

EUROPEAN PARLIAMENT



DG EXTERNAL POLICIES OF THE UNION
DIRECTORATE B, POLICY DEPARTMENT

Brussels, 16 August 2004
MB D(04) 35980

DISCUSSION PAPER ON THE REFORM OF THE GENERALISED SYSTEM OF PREFERENCES

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Introduction:

This study seeks to provide a general overview of the European Community's **scheme of generalised tariff preferences** (GSP), to enable discussion of the Commission's reform proposals for the 2006-2015 period.¹

It shall discuss the following issue areas:

1. History and evolution of the GSP;
2. The functioning of the GSP;
3. Main beneficiaries, impact assessments;
4. Prospects for GSP reform;
5. Linkage between GSP reform, EPA negotiations, and the DDA.

1. History and evolution of the GSP:

The European Union's current GSP scheme is based on a 1968 initiative by the United Nations Conference on Trade and Development (UNCTAD) that recommended the creation of '**Generalised System of Tariff Preferences**', under which developed countries would grant autonomous, non-reciprocated trade preferences to developing countries to foster their development. The GSP departs from the 'Most Favoured Nation' (MFN) principle of the GATT/WTO (Article I of the GATT), which prohibits discrimination among trade partners. This required the adoption of a waiver from Article I, which GATT signatories agreed in the framework of an 'Enabling Clause' in 1971. This clause requires developed countries to grant preferences under the GSP in a non-discriminatory, non-reciprocated, and autonomous manner. While general discrimination in favour of developing countries is allowed, discrimination between them is not, though special schemes for the Least Developed Countries (LDCs) are encouraged.

The European Community was the first to **implement a GSP scheme in 1971**, for a period of 10 years. This scheme was subsequently renewed, with the latest providing for the period between 1995 and 2004. While the scheme is implemented in cycles of 10 years, the Council adopts shorter-term Regulations to adapt the GSP to the changing requirements of the multilateral trading system. The last two Council Regulations implement the GSP from 1 January 2002 to 31 December 2004,² extending it to 31 December 2005.³ The EC GSP was considerably reformed in 1995: 'tariff modulation' replaced the previous practice of applying quantitative limitations on imports; and country-sector 'graduation' was introduced, as were special incentive arrangements for countries complying with certain criteria set by the European Union.

The EC currently operates **five separate arrangements** under the GSP: the general arrangement for all developing country beneficiaries, three special incentive arrangements for countries that protect labour rights, the environment, and participate in the fight against drugs; and a special arrangement for LDCs, the 'Everything But Arms' initiative (EBA), created in 2001. The general scheme is available in principle to 178 developing-country beneficiaries, although some may not have complied with the administrative requirements necessary to register for the scheme, and Myanmar is temporarily suspended from it. Please see Figure 1.1 for the full list of beneficiaries.

The special arrangements for labour rights and the environment are available, upon request, to all beneficiaries of the general scheme. The special arrangement for the fight against drugs is available primarily to countries in Latin America, although Pakistan was added to the scheme in 2001. The list of beneficiaries includes the following: Bolivia, Colombia, Costa Rica, Ecuador, El Salvador,

¹ COM(2004) 461 final. The term 'GSP' is sometimes used to refer to the overall Generalised System of Preferences, and sometimes to individual schemes operated by different countries and the European Community. This study shall use it in the second context.

² Council Regulation (EC) No 2501/2001

³ Council Regulation (EC) No 2211/2003

Guatemala, Honduras, Nicaragua, Pakistan, Panama, Peru, and Venezuela. India challenged the EU's **drug arrangement** in 2002, claiming that it was inconsistent with Article I of the GATT and that it violated the Enabling Clause. The WTO Panel initially found in favour of India, but the Appellate Body (AB) reversed the decision in April 2004, reaffirming that differentiation among developing countries was indeed possible. However, the AB panel also found that the EU's selection of beneficiary countries was not based on objective and transparent criteria. The EU is expected to take these criticisms on board and amend its special drug regime in the framework of the upcoming GSP reform.

Finally, the **Everything But Arms** initiative is available to 49 LDCs. The EBA amendment to the European Community's GSP was adopted by the Council on 26 February 2001⁴, subsequently incorporated into Regulation 2501/2001 on the GSP. EBA extends immediate duty and quota-free access to all products originating in LDCs, except for arms and ammunition. It maintains this special arrangement for an indefinite period (unlike the general GSP, which must be renewed periodically). EBA includes all agricultural products, although the import of fresh bananas, rice, and sugar is only gradually liberalised. For these products, tariff quotas are maintained, which are increased yearly before full liberalisation. Banana imports are to be liberalised by January 2006, sugar imports by July 2009, and rice imports by September 2009. Sugar imported under the ACP-EC Sugar Protocol is excluded from the EBA calculations, to uphold the viability of the protocol.

2. The functioning of the GSP:

The current GSP scheme **suspends duties on all non-sensitive products**, except for agricultural components. It also simplifies the treatment of sensitive products: in the case of *ad valorem* duties, it applies a flat-rate 3.5% percentage point reduction of the MFN duty; in the case of specific duties, it applies a 30% reduction of the MFN duty. Where the MFN duty includes both *ad valorem* and specific duties, only the former is reduced. Limited exceptions apply for textiles and clothing, whose MFN duties are reduced by 20%, and ethyl alcohol, whose MFN duties are reduced by 15%. However, given that MFN duty rates have been greatly reduced in subsequent rounds of multilateral liberalisation, preference margins have eroded on industrial products, reducing the value of the GSP for developing countries.

Additional tariff preferences under the three special incentive arrangements apply to the sensitive products mentioned above. Beneficiaries enjoy an additional tariff reduction generally of the same magnitude as the general GSP scheme, which doubles the level of reduction. For *ad valorem* duties, the reduction is 5 percentage points, which brings the total reduction to 8.5 percentage points. For specific duties, the same percentages apply as in the general GSP scheme, thus boosting total reduction to 60% for specific duties, 40% for textiles and clothing, and 30% for ethyl alcohol.

The GSP only covers products that are '**dutiable**'. For roughly 2,100 products out of a total number of approximately 10,300 tariff lines of the Common Customs Tariff, the MFN duty rate is zero. It is not possible to grant preferences on these products. The general GSP scheme covers roughly 7,000 products, 3,300 of which are classified as non-sensitive, and 3,700 as sensitive. EBA has a wider product coverage: it covers all 'dutiable' products, i.e. roughly 8,200 tariff lines, with the exception of arms and ammunition.

The EC GSP provides for the **exclusion** of countries that have reached a level of development similar to that of developed countries. The criteria for exclusion are based on a classification of countries by the World Bank and a development index. Countries that are classified by the World Bank as high-income for three consecutive years and whose EU development index is higher than -1 are excluded from the GSP. The Commission determines each year which country is to be excluded (they can be included again if their situation worsens), then notifies the country of its decision to withdraw preferential treatment.

⁴ Council Regulation (EC) No 416/2001

Individual sectors can also be **graduated**, i.e. lose their preferential treatment, even if the country as a whole qualifies for GSP. Graduation applies to countries participating in the general and drug regimes, but it does not apply to LDCs or countries whose development index is below -2. Graduation may occur either under the 'lion's share' clause or under the graduation mechanism. The lion's share clause refers to a GSP beneficiary country having more than a 25% share of the EU preferential market in any sector. The graduation mechanism considers the degree of specialisation of a beneficiary country's economy: it is triggered if a sector exceeds a certain threshold of specialisation.

The GSP also provides for **safeguard measures**, i.e. the re-introduction of the Common Customs Tariff, in case a surge in preferential imports causes or threatens to cause serious difficulties to Community producers. The procedure to introduce safeguard measures requires a thorough investigation by the Commission and consultation with the Generalised Preferences Committee, which is made up of representatives of Member States and chaired by the Commission. The GSP may also be temporarily withdrawn in case of fraud or failure to comply with the administrative requirements of the EC scheme. In more extreme cases, slavery, forced labour, prison labour, or money laundering can all lead to the temporary loss of GSP status.

Rules of origin (RoO) make up a crucial part of the GSP. Rules of origin are meant to ensure that only those countries and products benefit from the scheme for whom the GSP was intended. While products 'wholly obtained' in the exporting country are considered as originating there, products manufactured with inputs from other countries only obtain origin if they have undergone sufficient working or processing in the beneficiary country. The RoO requirements refer to technical criteria, added value, or a change of tariff heading.

Given that regional integration is a core objective of EU external relations, **regional cumulation** is often made possible for trade partners. Bilateral and diagonal cumulation is available to countries that have free trade agreements containing identical origin rules. Regional groups may also request from the EU the granting of a regional cumulation of origin. At present, there are three groups (ASEAN, the Central American Common Market and the Andean Group, and the South Asian Association for Regional Cooperation) benefiting from this arrangement.⁵ Norway and Switzerland have also been added to the EC regional cumulation regime. Non-agricultural materials that originate in Norway and Switzerland and undergo more than a minimal operation in a GSP beneficiary country are considered to originate in that country and may be exported to the EC, Norway, and Switzerland under the GSP scheme.

3. Main beneficiaries, impact assessments:

While the Commission has not published any impact assessment studies of its GSP and EBA schemes, UNCTAD and several academics have tried to assess the benefits of trade preferences for developing countries. The following section is based on these studies.

UNCTAD has published a wide-ranging study that seeks to assess the impact of trade preferences on LDCs.⁶ This study measures the product coverage and utilisation rate of preferential trade arrangements (PTAs) offered by developed countries for LDCs.⁷ PTAs can be granted either through unilateral preferences (GSP, EBA) or through regional trade arrangements (e.g. Cotonou

⁵ **ASEAN Group:** Brunei, Cambodia, Indonesia, Laos, Malaysia, Philippines, Thailand, Vietnam, Singapore; **CMCA and Andean Group:** Costa Rica, Honduras, Guatemala, Nicaragua, Panama, El Salvador, Bolivia, Colombia, Ecuador, Peru, Venezuela; **SAARC Group:** Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka.

⁶ UNCTAD, *Trade Preferences for LDCs: An Early Assessment of Benefits and Possible Improvements*, 2003

⁷ **Product coverage** is defined as the ratio between imports covered by a PTA and total dutiable imports from beneficiary countries. The higher the ratio, the more generous is the preferential regime. The **utilisation rate** is defined as the ratio between imports actually receiving preference and imports covered by the PTA.

Agreement). The UNCTAD study found the following (please refer to Figure 3.1 for comparative figures on trade volumes, product coverage, and utilisation rates under different PTAs):

ACP LDCs use Cotonou trade preferences: **ACP LDCs** use the preferences provided under the Cotonou Agreement, rather than the EBA, to enter the EC market. Product coverage (99.8%) and the utilisation rate (76.1%) are high under the Cotonou Agreement. However, dutiable imports make up just one-quarter (approx. USD 2 billion) of all ACP exports to the EC, which means that three-quarters of ACP exports enter the EC market on an MFN basis. More importantly, EBA records a shockingly low 2.6% utilisation rate for ACP LDCs. This means that ACP LDC producers use Cotonou preferences as the primary vehicle to export their dutiable products to the EC market.

Few ACP beneficiaries derive most benefits: There are a **handful of ACP LDCs** that derive the bulk of benefits under the Cotonou Agreement. In preferential animal imports, Senegal, Mauritania, Madagascar, Tanzania, Mozambique, Angola, and Uganda are the main beneficiaries. In vegetable products, Ethiopia is the top beneficiary, measured by the utilisation rate. Madagascar consistently records very high utilisation rates in textile and clothing. In the area of prepared foodstuff, Malawi, Tanzania, Senegal, Madagascar, and Uganda are the top beneficiaries.

Non-ACP LDCs are main users of EC GSP: **Non-ACP LDCs** are the main beneficiaries of the EC GSP scheme. Dutiable imports (approx. USD 4 billion) make up some 90% of all non-ACP LDC imports to the EC, which renders preferences extremely important to these countries. Despite a product coverage of 99.4%, the utilisation rate is very low at 46.9%. UNCTAD believes that onerous rules of origin requirements, as well as the limited regional cumulation options available to LDCs, are the main culprits for this phenomenon. In the case of Bangladesh and Cambodia, for example, almost half of cotton imports are sourced in China, which does not participate in the regional cumulation scheme of the EC GSP. This leaves very little room for cumulation to improve the utilisation of trade preferences.

Bangladesh is biggest GSP beneficiary: **Bangladesh** is by far the biggest beneficiary of the EC GSP, ranked by GSP-receiving trade volumes. Indeed, the top 10 products benefiting from the EC GSP come from Bangladesh (clothing products), accounting for 13.7% of all GSP exports to the EC. Bangladesh (82%) is followed by Cambodia (8%), Nepal (4%), and the Lao People's Republic (4%) as the main beneficiaries of the GSP. Prior to the adoption of the EBA scheme in 2001, Afghanistan, Bangladesh, Bhutan, the Lao People's Republic, Cambodia, Nepal, Yemen, Maldives, and Myanmar were the main beneficiaries of the EC GSP.

EBA records low utilisation rate: While dutiable products make up just 46% percent (approx. USD 6 billion) of all LDC exports to the EC, the **EBA** scheme provides full coverage for these products. However, the utilisation rate for EBA is a mere 38.6% for all LDCs (given that ACP LDCs make practically no use of this scheme), and 57% for non-ACP LDCs. UNCTAD and certain academics⁸ believe that the EBA's intricate rules of origin requirements are the main reason for the low utilisation rate among LDCs. The relatively high cost of compliance with RoO procedures and requirements may be a sufficient reason for LDC producers to forego the marginal benefits offered by a PTA.

⁸ Inama Stefano, *Trade Preferences and the World Trade Organization Negotiations on Market Access*, Journal of World Trade, 37:5, 2003

4. Prospects for GSP reform:

The Commission published on 7 July 2004 its GSP reform proposals for the 2006-2015 period.⁹ The Communication makes the following proposals:

Improve the product **coverage** of the GSP by moving certain sensitive products into the non-sensitive category;

Target the GSP on **LDCs**;

Simplify the GSP by merging the three special arrangements into a **single arrangement** to encourage sustainable development and good governance. This special, GSP+ arrangement would complement the general GSP and EBA schemes;

Simplify graduation by making the '**lion's share**' clause the core criterion for graduation;

Improve rules of origin requirements by introducing more 'flexibility' into the system and encourage **cross-regional cumulation** to improve the utilisation rate of preferences;

Apply **safeguard**, temporary withdrawal, and anti-fraud measures with vigour to protect the Community's financial interests.

The above Communication builds on a 2003 Commission Green Paper on the future of rules of origin in preferential trade arrangements.¹⁰ This Green Paper raised several ideas that may be integrated into future revisions of the RoO requirements of the GSP:

Revise the substance of preferential **rules of origin** requirements to bring them into line with the international trading environment and the Community's trade objectives;

Develop a strategy for **technical assistance** with PTAs and rules of origin;

Draft regional agreements on **regional cumulation** of origin;

Establish a better balance between exporter and governmental authorities for the **certification** of rules of origin.

These proposals could address some of the concerns raised about the current GSP scheme. As can be seen above, product coverage is not a core issue for developing countries because the GSP, EBA, and Cotonou Agreement all provide near-universal product coverage. It is rather the onerous rules of origin requirements and limits on regional cumulation that reduce the benefits of preferential schemes for developing countries.

More flexibility in RoO requirements and cross-regional cumulation are certainly a move in the right direction, but more precise proposals and impact assessment studies would be needed to evaluate the expected impact of the Commission's GSP reform proposals on developing countries. As for specific RoO reforms, UNCTAD recommends the following:

Replace the RoO 'domestic content' requirement with '**import content**', as exporters find it much easier to calculate and certify the latter;

Revise the stringent **rules of origin** on fish, the definition of vessels, and fish preparations;

Replace partial regional cumulation with **global cumulation**;

Simplify certification and administration procedures.

⁹ COM(2004) 461 final

¹⁰ COM(2003) 787 final

Targeting the GSP on LDCs also appears to be a move in the right direction, as it would consolidate what has already happened in practice in the EC's various PTAs. ACP LDCs use the preferences provided by the Cotonou Agreement to enter the EC market, while Asian LDCs tend to use the GSP and EBA schemes to receive benefits. With the negotiation of regional Economic Partnership Agreements with ACP countries, the GSP could become an LDC-focused development scheme, providing objective, transparent, and non-discriminatory treatment to all countries at a similar stage of development.

Simplifying graduation is likely to render the GSP more transparent and objective, a core necessity after the WTO Appellate Body delivered its report in the EC-India case on the EC drug regime. Indeed, the 'lion's share' clause appears to be the most transparent way of justifying the withdrawal of GSP status from developing-country partners. Likewise, the application of safeguard measures and the temporary withdrawal of GSP status must be based on clearly communicated, transparent, and objective criteria so as to reinforce the consistency of EC trade policy towards developing-country partners.

Finally, **regional cumulation** ought to be reformed in close consultation with GSP partners. UNCTAD proposes a global cumulation regime, but this seems to defy the logic of preferential arrangements, as well as the EC objective of encouraging regional cooperation in partner regions. Nevertheless, negotiations on cross-regional cumulation may continue in parallel with the ongoing EPA negotiations that the EU has been conducting with ACP partners since 2002.

5. Linkage between GSP reform, EPA negotiations, and the DDA:

After about a year of initial discussions and clarification, negotiations between the EU and ACP partners for regional Economic Partnership Agreements (EPA) are entering a new phase. The EU is determined to integrate the **Singapore issues** of investment, competition, transparency in government procurement, and trade facilitation into the EPAs, for it sees them as central to development. As Karl Falkenberg, Director at DG Trade, argued in a recent article, "foreign trade alone is not a sufficient condition for development. We have to look closer at the supply side, i.e. the capacity of developing partners to build production capacity, and the necessary human resources and infrastructures to integrate better into a global world economy."¹¹

The EU is also keen to integrate the Singapore issues into the EPA process because there is a great deal of reluctance among WTO members to discuss these issues in the framework of the Doha Development Agenda (DDA). Indeed, the recent framework agreement of 31 July 2004 only includes **trade facilitation**; positive rule-making on the other three issues has been decisively rejected by WTO members, at least for the time being.¹² With the multilateral track temporarily closed, it is possible that the EU will attempt to pursue negotiations on the Singapore issues on a regional track, i.e. in the framework of the EPA negotiations.

As for the **ACP side** of the EPA negotiations, some have argued that, in return for discussing the Singapore issues, ACP partners should push for major market access concessions by the EU and put agricultural subsidies and SPS measures at the heart of the negotiations. With the agricultural deal agreed in the WTO's July framework, however, the EU has already committed itself to eliminating export subsidies and disciplining domestic support. This is likely to reduce the bargaining power of ACP partners in the EPA negotiations. Others have suggested that ACP countries should aim to widen the scope of the EPA negotiations to trade and development. This would imply a broader discussion on EU development support, and separate talks on technical assistance to address supply-side constraints and the negative side-effects of trade liberalisation.¹³ It remains to be seen whether the EU will be open to discussing such issues in the context of the EPA talks.

¹¹ ICTSD, *EPAs and DDA - Parallelism or Crossroads?*, Trade Negotiations Insights (TNI), Vol. 3, No. 4, July 2004

¹² WTO, *Doha Work Programme - Decision Adopted by the General Council on 1 August 2004*, WT/L/579

¹³ ICTSD, *Negotiating EPAs between African Sub-regions and the EU*, TNI, Vol. 3, No. 4, July 2004

Figure 1.1: Beneficiary countries of the EC GSP and EBA schemes

The names of *Least Developed Countries* that are also eligible for the EBA are italicised.

United Arab Emirates	People's Republic of China	India	Mexico	El Salvador
<i>Afghanistan</i>	Colombia	British Indian Ocean Territory	Malaysia	Syria
Antigua and Barbuda	Costa Rica	Iraq	<i>Mozambique</i>	Swaziland
Anguilla	Cuba	Iran	Namibia	Turks and Caicos Islands
Armenia	<i>Cape Verde</i>	Jamaica	New Caledonia	<i>Chad</i>
Netherlands Antilles	Christmas Islands	Jordan	<i>Niger</i>	French Southern territories
<i>Angola</i>	Cyprus	Kenya	Norfolk Island	<i>Togo</i>
Antarctica	<i>Djibouti</i>	Kyrgyzstan	Nigeria	Thailand
Argentina	Dominica	<i>Cambodia</i>	Nicaragua	Tajikistan
American Samoa	Dominican Rep.	<i>Kiribati</i>	<i>Nepal</i>	Tokelau Islands
Aruba	Algeria	<i>Comoros</i>	Nauru	Turkmenistan
Azerbaijan	Ecuador	St Kitts and Nevis	Niue Island	Tunisia
Barbados	Egypt	Kuwait	Oman	Tonga
<i>Bangladesh</i>	<i>Eritrea</i>	Cayman Islands	Panama	East Timor
<i>Burkina Faso</i>	<i>Ethiopia</i>	Kazakhstan	Peru	Trinidad & Tobago
Bahrain	Fiji	<i>Lao People's Dem. Rep.</i>	French Polynesia	<i>Tuvalu</i>
<i>Burundi</i>	Falklands Islands	Lebanon	Papua New Guinea	<i>Tanzania</i>
<i>Benin</i>	Federated States of Micronesia	St Lucia	Philippines	Ukraine
Bermuda	Gabon	Sri Lanka	Pakistan	<i>Uganda</i>
Brunei Darussalam	Grenada	<i>Liberia</i>	St Pierre and Miquelon	US Minor outlying islands
Bolivia	Georgia	<i>Lesotho</i>	Pitcairn	Uruguay
Brazil	Ghana	Libya	Palau	Uzbekistan
Bahamas	Gibraltar	Morocco	Paraguay	St Vincent and Northern Grenadines
Bhutan	Greenland	Moldova	Qatar	Venezuela
Bouvet Island	<i>Gambia</i>	<i>Madagascar</i>	Russian Federation	British Virgin Islands
Botswana	<i>Guinea</i>	Marshall Islands	<i>Rwanda</i>	US Virgin Islands
Belarus	<i>Equatorial Guinea</i>	<i>Mali</i>	Saudi Arabia	Viet Nam
Belize	South Georgia & South Sandwich Isl's	<i>Myanmar (temp. suspended)</i>	<i>Solomon Islands</i>	<i>Vanuatu</i>
Cocos Island	Guatemala	Mongolia	Seychelles	Wallis and Futuna
<i>Dem. Rep. of Congo</i>	Guam	Macao	<i>Sudan</i>	<i>Samoa</i>
<i>Central African Rep.</i>	<i>Guinea-Bissau</i>	Northern Mariana Islands	Santa Helena	<i>Yemen</i>
Congo	Guyana	<i>Mauritania</i>	<i>Sierra Leone</i>	Mayotte
Côte d'Ivoire	Heard Island and McDonald Islands	Montserrat	<i>Senegal</i>	South Africa
Cook Islands	Honduras	Mauritius	<i>Somalia</i>	<i>Zambia</i>
Chile	<i>Haiti</i>	<i>Maldives</i>	Suriname	Zimbabwe
Cameroon	Indonesia	<i>Malawi</i>	<i>São Tomé and Príncipe</i>	

Source: Council Regulation (EC) No. 2501/2001

Figure 3.1: Product coverage and utilisation rates under different preferential schemes, 2001

Beneficiary	Total imports (USD 1000)	Dutiable imports (USD 1000)	Covered imports (USD 1000)	Receiving imports (USD 1000)	Product Coverage (%)	Utilisation rate (%)
ACP LDCs (Under Cotonou)	8,060,711	2,063,470	2,059,787	1,570,422	99.8%	76.2%
ACP LDCs (Under EBA)	8,523,800	2,036,000	2,035,200	53,900	100.0%	2.6%
Non-ACP LDCs (Under GSP)	4,372,400	3,958,100	3,935,700	1,847,400	99.4%	46.9%
All LDCs (Under EBA)	12,932,600	6,018,400	6,017,700	2,325,100	100.0%	38.6%
Non-ACP LDCs (Under EBA)	4,408,800	3,982,400	3,982,400	2,271,200	100.0%	57.0%

Source: UNCTAD, Trade Preferences for LDCs, 2003