many of the preference-recipient countries. The category of "sensitive products" in the framework of the proposal for modalities substantially jeopardizes reductions of tariff peaks.

A second condition for such a move, which would involve the abolishment of deep preferences due to substantial cuts in tariff peaks, would be some adjustment assistance for those countries that would be most substantially hit. Adjustment assistance could be used for the improvement of competitiveness as well as diversification of production. Such adjustment assistance, however, may be limited in coverage as only a few products and countries get the bulk of preference value. Other aspects add to the limited need for adjustment assistance. Preference erosion can be anticipated, is spread out over time and some compensation may occur due to better MFN market access and the resulting higher world market prices. Further, for most countries, the loss of the VPM is small compared to the size of their total exports as well as their economies as a whole. Nonetheless, preference erosion can substantially impact a few countries, and as such preference erosion can be anticipated and transparent rules for adjustment support could be fixed in advance. Such adjustment support may be agreed upon bilaterally, but could also be a part of the Doha Round package.[7] Including an agreement on adjustment assistance as part of the Doha Round package may enhance the trust in the reliability of such assistance and thus the support of the countries concerned in the process of multilateral trade liberalization.

[7] For a discussion on the pros and cons of different forms of adjustment assistance see Hoekman and Prowse (2005).

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