Unilateral tariff cuts: a theory

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1. Introduction

Trade liberalization in countries worldwide is provided in the form of gradual abolition of tariff and non-tariff barriers in foreign trade. Nowadays the developed countries often grant unilateral tariff preferences to the developing and transition economies in order to promote their exports and their industrialization (by diversifying their export structure), and also to accelerate their economic growth. This is intended to attract more investment, create more jobs etc. in order to achieve a sustainable development. It is based on the most favored nation (MFN) principle of the General Agreement on Tariffs and Trade (hereafter GATT) and its successor, the World Trade Organization (hereafter WTO).

Now Ukrainian government set a course for Ukraine's joining to European Union (hereafter EU); notably, it elaborated the EU-Ukraine Association Agenda to prepare and facilitate the implementation of the Association Agreement for 2014-2017, main directions of sectoral coordination are agreed, new conditions of Ukraine-EU commodity trade are defined, particularly the unilateral reduction or elimination of the EU customs duties for commodities originating in Ukraine in the framework of Autonomous Preferential Trade Regime (hereafter APTR). At the moment Ukraine also enjoys Generalized System of Preferences (hereafter GSP), granted by EU, for all products covered by the system except railway and tramway vehicles and products

According to the trade theory the reduction of a tariff ceteris paribus leads to the increase of commodity flows. Taking into account that now raw materials and intermediate products consist a large part of Ukrainian export to the EU, the reduction or elimination of import tariffs could lead to the increase of their exports, therefore favoring to recognizing Ukraine as net exporter of raw materials and semi-finished goods. This is the case firstly for agricultural goods (which, however, are regulated by EU by non-tariff measures, notably, quotas), and also for output of mining and processing industries and metallurgy. Notably, a considerable part of Ukrainian metallurgical export to the EU, consists of raw materials and unfinished goods, which are processed later on European plants in order to create high value added production. But in current economic environment government's behavior should be focused on departure from the image of raw materials exporting country since such economic policy is no longer effective.

But in real economic conditions when commodity flows are influenced along with tariff by other factors, tariffs (as distorting element) could not be the main reason of changes of commodity flows. In this context tariffs could be eliminated in order to reduce their distorting effects in international trade.

So, the main purpose of this paper is to analyze the APTR, granted by EU to Ukraine, in the context of modern theory of non-reciprocal trade agreements. To do this we structured paper as follows. Section 2 reviews theoretical and empirical research on the non-reciprocal trade liberalization. Section 3 provides brief examination of some theoretical approaches and practical implications of GSP arrangements in the world. Section 4 analyses current situation with tariff regulation in Ukraine-EU commodity trade. Finally, Section 5 presents some concluding remarks.

2. Literature review

The largest part of research studies the impact of trade freedom on economic growth (e.g., Krueger, Rivera & Romer, Akin et al. etc.). These papers usually use a panel data in order to investigate such impact. They concluded that trade freedom is highly significant and is positively related to economic growth.

Onguglo analyzed the relevance of GPS schemes for developing countries in the 1990's. He concluded that the existing trade preferences should be maintained, improved and effectively utilized and should be combined with other policy measures in order to improve the productivity, quality of products, and horizontal and vertical diversification in exports. Herz & Wagner analyzed the efficiency of GSP. They concluded that the GATT/WTO approach is a much better way to foster exports of low-income countries.

Another set of papers studies impact of non-reciprocal tariff arrangements on concrete regions, countries and industries (e.g. Candau & Jean, Low et al., Jones et al. etc.).

The investigations providing quantitative evaluation of consequences of granting of tariff preferences, using statistical and econometric analysis, deserve a special mention.

Ozden and Reinhardt developed and tested theoretical model of a small country's trade policy choice, using a dataset of 154 developing countries for 1976-2000. They find that countries removed from the GSP adopt more liberal trade policies than those remaining eligible. Thus, their results suggest that developing countries may be best served by full integration into the reciprocity-based world trade regime rather than continued GSP schemes.

Following their analysis, Grossman & Sykes considered the law and economics of discrimination within GSP schemes for developing countries. They concluded that the case against discriminatory preferences is at best an uneasy one, both in legal and in economic terms. Moreover, the ostensible justification for GSP schemes– to promote growth and development – is unlikely to be served well by existing GSP policy.

François et al. examined the scope for preference erosion, using an econometric analysis, and modeling full elimination of OECD tariffs. They conclude that tariff preferences are underutilized due to administrative burden. And for those products where preferences are used, the primary negative impact follows from erosion of EU preferences. Gamberoni analyzed the impact of the EU unilateral trade preferences on both the intensive and the extensive margin of trade. She found that the impact of non-reciprocal trade preferences on both margins is linked to the sector under analysis and to the type of preferences a country benefits from. Also she confirmed that the GSP schemes for least developing countries did not change their export pattern, while the traditional GSP and the regime to combat drug production tend to promote export diversification.

Hoekman et al. analyzed potential losses of erosion of tariff preferences. They concluded that such preferences are being eroded by liberalization at all levels, but at the same time the Doha Round is likely to lead to relatively limited preference erosion. Consequently, a re-orientation of trade policies away from procedures that tend to hollow out the multilateral trade system would enhance the global welfare [10]. Fugazza & Nicita investigated to what extent preferential market access affects bilateral trade, using an appropriate gravity model for two indices of market access conditions which take into account the structure of tariff preferences and reflect both direct and indirect market conditions. Their results indicated that both of these two market access conditions affect bilateral trade.

Laird analyzed the implementation of GSP schemes of seven major markets (Canada, China, European Union, India, Korea, Japan, and the United States) and simulated the impact on LDCs' exports of extending full duty-free and quota-free market access. He concluded that the Doha Round might not have a significant impact on LDCs' trade, but, however, a possible Doha Round scenario combined with duty-free and quota-free market access could bring significant benefits to these countries [15]. Snyder analyzed nonreciprocal preference programs (upon the examples of the EU and U.S.). He concluded that preference-granting countries could improve the effectiveness of their programs through increasing the stability of preference programs, developing more defined eligibility criteria, expanding product coverage, and making rules of origin simpler and more flexible. Ketterer et al. using detailed product-level tariff and trade data, analyzed Japanese external tariff adjustments in the presence of trade preferences. As a result they suggested that trade preferences may have hindered further Japanese external tariff liberalization during the last successfully concluded multilateral trade round.

The mentioned research does not consider the non-reciprocal tariff preferences, which now Ukraine enjoys in the trade with EU, so it makes sense to analyze them in the context of modern theory of non-reciprocal trade arrangements.

3. Theoretical background

Let's briefly examine some theoretical approaches and practical implications of GSP arrangements in the world.

Firstly the program concept was adopted internationally in 1968 by the United Nations Conference on Trade and Development (UNCTAD) at the UNCTAD II Conference, which recommended the creation of a Generalized System of Preferences under which industrialized countries would grant trade preferences to all developing countries.

According to the UNCTAD resolution, the objectives of the GSP system for developing countries should concentrate in promoting both of their exports and their industrialization, and also to accelerate their rates of economic growth.

Two types of trade agreements should be distinguished: reciprocal (contractual) preferential trade agreement such as European Free Trade association (EFTA), and autonomous (unilateral, non-reciprocal) preferential trade agreements such as GSP.

Under GSP schemes, selected products originating in developing countries, are granted reduced or zero tariff rates. At the same time, the least developed countries (LDCs) receive special and preferential treatment for a wider coverage of products and deeper tariff cuts.

According Borrmann et al. the developing countries hoped the introduction of GSP schemes would both increase their earnings from exports of semi-finished and finished products and widen the domestic market by creation of additional foreign demand and by providing incentives in order to extent export capacities.

In 1971 the European Community implemented its first GSP scheme in the framework of 10-year programs through different regulations for industrialized, textile products and agricultural products and also those covered by the European Coal and Steel Community (ECSC) Treaty. In 1979 was adopted the “Enabling Clause”, which both created the legal framework for the GSP and authorized developed countries to establish individual GSP schemes.

Generally, the GSP is regarded as an autonomous trade arrangement through which the EU provides unilateral preferential access to the EU internal market to developing countries. The general arrangements cover both non-sensitive and sensitive products. Their sensitivity is determined by the situation of the sector producing the same products in the EU. Sensitive products require a higher border protection, while for non-sensitive goods tariffs could be reduced or eliminated. In other words, non-sensitive products have duty free access to the EU internal market, while sensitive products could enjoy a tariff reduction. The EU GSP scheme has been revised several times in order to reflect evolutions in international trade and development. The latest revision was applied from 2014. The new scheme focuses 90 countries (beneficiaries) in order to ensure more impact on countries most in need.

There are three main variants of this Scheme:

the standard (general) GSP arrangement, offering generous tariff reductions to developing countries. This means partial or entire elimination of tariffs on two thirds of all product categories.

the “GSP+” enhance preferences mean full removal of tariffs on essentially the same product categories as those covered by the general arrangement. This arrangement is granted to countries both ratified and implemented main international conventions relating to human and labour rights, environment and good governance;

"Everything but Arms" (EBA) arrangement for least developed countries (hereafter LDCs), granting both duty-free and quota-free access to all products, except for arms and ammunitions.

According to EU regulations, the main key objectives for the GSP reform are the following: to concentrate GSP preferences on developing countries most in need, to reinforce the trade incentives in order to respect main human and labour rights, environmental and good governance standards by implementation of the GSP+ arrangement, to strengthen the effectiveness of the trade concessions for LDCs, and to increase predictability, transparency and stability of the GSP. At the same time, a number of countries, which do not require GSP preferences in order to be competitive on the EU markets, no longer benefit from the GSP, notably, countries that have another preferential access to the EU (for example, under a Free Trade Agreement or a special autonomous trade regime); countries, achieved a high or upper-middle income per capita; overseas countries and territories, which are either attached to the EU or are linked to another developed country. Their exports enter into EU internal market with a normal tariff applicable to all other developed countries. Current GSP preference-granting countries (as of February 2015): Australia, Belarus, Canada, EU countries, Japan, Iceland, Kazakhstan, New Zealand, Norway, the Russian Federation, and Switzerland, Turkey, U.S.

According to Wall and Jones, the GSP schemes were established based on an economic theory that preferential tariff rates in developed country are able to promote export-driven industry growth in developing countries. This, in turn, would help to GSP beneficiaries both to diversify their economies in order to promote sustainable development and to withdraw from dependence on trade in primary products and raw materials. Differences in tariff regulation and economic structures between developed and developing countries conditioned difficulties of creation of unified system of tariff incentives. And the GSP was an attempt to build a system of individual national schemes based on common principles and purposes. As a result, the preference-granting countries implemented various individual schemes of preferences under which tariffs on imports originating certain developing countries were reduced or eliminated.

Grossman & Sykes in analyzing of economic effects of tariff preferences considered both small and large countries. When small country, which has no market power on the world markets, receives tariff preferences, its exporters can sell their output at higher price and remain competitive in the foreign market. This leads to export growth. So, the tariff preferences under GSP schemes provide a “terms of trade” benefit to the exporting country, reflecting the trade creation. When tariff preferences are granted to a large country, having market power, this also raises the internal price in the preference-receiving country (Fig. 1), as for the small economy.

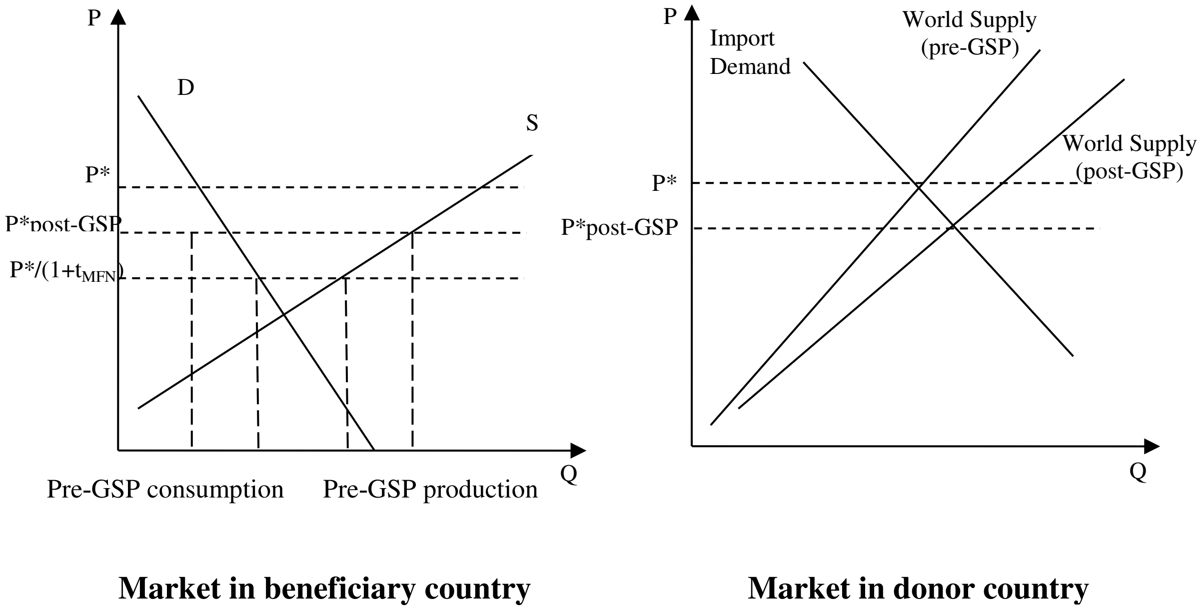

Fig. 1. Impact of non-reciprocal tariff preferences on welfare both donor and beneficiary countries

But in this case there is a significant impact of the export growth on the world price (p^*). The total world supply to the preference-granting country expands, which means that the market price falls from p^* to $p^*_{post-GSP}$. The beneficiary country still enjoys by a terms of trade gain, but not as great as before. Welfare rises by the area bounded by the demand and supply curves and by the price lines $p^*/(1+t_{MFN})$ and $p^*_{post-GSP}$, where t_{MFN} is an MFN ad valorem tariff rate. In this case, the export growth in the preference-receiving country reflects both trade creation, since tariff preferences reduce the internal price in the beneficiary country, expanding its consumption and contracting its home production and trade diversion, since the fall in the world price leads to a terms of trade loss for other countries that export to the beneficiary country, imposing the negative externality on the exporting countries that do not enjoy GSP schemes.

The analysis of existing schemes of granting unilateral tariff preferences allowed us to summarize them in the Fig. 2.

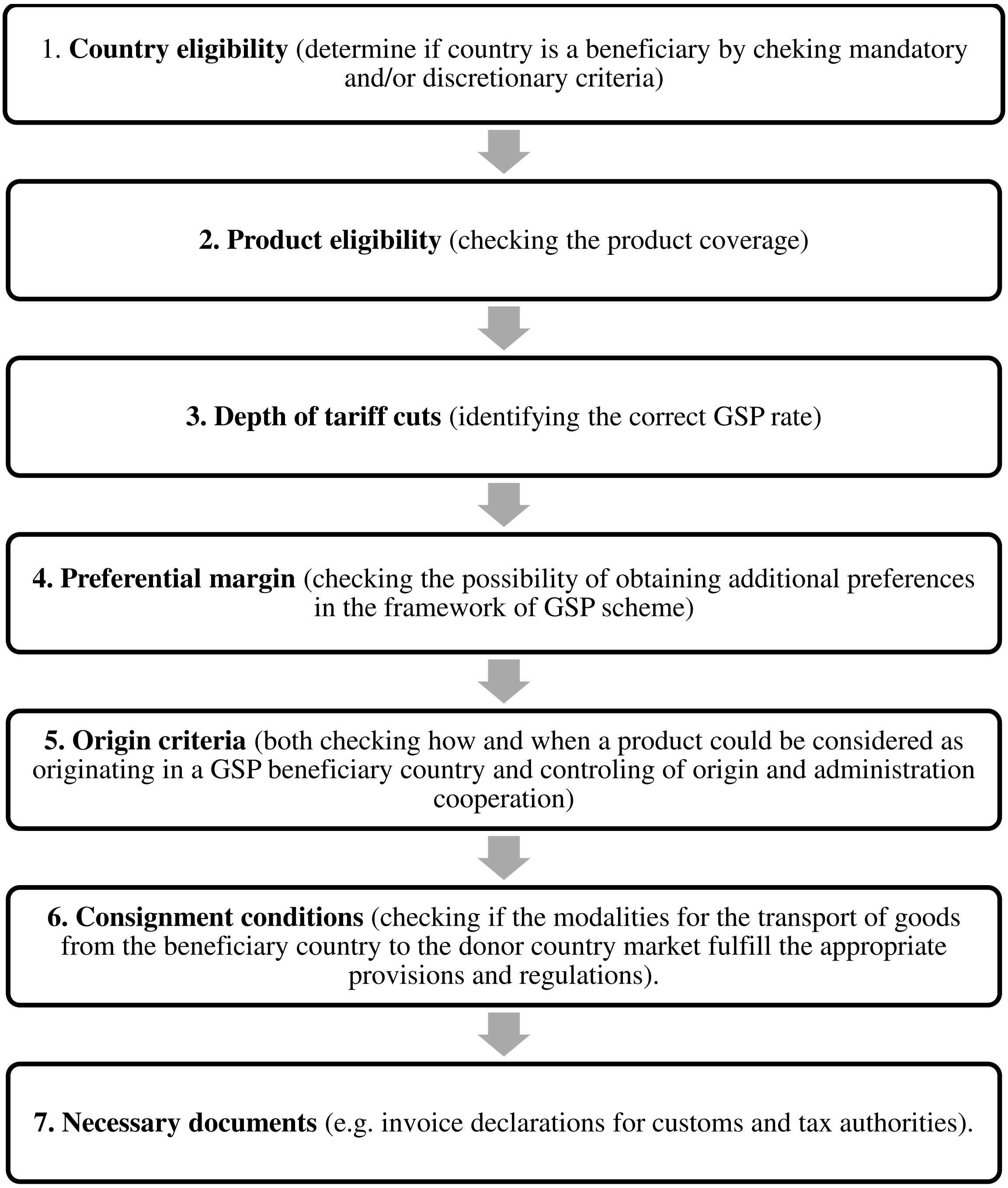

Fig. 2. General sequence of steps needed to beneficiary country in order to obtain non-reciprocal tariff preferences

Some possible conclusions derived from analysis above are the following.

1. The granting of tariff preferences could serve to promote trade volume and export earnings in the beneficiary countries.

2. Granting of tariff preferences faces both opportunity and compliance costs, which in practice diminish the benefits of GSP arrangements.

3. The macroeconomic benefits from tariff preferences in the long-run will be further diminished (or even become negative) if they lead to over-investment in the sectors that are eligible for GSP schemes. Such arrangements could distort invest-

ment decisions, rather than encouraging investment where long-term growth opportunities are present.

4. Preferential tariff arrangements may retard trade liberalization in preference-receiving countries, since applying the GSP schemes could reduce the incentive that export industries in developing countries have to lobby for trade liberalization at home in order to obtain access for foreign markets.

4. Ukraine and APTR with EU

Let's briefly investigate current situation with tariff regulation in Ukraine-EU commodity trade.

Now Ukraine applies import duties (general, reduced and preferential) for products originating in EU.

According to GSP provisions, Ukraine benefit from GSP for all products covered by the system except railway and tramway vehicles and products. Also Ukraine is eligible for the GSP+. If in the future it applies for and is granted GSP+ treatment, the above limitation will not apply.

Starting from May 2014 EU provided Ukraine the autonomous trade preferences in view of the security, political and economic challenges faced by Ukraine, and in order to support country's economy. Previously, EU governments applied import duties according Council Regulation (EC) №1186/2009 at rates common for all third countries.

Late in April 2014 EU provided Ukraine the APTR, involving the unilateral reduction or elimination of EU customs duties on goods originating in Ukraine: on April 16, 2014 the EU Council adopted an appropriate decision and on April 22, 2014 an appropriate Regulation of European Parliament and of the Council was published in the Official Journal of the European Union.

This Regulation provides that the appliance of the autonomous trade preferences will start from May 2014 and last until November 2014. Effective as of introduction of APTR, EU governments set import duties at the level of the first year after coming in force the Agreement of Deep and Comprehensive Free Trade Area (hereafter DCFTA) between Ukraine and EU.

In the framework of tariff and non-tariff regulation this proposal concerned the following commodities.

1. Industrial Products. Existing EU tariffs for industrial goods exported from Ukraine will be removed immediately for 94,7% of commodities. For the remaining handful of products (some chemical products, etc.) the tariffs will be reduced.

2. Agricultural Products. For agricultural goods, the EU has taken important but more limited action to open up its market to Ukrainian agriculture in order to ensure the European agricultural sector is not harmed by this unilateral trade action. Notably, the EU will grant immediate and unlimited preferences to 82,2% of Ukraine's ex-

ports. For the other products (cereals, pork, beef, poultry and a handful of additional products) a partial liberalization will be achieved by the granting of duty-free tariff rate quotas (TRQs), which limit the amount of certain goods able to benefit from the trade preference.

3. Processed food products. The EU will grant immediate preferences to 83,4% of Ukraine's exports. The remaining 15,9% will be partially liberalized through TRQs.

According to the Fitch's estimations, the approval of favorable tariffs and quotas would support long-term growth of Ukrainian exports to EU. Almost all Fitch-rated Ukrainian agricultural companies have substantial export sales. Most of them are focused on exports to Middle East, Asia and CIS countries, but at the same time they see the European Union as an attractive market for further export growth and diversification. Notably, greater opportunities may arise in southern and eastern European countries that are easier to service from Ukraine.

On September, 2014 the implementation of statements of Ukraine-EU Association Agreement, related to the DCFTA was postponed to the beginning of 2016. At the same time the APTR was unilaterally extended to the December 31, 2015. This means that after January 1, 2016 the import duty rates applied by EU governments to products originating in Ukraine, remained unchanged. Ukrainian government, in return, will start the gradual reduction of import duties for goods originating in EU in order to allow domestic economic agents to adjust to the new competitive conditions. The transition period will be 3-10 years, for automotive industry – 15 years.

In the period of APTR the EU leaves the possibility to use the conditions of GSP regime currently applied for Ukraine. This means that Ukrainian exporters could decide by themselves whichever regime they could use in order to export to the EU market.

5. Conclusion

Preferential trade regimes (GSP, GSP+, APTR) are established in order to increase reciprocal trade and to provide access to the internal markets of developed countries for commodities originating from developing countries by reducing or eliminating tariffs.

The unilateral tariff reduction or elimination under these schemes could lead either to trade creation or trade diversion, depending firstly form the presence of market power of beneficiary country. Ukraine now has no market power on the world commodity markets, and current situation with implementing of APTR arrangement involve further econometrical and statistical analysis in order to estimate the impact of non-reciprocal reduction of tariffs by EU governments on Ukrainian export flows.

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