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Graduation from the European Union's Generalized System of Preferences

A Bachelor Thesis

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Abstract

The European Union's Generalized System of tariff Preferences currently provides preferential access to 176 countries. In 2007 the total value of the preferential imports was €57 billion. The objective of the European Union's Generalized System of Preferences is to promote development through preferential trade. Thus the countries benefit from various tariff reductions and exceptions depending on their status as a developing country. However when the export from the countries grow they face the risk of being graduated, either in a specific export sector or the country as a whole. The graduation will force the countries to pay the higher normal tariff on goods exported to the European Union. Throughout the years countries has thus lost the preferential access once they managed to compete successfully with domestic production. According to the EU today a product group will be graduated once it has reached a level of competitiveness which is likely to ensure further growth without the preferential tariff reduction, this will ensure that the benefits of the preferential access target those in most need.

The purpose of the essay has been to examine how the graduation process has worked and to analyze how trade volumes have been affected by the sector graduation. This has been done by studying how the graduation process has changed throughout the years and by carrying out an empirical analysis on the graduations the recent years.

The graduation process has been simplified throughout the years and today the graduation process is more predictable and the GSP more stable compared to before. However according to the empirical analysis most countries whom had sectors graduated the recent years have seen a relative decrease in exports, hence it seems as graduated product groups haven't managed to stay competitive. If the European Union´s thought behind the graduation is that graduation only shall occur to competitive products they might have to review and change the graduation mechanism.

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Abbreviations and Acronyms

ACP	African Caribbean and Pacific
AGOA	African Growth and Opportunity Act
ASEAN	Association of South East Asian Nations
BRIC	Brazil Russia India and China
CCT	Common Customs Tariff
CN	Combined Nomenclature
EBA	Everything But Arms
EEC	European Economic Community
EPA	Economic Partnership Agreement
EU	European Union
GATT	General Agreement on Tariffs and Trade
GDP	Gross Domestic Product
GNI	Gross National Income
GSP	Generalized System of Preferences
LDC	Least Developed Countries
MFN	Most Favored Nation
OECD	Organisation for Economic Co-operation and Development
UK	United Kingdom
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
US	United States
WTO	World Trade Organization

1. Introduction

The Generalized System of Preferences (GSP) was born in 1968 when a resolution about tariff reductions for developing countries was accepted for the first time at the United Nations Conference on Trade and Development (UNCTAD). The objectives of preferences were to increase export earnings, promote industrialization and accelerate economic growth of developing countries. This was supposed to occur through "generalized, non reciprocal and non discriminatory preferences" (GATT 1971) for developing countries.

However more than 40 years later, only a few of the beneficiaries have actually had the fortune to experience the kind of rapid economic growth, strong enough to place them among the world's developed countries. The majority of the beneficiaries still struggle as developing countries with high poverty. Hence the ambitious objectives of trade preferences have not been close to being realized.

A wide range of factors could be the cause of the somber outcome. Examples include: too small preference margins, poor product coverage and restrictive rules of origin. The fact that tariffs have been least reduced (or the products have been completely excluded from the GSP) for products that the developing countries have comparative advantages in, is probably a big reason for the lack of success. These products are also the ones that would disrupt markets of the preference donors the most. Besides these problems there are plenty more, that could have played part.

However, I have chosen to look closer at the graduation mechanism, which throughout the years has graduated products and countries from the preferential treatment once they managed to compete successfully with domestic production.

The reasoning behind today's graduation process given by the European Commission (2009) is that the product has reached a level of competitiveness which is likely to ensure further growth without the preferential tariff reduction, and that the graduation process will ensure that the benefits of the preferential access target those countries in most need.

Currently the European Union´s Generalized System of Preferences provides preferential access to 176 countries. In 2007 the total value of preferential imports under the GSP was €57 billion. According to the European Commission (2010d) the primary objective of the GSP today "is to contribute to the reduction of poverty and the promotion of sustainable development and good governance".

1.1 Purpose of study

The objective of the European Union’s Generalized System of Preferences is to promote development through preferential trade. Thus the countries benefit from various tariff reductions and exceptions depending on their status as a developing country. However, when export grows they face the risk of being graduated, either in a specific export sector or the country as a whole. The graduation will force the countries to pay a higher tariff on goods exported to the European Union.

The purpose of this essay is: to describe how the graduation process of the EU’s GSP has worked, to examine the trade impact of the sector graduation and to discuss the possible risks and opportunities of the graduation process.

There are a wide range of articles and research done on preferential trade and the Generalized System of Preferences. However, this paper’s focus on the EU’s graduation process is quite unique and will bring something new to the table when it comes to studies of preferential trade. The European Union regularly performs reviews of their GSP and this paper’s focus on the graduation might bring some new insight that can be useful in these reviews.

1.2 Delimitations

According to UNCTAD (2010) there are currently 13 nations besides the EU that offers preferential access under different GSP schemes; however this paper solely focuses on the EU´s GSP scheme.

As stated earlier a wide range of factors could be the cause of the modest result when it comes to reaching the early objectives of the GSP. Even the very fact that the preferences offered under the GSP are good for development has been questioned (Ozden and Reinhardt 2003). However, the focus on this paper is the graduation process.

1.3 Structure

The paper starts with a presentation of the GSP in section two. The section includes a background of the GSP and describes the current GSP of the European Union. In order to give a context to the GSP it also contains a description of the other preferential trade agreements governing the European Union´s trade.

Section three of the paper provides a theoretical background of the GSP. This presents the static and dynamic economics of trade preferences and also explains the concepts of trade creation and trade diversion. The section is concluded with a theory that analyzes the fact that trade preferences often are focused on the poorest countries.

Section four is devoted to the graduation process. It starts off with a definition, brief description and background to the graduation mechanism. The section also includes an exposition of the European Union's graduation process throughout the years.

Section five of the paper contains an empirical analysis of how trade volumes have been affected by sector graduation.

Section six summarizes and contains a concluding discussion.

2. GSP - History and Patterns

2.1 The early history

During the first half of the 20th century the developing countries position in international trade was getting worse relative to the trade of the developed countries[1]. The early trade negotiations in the General Agreement on Tariffs and Trade (GATT) context took place between the developed countries and thus naturally represented their interests. Since manufactures was something that was being produced in the developed countries, trade liberalization occurred in this area. Developing countries did not yet have a good ability to produce these products and thus gained very little from trade liberalization. At the same time protection against agricultural and textile imports increased. And these were sectors in which developing countries had comparative advantages.

Another problem was the structure of tariffs facing the developing countries as a result from the GATT negotiations. The structure was set up so that raw materials faced low tariffs while processed material faced high tariffs. This contributed to the slow industrialization process of the developing countries by inducing them to export raw material instead of building up processing industries.

However in the beginning of the sixties the problems facing the developing countries concerning trade began to be recognized even in the GATT forum. A program of action was declared in 1963; unfortunately the program didn't lead up to much change. Instead the developing countries turned to the United Nations (UN) to address their problem. Since the number of developing countries joining the UN was increasing, a shift in the UN towards the topics of interests for developing countries occurred.

In 1961 the developing countries of the UN proposed for a conference about trade and development. The voting for the conference turned out in favor of the developing countries with 44 votes for and 36 against, the opposition came from the richer developed countries.

The United Nations Conference on Trade and Development was held in the spring of 1964 and it was there that the concept of trade preferences for developing countries was introduced for the first time. The aim of the conference was to establish a new trade order that would increase the developing countries' wealth through trade instead of the traditional aid. The

[1] The following is based on Murray (1977)

conference didn't really succeed with its ambitious goal; however a permanent UN organ by the name of UNCTAD was established.

A lot of negotiations regarding trade preferences for developing countries followed the establishment of UNCTAD. Since preferences were perceived to not only cause injury to domestic producers but also to increase competition among exporters, the Organisation for Economic Co-operation and Development (OECD) countries faced lobbies from both domestic industries and export competing industries (which usually are the pro trade supporters). Among the most vocal of the opponents against trade preferences was the US.

In 1968 a second UNCTAD conference was held in New Delhi. At this conference the US proclaimed their participation; the principle of tariff reductions for developing countries was formally accepted as a resolution. A special committee was established for negotiation with the developed countries. In 1969 the original OECD countries were the first submit their offers. However the agreement violated the MFN principle under GATT and a special ten-year waiver authorized the preferences legally in 1971. The same year the EEC countries were the first to implement a preference scheme towards developing countries. Other developed countries followed[2].

2.2 The European Union's GSP – Today

Today 176 countries enjoy preferential access for a wide range of products to the European Union under its GSP scheme. The European Union's last renewal of its GSP scheme occurred in 2006 and the current scheme is supposed to last until 2015 with scheduled regular updates of the regulation every three years. According to the European Commission (2008a) "the primary objective of the GSP is to contribute to the reduction of poverty and the promotion of sustainable development and good governance". This will be achieved by preferential access which allows developing countries to participate more in the world trade economy and thus will give them increased resources to develop according to their own poverty reducing and sustainable development policies.

In 2007 the value of total GSP preferential imports was €57 billion and the largest sectors receiving the preferences were; Textile and Clothing (€13.1b), Machinery (€5.8b), Mineral

[2] A more detailed account of the early history of the GSP is found in Murray (1977 p. 5-17).

Products (€5.1b), Plastics and Rubber (€4.5b), Base Metals (€3.8b), Footwear and Animals & Animal Products (€3.5b) (The European Commission 2009). However compared to total EU trade, the importance of preferences is still low, in 2008 5.1 percent of the European Union's trade entered under the GSP arrangement while 86 percent entered under MFN arrangements (the rest entered under other regional trade agreements or couldn't be classified). A great amount of trade from the GSP eligible countries also enter under MFN=0, in 2008 64 percent of the trade to the EU from GSP-countries entered under a MFN tariff of zero (Gasiorek et al. 2010 p.22, 33).

The GSP scheme consists of three different GSP arrangements; GSP, GSP + and Everything but Arms (EBA). GSP is the general GSP arrangement, GSP + is a "special incentive arrangement for sustainable development and good governance" (European Union 2008a) and EBA is a special arrangement for the least developed countries.

The general GSP arrangement covers 6244 products which are categorized into non-sensitive and sensitive products with about 50 percent of the products placed in each category. The non sensitive products are granted duty free access to the community market and the sensitive receives a reduction of the tariff rates of 3.5 percentage points of MFN tariffs rate (ex 17% - 3.5% = 14.5%) While textile products receives a reduction of 20 percent and specific duties is reduced by 30 percent. In 2007, €47.8 billion worth of trade occurred under the General Arrangement and the three largest users were; India (11.7b), Brazil (4.4b) and Thailand (4.2b).

The GSP+ arrangement is designed to give additional preferences to countries considered vulnerable by the EU. The countries also have to ratify and implement 27 specific international conventions concerning human rights, labor standards, sustainable development and good governance in order to be eligible for the arrangement. Countries are considered vulnerable by being poor and having a low degree of diversification. The criteria are; that the countries are not considered high income countries by the World Bank, total GSP covered exports have to be less than 1% of total EU imports from the GSP beneficiaries, and the country's five largest sectors of GSP covered exports have to represent more than 75% of its total GSP covered exports.

Currently GSP+ covers 6336 products which either enjoys additional tariff reductions or duty free access to the community market. In 2009 sixteen countries enjoyed the extra preferential access of GSP+ and in 2007, €4.9 billion worth of trade occurred under the scheme. The five largest users were; Sri Lanka, Ecuador, Peru, Colombia and Costa Rica.

The EBA arrangement gives duty free access to the community market for all products except for arms. The arrangement is available to all countries classified as a Least Developed Country (LDC) by the UN. There are currently 49 countries belonging to the category. The criteria to be classified as a LDC by the UN are that the country has to have an average Gross National Income (GNI) per capita below 750 USD for three years. Score below a certain number on a Human asset index and score above a certain number on an economic vulnerability index. The country also has to have a population less than 75 million (United Nations 2010).

In 2007, €4.3 billion worth of trade occurred under the EBA arrangement and the five largest users were Bangladesh, Cambodia, Laos, Nepal and the Maldives (The European Commission 2009).

Table 2.1: The three GSP arrangements

2007 data	GSP	GSP+	EBA
Type of arrangement:	General	Special incentive	Special for LDCs
Available to:	Countries not classified as high-income and sufficiently diversified in exports (according to a criterion).	Vulnerable countries (according to a criterion) who ratify and implement specified international conventions.	Countries classified as LDC's by the UN.
Product classification:	Around 3200 non sensitive and 3000 sensitive.	-------------------	------------------
Tariff reduction:	Non Sensitive Products: duty free, Sensitive Products: 3.5 % points of MFN rate, Textile Products 20 % reduction	Ad valorem and specific duties suspended on all covered products (with exceptions).	Duty free access for all products.
Beneficiary countries	176	16	49
Product coverage	6244 products	6336 products	7140 (All products except arms)
worth of trade (€ millions):	47848	4900	4302
Nominal Duty Loss (€ millions):	1,542	0,501	0,505

Source: Statistics from the European Commission (2009) and the European Commission (2008a).

2.3 The GSP in a context

Besides the generalized system of preferences and the World Trade Organization (WTO) negotiations there are a lot of preferential trade agreements governing the European Union's trade. Currently the union has notified the WTO of 28 regional trade agreements in force (World Trade Organization 2010a). And according to the WTO's Trade Policy Review Body (2009 p. 20) only a few (at the moment of writing; 9) countries trade with the community is actually governed exclusively by the European Union's WTO bound Most Favored Nation tariffs. Countries with other agreements are also expected to use these rather than the GSP when exporting (even though they formally could use the GSP)

These regional trade agreements consist of various bilateral negotiated free trade areas with different regions, and countries as distant as Mexico and South Africa. The European Union previously also maintained a special preference system with developing countries from Africa, the Caribbean and the Pacific (the ACP countries). Another special arrangement which targets several developing countries is the arrangement with the Mediterranean countries.

Besides the GSP, these are the two arrangements which have been targeting most developing countries.

The ACP preferences origins all the way back from the Treaty of Rome in 1957. In the treaty it was envisaged that the European Union should take extra care of countries with colonial ties to the Union, through investment contributions and abolished custom duties (European Union treaty, Consolidated Version 2002). This later took form by the signings of the Yaoundé agreements in the sixties. When the UK joined the union in the seventies, a new agreement was signed; The Lomé convention. This agreement included trade preferences more far reaching then the preferential access under the GSP. The Lomé convention was updated 3 times, however since the trade preferences were discriminatory to other developing countries the convention had to be covered by WTO waivers. Thus after Lomé IV expired in 2000 (in order to abide by the WTO rules) the Cotonou agreement was signed between the community and 77 ACP countries instead (acp-eu-trade.org 2010).

The basics of the Cotonou agreement is that through Economic Partnership Agreements (EPAs), the ACP preferences is supposed to be turned into various (WTO compatible) free trade areas between the Union and six groups of ACP countries. Hence following transitional periods the non reciprocal trade preferences will be replaced by reciprocal access through free trade areas. Currently there is only one signed EPA; this is between the union and the Caribbean region. The other EPA's are still being negotiated and the trade instead occurs under interim agreements, the GSP or EBA (European Commission 2010a).

According to Bicchi (2004 p.3), European-Mediterranean preferential trade first started in the 1960s through bilateral association agreements between Europe and a few Mediterranean countries. In the seventies the cooperation was extended to more countries and a Global Mediterranean Policy which treated the Mediterranean countries as a homogenous region was born. However the current trade is governed through the Euro-Mediterranean partnership which first got launched at the Barcelona conference in 1995. On the agenda of the conference was the creation of a free trade area between the European Union and the Mediterranean countries. Currently 16 Mediterranean countries are included in the partnership. According to the Barcelona Declaration, the free trade area was supposed to be completed by 2010. This has been postponed and the trade is currently still governed by bilateral association agreements between the EU and the individual countries (European Commission 2010b).

Besides these already mentioned agreements several new free trade agreements are currently being negotiated between the union and; The Andean community, Central America, Gulf states, Ukraine, India, South Korea and the Association of South East Asian Nations (ASEAN) (World Trade Organization 2009 p. 28-30).

Hence because of the large amount of free trade arrangements which governs the European Union's trade, the preferential access of the GSP is actually not as favorable as it might seem. When comparing the regular GSP scheme with WTO compatible free trade agreements the tariff reductions of the regular GSP are lower. However the EBA for the least developed countries (which offer duty free access on a wide range of products) offers a non reciprocal access which can be compared to free trade area access (although the rules of origin of EBA are more restrictive).

3. The economics of trade preferences

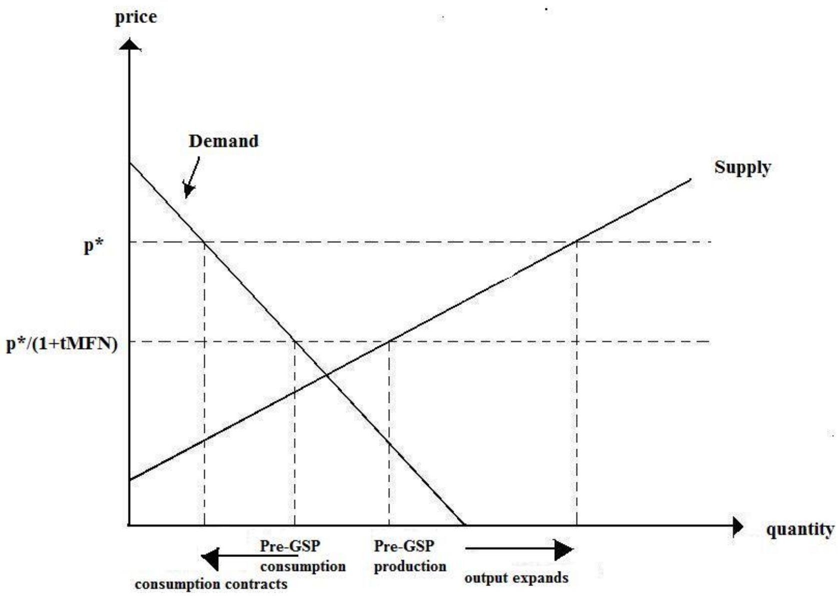
3.1 Gains from preferential access

The economic objective of tariff preferences is to boost trade and accelerate economic growth of recipient developing countries. This is hoped to occur both through static and dynamic gains. The static gains of a price advantage will increase export and export earnings. This in turn will also bring about the dynamic gains. The static gains can be analyzed both through a small and a large country assumption according to Grossman and Sykes (2007 p. 271).

3.1.1 Small country assumption

If the country receiving the trade preferences is a small country or the whole group of countries that receives them is small together then the countries are unable to affect the world price. Hence they face a given world price for the commodities which they export under the preference scheme. If they would face the world price of P* and a MFN-tariff, then they must sell their exported goods at the price: p*/ (1 + MFN tariff) in a competitive equilibrium. This will also be the price on the market in their home country; they will not want to charge less for it since the profit then would be higher when exporting the goods. If the country is granted preferential access then it will not have to pay the MFN duties hence it can export and sell the commodities at the price p*. At this higher price exports will increase, however because the price will increase in the home country as well, consumption will decrease in the home country. The producers of the exported goods will gain both because of the higher price and the increased output. Some of the gains for the producers come from decreased domestic consumer surplus because of the increased domestic price. However the country's total welfare has increased. Since the price of other exporting countries without preferential access remains at p*/ (1 + MFN tariff), they don't suffer. The gains from the preferential access are due to trade creation.

Figure 3.1: Small country assumption



Source: Grossman and Sykes 2007 p. 272

3.1.2 Large country assumption

If the country benefiting from trade preferences is a large country or the whole group of countries that receives them is large together, the countries will be able to affect the world prices. The countries receiving the preferences will export more to the higher price, this will in turn increase the supply of the commodity on the world market; hence the world price will get lower. Since the world price has decreased the gains will be smaller for the country that receives the preferences. The total welfare will increase but not as much as for the small country. The price on the domestic market will still increase while the price in the preference granting country will get lower. However this time the gains from the preferential access are due to both trade creation and diversion. Since the world price falls the production in the preference granting country is decreasing while the consumption is increasing. Thus the preference receiving country can increase its exports, but this also occurs on the expense of other countries because of the fallen world price (Grossman and Sykes 2007 p. 271-273).

Figure 3.2: Market in preference receiving country

Figure 3.3: Market in preference granting country

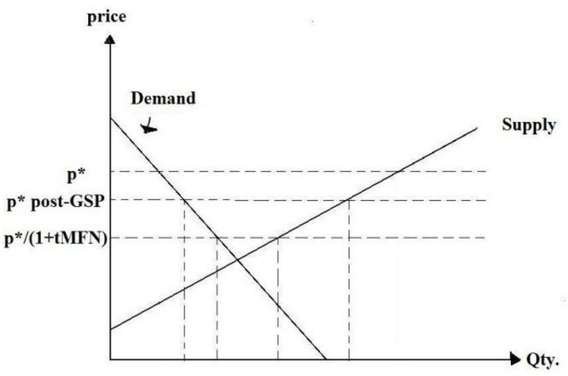


Figure 3.2

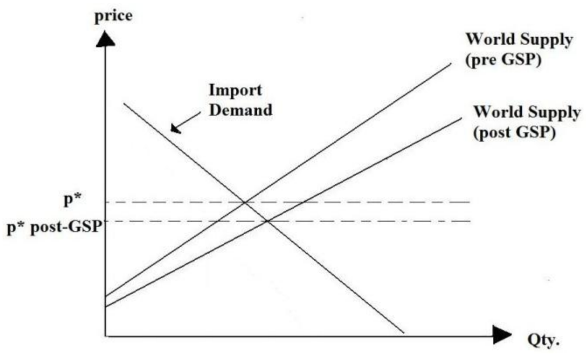


Figure 3.3

Source: Grossman and Sykes 2007 p. 273

3.2 Trade creation and diversion

The gains of preferential trade are similar to the gains from a formation of a customs union. The static gains of the GSP can thus be divided into two different effects; trade diversion and trade creation.

The meaning of trade creation is that the increased export from the preference receiving country is replacing domestic production due to an increased demand in the preference granting country. Since the foreign production succeeds with replacing domestic production it must be more cost efficient and there is a static gain in total welfare.

When trade diversion occurs increased export is replacing exports from other countries which originally had faced the same tariffs. The preference receiving countries exports only succeed to compete because of the lower tariffs, it might be both more costly to produce and less efficient. Hence it is not economically optimal and distorts trade in a way which implies a welfare loss and could inflict damage on countries receiving less preferential access.

Both trade diversion and trade creation would be beneficial to the beneficiary of the preferences since the sum reflects the gain of the increased export (Langhammer and Sapir 1987 p. 29-30).

However when it comes to graduation, trade diversion would benefit the remaining beneficiaries if they have similar export capacity and thus can manage to take over the trade of the graduated country. If the remaining beneficiaries don't have similar export capacity they will not be able to take over the trade. The result of the graduation would be a decrease in trade creation and the domestic import competing industry would be the only one to gain from the graduation.

3.3 Dynamic effects

Besides the static gains of tariff preferences and redistribution of income in favor of the developing world, there are also dynamic benefits that can be achieved, and will lead to the economic growth of the beneficiary country.

Langhammer and Sapir (1987 p.8) state, that the two arguments which have been used for tariff preferences are those of the infant industry argument and economies of scale. According to the economies of scale argument, the current market in developing countries is too small to support industries on a cost-effective scale. Since the market is too small the country's industry will not develop and the country stays under-developed. Introducing tariff preferences will increase the market through increased export and the industries can make use of economies of scale. This will lead to increased investment and income, which in turn will expand the domestic market, and thus increase the rate of the economic growth.

The infant industry argument states that industries in developing countries have smaller chances of competing with industries of developed countries since they are less developed and thus less efficient. In order to be able to grow and compete internationally the industry needs protection until it reaches the stage where it is competitive. At this stage it might also be able to generate learning spillovers and positive externalities to other industries. In the case of preferences it could be viewed as an aid to the industry that works in the same way as protection.

These two arguments assume increased exports and investments. A reduced tariff might influence export-oriented investment decisions at the margin and thus the preferences might impact and increase investments in the beneficiary country. This could in turn lead to increased economic growth. However, for the GSP to affect investment, this of course also requires an already stable market with all the other prerequisites affecting investments fulfilled. It is also very important that the tariff relief is reliable and predictable (Langhammer and Sapir 1987 p.72-74)

Since the tariffs facing the developing countries at the introduction of the GSP was constructed in a way that encouraged the exports of raw materials instead of processed goods. Tariff preferences for manufactured products were also supposed to increase incentives of building up processing industries and thus bring about an increased rate of industrialization in the developing countries (Murray 1977 p. 25-26).

3.4 Trade preferences to the poorest

The reasoning behind graduation given by the EU is that it will ensure that the benefits of the preferential access target those in most need. This is supposed to occur through the transfer of preferential margins. As explained above, transfer of preferential margins might benefit the remaining beneficiaries if they have similar export capacity. However, Arne Melchior (2005) of the Norwegian Institute of International Affairs provides a different perspective on graduation.

If developed countries fear import competition from large developing countries like India and China they might be induced to narrow the focus of tariff preferences to the LDC's which accounts for only a small part of the world export. Melchior uses a neoclassical trade model to analyze this;

According to the model underdeveloped countries have a low capital/labor ratio. As these countries develop, their capital/labor ratio increases and the countries become more efficient in producing labor intensive products. Thus the exports of labor intensive goods from the developing countries also increase. This increased export puts wages and prizes of labor intensive products in the developed countries under a downward pressure, while the accumulated capital in developing countries makes their wages increase. Once the countries reach a certain capital/labor ratio, factor price equalization occurs and the wages are equalized. At this point labor intensive exports from developing countries will decrease.

Hence as the capital/labor ratio increases, the developing country becomes more efficient and the threat to the wages in the developed countries increases, but at a certain point the threat disappears.

Thus according to this theory the "threat" of import competition will disappear when it is the greatest. This could be applied to China and other countries which currently are putting downward pressure on labor-intensive goods and wages. Instead of limiting and graduating the exports of China and other similar countries it would hence be economically best to help them achieve further growth and capital accumulation which will make their wages rise. This type of capital accumulation has already happened in Hong Kong and Korea. Since China is such a big country it may, however, take a while longer for it to occur in China.

However because of the downward pressure on labor-intensive goods and wages in developed countries this type of policy carries, it might be politically hard to implement.

Even though the least developed countries may gain temporary static gains from the decreased competition of China through graduation, the long run dynamic gains of a more developed China with increased wages would probably be greater. China would then no longer pressure wages and prices on labor-intensive goods which are exported from developing countries.

4. The Process of Graduation

The basic idea with the GSP system is that preferences are good and should be directed towards the neediest. In order to select who the neediest are, one also has to do some sort of differentiating. With differentiating comes the need for a graduation mechanism. The graduation mechanism will graduate countries that have reached further in their development and thus hopefully benefit the remaining beneficiaries.

Langhammer and Sapir define the principle of graduation in the following way: “According to this principle, preferential treatment would be gradually withdrawn from individual advanced developing countries, depending on their development, and on their financial and trade needs” (1987 p. 75).

This is a good way of defining the original idea with graduation. However, as will be made clear in the following text, the GSP has changed throughout the years. Consequently the graduation process and the criteria regulating graduations have also changed. This makes Langhammer and Sapir’s definition a bit flawed and narrow. Graduation has not always occurred gradually and the reason for graduation can also sometimes be debated. In order to fully cover the evolution of the graduation process, I have chosen a broad view of the concept of graduation. If a country or a sector is being withdrawn from the preferential treatment, either gradually or directly (and the withdrawal not is due to a violation) they are being graduated.

4.1 The background

Graduation was neither mentioned in the original GSP scheme of 1971, nor in the special waiver which made the GSP legal for ten years.

Instead the concept first originates from the WTO Tokyo round where it was negotiated in the enabling clause (officially named the Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries) during 1979. Before 1979 the GSP conflicted with the GATT rules and this conflict had been resolved by special waivers. However during the Tokyo round the developing countries wanted to make it permanent on a legal basis. The developed countries on the other hand didn’t want to make it legal unless there was a possibility of graduation (Abreau and Fritsch 1987).

A framework group was put together in 1976 to “seek to negotiate improvements in the international framework for the conduct of world trade, particularly with respect to trade between developed and developing countries and differential and more favorable treatment” as stated in the notes by the chairman (GATT Trade Negotiations Committee 1976). In the GATT decision of 1979 they presented their work in the enabling clause which would make the GSP legal.

According to paragraph 7 in the enabling clause; less developed countries are expected to participate more fully in the GATT agreement with the progressive development of their economies. The enabling clause thus permits developed countries to – to some extent – discriminate among developing countries and also to give special treatment to the least developed countries according to paragraph 2d (GATT 1979). It was the developed countries that insisted on this clause in the final agreement because they argued that they shouldn’t have to continue give preferential treatment once the developing countries had developed (Kirkman 1989).

Since the original intent of the GSP was to promote economic growth through increased export, the graduation concept could be viewed as a way to exclude the beneficiaries once they have reached a higher rate of economic growth. The remaining beneficiaries will then have the possibility of benefiting more (Kirkman 1989). However one could also view the developing countries wishes’ for the possibility of graduating as protectionism, built upon worries about the increased export from developing countries (Abreau and Fritsch 1987). During the time of the Tokyo round, the OECD countries suffered from the first oil shocks and the world experienced an economic downturn. At the same time there was also a rapid increase of cheap imports from developing countries. According to Boltho (1996) the developed countries responded with a sharp increase in non-tariff protectionist measures.

At the fifth UNCTAD meeting which took place in Manila during the spring of 1979 the developing countries in the Group of 77 responded to the concept of graduation. According to the rapport by the Swedish Ministry of Foreign affairs and Trade (1979 p. 34), it was criticized on the grounds that it gave the developed countries the rights to arbitrarily and unilaterally decide on which countries and products that would be ready for graduation. The developed countries of Group B in UNCTAD were divided about whether to even discuss principles and criteria for graduation with the developing countries.

4.2 The evolution of the European Union's graduation system

4.2.1 The early years

The European Union first implemented its GSP regime in 1971. The foundation from the beginning were full tariff relief for most manufactured and semi manufactured products with certain exceptions and conditions, among others quota restraints which were renewed annually. Cotton and textile products were still controlled by the Multifibre Arrangement until 1980, when the community offered preferential access to countries which had bilaterally negotiated voluntary export restraints with the community (Langhammer and Sapir 1987 p. 20).

The GSP regime had a classification of non sensitive, semi sensitive and sensitive products, all which were granted different preference margins. Non sensitive product status was granted to products which didn't threaten domestic industries and thus received duty-free access. The semi-sensitive category consisted of products which might affect domestic industries; hence they were kept under surveillance and faced a tariff of 35 % of the Common Customs tariff (CCT) (Abreau and Fritsch 1987). The sensitive products faced a tariff of 70 % of the CCT. They were restricted by quotas under which they faced MFN tariffs if they reached the ceilings of the quota. There was also a maximum amount rule that limited the share of any country to avoid a crowding out effect by the bigger countries.

In 1977 the European Union introduced special rules for the least developed countries. These rules provided additional preferential access and an extended GSP-covered product range to the least developed countries (Langhammer and Sapir 1987 p. 21).

Since the beginning the Union carried out a comprehensive review of the GSP program every ten years, and in 1981 the GSP scheme was renewed for 10 years further. In accordance with the review of 1981 the union created a new category of very sensitive products which had a tariff of 85 % of CCT (Hoekman and Özden 2005). The new category was restricted by different types of quotas and tariffs which could be re-imposed by requests of member states (Abreau and Fritsch 1987).

To conclude, the early years of the European Union´s GSP were characterized by the different product classifications which were restricted by an extensive use of quotas instead of a graduation mechanism.

In 1986 a limited midterm review of the GSP took place. The next review and renewal of the program was supposed to occur in 1991 however it was postponed until the end of the GATT Uruguay round negotiations. The new regulation was put into force in December 1994.

4.2.2 1995 – 1998

The new GSP regime of 1995 was supposed to "consolidate the GSP's role as a development instrument by simplifying its administrative procedures, improving the distribution of its benefits and assigning it new goals in the social and environmental fields" according to the European Commission (1995).

As stated earlier in the text, the union had updated the preferential arrangements annually with the renewal of various quota restraints. Now, however, the goal was to create a more stable market for the beneficiary countries and the arrangements were supposed to be valid for periods of 4 years. This was however only going to cover the industrial products. For agricultural products the arrangements were supposed to be reviewed again in 1996 (the following year) and then reach over three year periods.

The arrangement for the industrial products was supposed to be based on two mechanisms; tariff modulation and a safeguard clause. All quota restraints or quantity limits were abolished and instead the new GSP was to be controlled by the different product classifications. The quantity limits were also replaced with a safeguard clause that was supposed to protect domestic industries. However the safeguard clause was much stricter "it can be brought into play in exceptional cases, where community producers are caused or are threatened by, serious difficulties" (The European Commission 1995) and thus fell more into compliance with the GATT safeguard clause.

According to the European Commission (1994) the priority of the new GSP scheme in 1995 was to "increase export opportunities on the community market and boost actual take-up of preferences for the ordinary or least developed developing countries". They concluded that the way to succeed with this was by transferring preferential treatment, through graduation.

While the last systems' graduation process relied heavily on different restraints and quotas, the system of 1995's graduation process relied on an evaluation process of "the industrial capacity achieved by each beneficiary in each major production sector" (The European Commission 1995). The GSP would be gradually withdrawn in a specific sector of a country if it was determined that the country didn't longer require its help. In the first step there would be a 50% reduction in the preferential margin, and in the second step the production sector graduated completely.

The criteria for the sector/country graduation process were built upon a combination of two indices. The first of these was a development index which reflected a development criterion based upon the country's per capita income and the level of manufactured export compared to the union. The other index was a specialization index which measured relative industrial specialization. This was based upon the relationship between the preference receiver's share of total import to the union and the preference receiver's share of the total import within a certain sector (The European Union, Council Regulation 1994).

1. Development index

The development index refers to a country's level of industrial development. It compares that level to the one of the European Union, using the following formula:

$\{\log[Y_i/Y_{ue}]+\log[X_i/X_{ue}]\}/2$

Where:

Y_i = the beneficiary country's gross national product per capita,

Y_{ue} = the European Union's gross national product per capita,

X_i = the value of the beneficiary country's manufactured exports,

X_{ue} = the value of the European Union's manufactured exports.

Manufactured exports are those of Standard International Trade Classification (SITC) 5 to 8 less 68.

2. Specialisation index

The specialisation index refers to the importance of a sector in the Community imports from a beneficiary country. It is based on the ratio between that country's share in imports from all countries, of all products of the sector concerned, whether included in the preferential arrangements or not, and its share in all imports from all countries.

3. Thresholds

Development index	Threshold for the Specialisation index
= or > - 1,00	100 %
< - 1,00 and = or > - 1,23	150 %
< - 1,23 and = or > - 1,70	500 %
< - 1,70 and = or > - 2,00	700 %.

There were three exceptions to the country/sector graduation:

1. Total exclusion of the most developed countries which had a GDP per capita of over 6000 US-dollar during 1991.

2. The lion's share clause; which stated that countries responsible for more than 25% of the exports to the EU in a GSP covered sector was to be removed from GSP eligibility in this sector.

3. Minimal share clause; the countries whose share was less than 2 % in the specific sector were excluded from graduation.

Besides these graduation criteria, the GSP regulation of 1995 also launched two special incentive arrangements which would be available from 1998 (The European Union, Council Regulation 1994). The incentive arrangements would give additional preferences to countries who adopted certain social and environmental policies. According to the European Commission (1995) these arrangements were set up "to offset the extra cost incurred by the countries concerned in introducing such policies".

A special GSP scheme with complete tariff relief for countries combating drug trafficking had also been approved 1990 and was extended in 1995.

The least developed countries also enjoyed special treatment which consisted of duty-free exports for industrial products.

However agricultural products remained a sensitive topic with far more limited tariff reductions than industrial products. According to the commission this was "primarily because the priority GSP objective has always been to foster the industrialization of the developing countries rather than encourage exports of primary products" (European Commission 1995).

To conclude these years; the large usage of quotas was abolished in 1995 and replaced with various graduation mechanisms. This was in the spirit of the Uruguay Round which promoted conversion of quotas into tariffs. Sensitive sectors in the EU's domestic market was said to be protected by the emergency safeguard clause and the modulation of preferential tariff margins through the different product sensitivity classifications. The graduation mechanisms were supposed to have been put in place in order to increase take-up of the preferences for less developed countries.

4.2.3 1998 - 2005

The next renewal of the GSP regulation occurred in 1998, only minor changes were done this time. The special incentive arrangements were in effect and the beneficiaries under the scheme were excluded from the country/sector graduation mechanism. The graduation of high income countries had also been modified, the country was graduated from the GSP if it had higher than -1 on a development index and a higher per capita income than a member state of the community (8210 USD for 1995). The countries scoring on the index depended on its manufactured export to EU and its GDP per capita (The European Union, Council Regulation 1998).

In 2001 the European Union's GSP scheme was updated once again. The classification of the sensitiveness of products was simplified to only contain the two categories non sensitive and sensitive. The non sensitive products had full tariff exemption and the sensitive products only received 3.5 % points of MFN tariff rate.

In order to be excluded on the ground of being a high income country the criteria for exclusion now had to be met during three consecutive years. The exclusion should be applied once a year and the countries were readmitted if they failed to meet the criteria for three consecutive years. This rule was also put in effect for the sector graduation (The European Union, Council Regulation 2001).

In 2001 a special arrangement for the countries classified as least developed countries (LDC) by the UN also was introduced. Previously these countries had enjoyed additional preferential access, now however the special arrangement was extended even further. The new arrangement was named EBA and meant full tariff relief for the LDCs on everything but arms (Chapter 93 - Arms and ammunition, was excluded). In the beginning there were exceptions on sugar, rice and bananas which were phased out between 2006 and 2009 (Panagariya 2002). In order to be classified as an LDC by the UN the country have to have an average GNI per capita below 750 USD for three years, score below a certain number on a human asset index and score above a certain number on an economic vulnerability index. Countries with a population greater than 75 million are not eligible (United Nations 2010).

To conclude these years; the predictability of the GSP scheme increased in 2001 when the rule of three consecutive years was added to the graduation criteria. The system of using indices was extended to the exclusion of high income countries and the LDCs preferential access was extended.

4.2.4 The recent years

In 2006 the GSP was updated for a new 10 year cycle (2006-2015). Following the update the union reduced the number of different schemes from five to three. The regular GSP and EBA remained but the different special incentives schemes was reduced to one scheme called GSP +. This scheme was according to the European Commission (2008b) supposed to be a “special incentive arrangement for sustainable development and good governance”, and provided far more additional preferences then the regular GSP scheme. In order to qualify for the new GSP + scheme the countries had to comply with 27 international conventions (related to sustainable development and good governance) have low diversification and be small beneficiaries. The criteria were; that the countries not were considered a high income country by the World Bank, total GSP covered exports had to be less than 1% of total EU imports from the GSP beneficiaries, and the countries five largest sectors of GSP covered exports had to represent more than 75% of its total GSP covered exports.

The sector graduation process which was now justified by the fact that the graduated countries no longer needed GSP to help exports was made simpler. Instead of the previous index-based criteria, product groups were now graduated if the export of a product group from a country on average exceeded more than 15% (12.5% for textiles) of total exports of the product group to the union during three consecutive years. However a country with more than 50% of their total export represented by a single group would not be graduated (European Commission 2004).

A country could also be completely removed from the GSP scheme, if it was classified as a high income country by the World Bank during three consecutive years, and when the country’s five largest sectors of GSP covered exports represented less than 75 % of its total GSP covered export to the union (European Union, Council Regulation 2005).

A new paragraph was also added to the article governing the EBA scheme. If a country was removed from the UN's list of LDC's, the Commission should decide on a transitional period for at least three years for removal of the country from the scheme.

At the end of 2008 the current regulation from 2005 expired and the EU adopted a new regulation valid from 2009. The new regulation remained the same substance as the old in order to "ensure continued stability, predictability and transparency" as desired by the users, according to the European Commission (2008a).

To conclude the recent years of the graduation process consisted of a simplification. The earlier index-based graduation was abolished and replaced by a simpler criterion with few exceptions. In order for exports of product groups to still be eligible for the GSP a country was not allowed to exceed 15 % of total export to the union for the product group. The special arrangements were abolished due to a ruling in the WTO after complaints by India. Instead the EU launched the GSP+ arrangement.

5. Graduation – Implementation and trade effects

5.1 Sector graduations and de-graduations the recent years

In 2005, Brazil, China, Algeria, Indonesia, India, Malaysia, Russia, Thailand and South Africa lost preferences in certain sectors according to the sector graduation process in the 2005 GSP regulation. However, according to the GSP regulation of 2001, Brazil, China, Indonesia, India, Malaysia, Russia and Thailand had already been graduated in the same sectors or partly the same sectors in 2001. Thus the actual graduations at the end of 2005 where:

Table 5.1: Graduations 2005

Country:	**Sector:**
Algeria	V
Brazil	IX
China	VII, IX, X, XI(a), XIV, XVI, XVII and XVIII
India	XIV
Russia	VI and X
South Africa	XVII
Thailand	XVII

Source: European Union 2001 and European Union 2005 (see the appendix for sector descriptions)

According to the GSP regulation of 2008, seven countries had one or more sectors that had been removed from the GSP scheme in accordance with the sector graduation. These countries were: Brazil, China, Indonesia, India, Malaysia, Thailand and Vietnam. However, when comparing with the graduations according to the 2005 GSP regulation all of these countries except for Vietnam were already graduated in 2005. Thus this means that the only country that actually was graduated and lost its trade preferences at the end of 2008 was Vietnam, and the specific sector was XII (footwear etc). The other countries had already been graduated previously. Except for graduations in 2008 a certain number of de-graduations also occurred, meaning that countries which previously had been graduated and lost their preferences in certain sectors (The European Union, Council Regulation 2005) were now re-introduced in 2008 because they no longer met the requirements for graduation. These countries and sectors were: Algeria section V, Russia section VI, Indonesia section IX, India section XIV, Russia section XV, Thailand section XVII and South Africa section XVII (The European Union, Council Regulation 2008).

Table 5.2: Graduations and de-graduations 2008

Graduations 2008 (country):	**Sector:**
Vietnam	XII
De-graduations 2008 (country):	
Algeria	V
India	XIV
Indonesia	IX
Russia	VI & XV
South Africa	XVII
Thailand	XVII

Source: European Union 2008

Hence five out of seven countries that had product groups which had been graduated in 2005 had preferences re-established at the end of 2008 due to the fact that the sections no longer met the criteria for graduations (meaning the countries' exports to the union had decreased relative to other GSP recipients). The countries and sectors were the following: Algeria section V, India section XIV, Russia section VI, Thailand section XVII and South Africa section XVII.

5.2 Methodology

In this empirical analysis I have chosen to examine the trade volumes of the sections graduated in 2005 and 2008. I have been using Eurostat's External Trade statistics (European Commission 2010c) which is the European Union's database for external trade. According to the current GSP regulation (European Union 2008b) this is also the statistical source being used by the European Union upon calculation of removals from the GSP scheme in accordance with the graduation mechanism.

In the GSP regulation (Annex III) there is a list of the products which are included in the GSP arrangement. In the list the products are defined by their CN codes (the tariff and statistical nomenclature of the Customs Union), sometimes specified as a specific product down to an eight digit level or as a whole product group on a two digit level. The GSP regulation also has listed which countries have lost their preferences and in which sections. By section, meaning any of the sections of the European Union's Common Customs Tariff, which can be found in Regulation (EEC) No 2658/87. In total there are twenty sections and each section contains one or more chapters (product groups) (there are 99 chapters divided into the twenty sections). Hence when collecting the data I first looked up which sections had been graduated in the GSP regulation and then checked the Common Custom Tariff Regulation (European Union 2008c, Commission Regulation) to see which product groups that belonged to each of the graduated sections. Since not all products in a product group are included in the GSP arrangement I had to sort out the ones that were included and were receiving the preferential treatment. Using the European Union's database for external trade I then compiled the data of the products that were included in the GSP arrangement of each graduated section. However, since some product that are covered by the GSP arrangement already have a Most Favored Nation duty of zero and thus the importers already pay zero duty regardless of the GSP, they should not be included in the calculation. According to the European Union´s trade information desk (Menchen 2010), the tariff lines with a Most Favored Nation duty rate of zero are also excluded for calculations of sector graduation. In order to exclude these in my empirical analysis I used the World Trade Organization's Tariff Analysis Online (2010b) data to find out which products had an applied Most Favored Nation duty rate of zero. The database has this information down to the 8 digit level which is the highest level of detail publicly available.

The data compiled thus show the value of the GSP-covered imports to the union for the graduated country in the specific section. (See the appendix for a table containing this data). The removal of sections from the GSP scheme in 2005 should apply from the first of January 2006 according to the GSP regulation of 2005, while the removals of 2008 should apply from January 2009. Hence it would be most interesting to look at how the graduation has affected the exports of the country by focusing on the year after graduation compared to the year before. As for the sectors that got de-graduated in 2009 it is also relevant to look at how these have been affected by the re-introduction to the GSP scheme.

In order to get a measurement of how the graduated countries exports would have performed if they not had been graduated, I have also used the same data to compile the European Union's total import in the graduated sectors. This provides a counterfactual measurement, although it is very weak since various other factors could have affected the country to diverge from the mean. A better method would have been to use gravity modelling. Due to resources and time constraints this is outside the scope of this paper, but would be an interesting method to use for future research on the subject.

5.3 Statistics

Table 5.3: Changes in imports (in %) to the Union upon graduation and de-graduation

Year	2005-2006	2008-2009
Country/sector		
Algeria Sector V	25	34
EU Total Imports (sector V)	30	-18
Brazil Sector IX	0	graduated
EU Total Imports (sector IX)	10	
China Sector VII	15	graduated
EU total Imports (sector VII)	15	
China Sector IX	24	graduated
EU total Imports (sector IX)	10	
China Sector XIa	16	graduated
EU Total Imports (sector XIa)	9	
China Sector XIV	10	graduated
EU Total Imports (sector XIV)	12	
China Sector XVI	69	graduated
EU Total Imports (sector XVI)	48	
China Sector XVII	23	graduated
EU Total Imports (Sector XVII)	32	
China Sector XVIII	18	graduated
EU Total Imports (Sector XVIII)	15	
India Sector XIV	10	-2
EU Total Imports Sector XIV	12	-14
Russia Sector VI	-2	-45

EU Total Imports Sector VI	7	-21
South Africa Sector XVII	17	-7
EU Total Imports Sector XVII	32	-20
Thailand Sector XVII	8	-34
EU Total Imports Sector XVII	32	-20
Vietnam Sector XII		-18
EU Total Imports Sector XII		-4

5.4 Comments on the results

In 2005 Algeria lost its preferences in sector V. Nevertheless the following year Algeria's exports to the EU in this sector still increased with 25 percent compared to the year before. The same year the European Union´s total imports in this sector increased by 30 percent compared to 2005. If this was the normal export growth of 2005 in the sector, the Algerian export growth increased 5 percent less than exports from the average exporter. Because of a relative decrease of its exports to the EU in the graduated sector Algeria also became de-graduated in 2008. The year that followed the de-graduation the country experienced a 34 percent increase in the export of the sector to the EU. 2009 was also the second year of the economic downturn that affected the world economy; hence the total imports in the sector to the European Union decreased 18 percent this year compared to the year before. Thus compared to the Union's decrease in imports, Algeria had a huge increase in exports (to the EU) in the specific sector when it once again was included in the GSP scheme.

In 2005 Brazil lost its preferences in sector IX and the following year the country had a decrease of 0.1 percent in imports to the Union in the graduated sector. The same year the European Union had an increase of 10 percent. This equals a total trade loss of 10.1 percent compared to the Unions increase in the specific sector. However the relative decrease in trade during three consecutive years was not enough for the sector to become de-graduated since it still was graduated in 2009.

China lost its preferences in seven sectors in 2005. When comparing the export of these the following year to the total EU import in the specific sectors the following year, China experienced a sharp relative increase in its export to the EU despite its graduation in three of these sectors (IX, XIa and XVI). In three other sectors (VII, XIV and XVIII) the results were modest, and in sector XVII China saw a decrease compared to the Union. All of the sectors also remained graduated in 2008, hence it seems reasonable to assume that China with its booming economy is competitive in these sectors even without help from the GSP scheme.

In 2005 India lost its preferences in sector XIV and the following year it had still increased its exports to the union with 10 percent. Compared to the Unions increase of 12 percent in total imports of the same sector this was a 2 percent decrease. However the decrease must have been significant relative to the other GSP recipients during three consecutive years, since India got de-graduated in the same sector in 2008. Following the de-graduation the Indian exports of the sector still decreased with 2 percent compared to the year before. The European Union's imports of the same sector decreased with 14 percent; hence this equals a 12 percent increase for India.

Russia lost its preferences in sector VI in 2005. This meant a decrease of 2 percent in exports to the union the following year, while the EU imports increased with 7 percent. Hence the total loss was 9 percent and in 2008 the sector got reintroduced to the GSP scheme again. In spite of the reintroduction Russia's export to the Union still decreased with 45 percent in 2009 while the EU's export only decreased with 21 percent. Thus it seems like Russia's export in the sector was unaffected by the reintroduction.

South Africa lost its preferences in sector XVII in 2005. The following year the exports to the EU in the sector increased by 17 percent while the EU's total imports in the same sector increased by 32 percent. Hence compared to the Union's total import, South Africa had a 15 percent decrease in the sector. In 2008 the sector got reintroduced to the preferential treatment and the sector export only decreased by 7 percent in 2009. In comparison to the EU for which total import in the sector dropped to 20 percent South African exports thus increased by 13 percent.

In 2005 Thailand lost its preferences in sector XVII and the following year the sector experienced an increase in its export to the Union with 8 percent. The EU saw an increase of 32 percent the same year, thus in comparison Thailand exports witnessed a drop by 24 percent. The sector was also reintroduced to the GSP Scheme in 2008. In 2009 its exports dropped by 34 percent while the EU's only dropped by 20 percent. Hence Thailand was not able to turn the negative trend around and profit from the reintroduction.

In 2008 the only country who experienced a sector graduation was Vietnam and the sector graduated was XII. The following year the exports from Vietnam to the EU in the graduated sector had dropped by 18 % while the EU's total Import in the sector only had dropped by 4 percent.

5.5 Conclusions from the empirical analysis

Out of the seven countries which experienced sector graduation in 2005 only two remained graduated in 2008: China and Brazil. A de-graduation signifies that the country's exports of the product group to the EU have decreased below 15 percent of total exports of the product group to the union on average during three consecutive years. Consequently this is an indication that the countries' relative competitiveness compared to the other GSP recipients in this sector has decreased.

According to the EUs reasoning (The European Commission 2010d) graduation is a sign that the GSP has performed its function successfully, graduation is supposed to be applied to sectors from countries that are competitive and no longer need the GSP to increase their exports. Using the same line of reasoning, de-graduation should be an indication that graduation has failed. However, the graduated sectors in China and Brazil still seemed to be competitive. With the Chinese economic boom, China's competitiveness comes as no surprise. Just like China, Brazil also has a huge domestic market and alongside with Russia, India and China it has been named a BRIC Country, meaning it is one of the four great up and coming economic powers (Purushothaman and Wilson 2003). According to the World Economic Forum's Global Competitiveness report last year, Brazil is improving its competitiveness in spite of the economic crisis. In the Global Competitive Index of 2009-2010 it improved its ranking by eight places (World Economic Forum 2009).

It seems that these were the only countries for which the sector graduation fulfilled its purpose.

Regarding the countries that were de-graduated in 2008 Algeria, India and South Africa all had increasing exports relative to the total EU imports in the sectors the following year. This could be seen as a sign that the GSP is important for these countries competitiveness in the specific sectors on the European Union market.

Thailand and Russia on the other hand were unsuccessful in turning the negative trend around and kept on having decreasing exports in the sectors despite their reintroduction to the GSP scheme. The reasons for this could be plenty; one of them being that the imports of certain products takes place under long term contracts reaching over years. Hence the effect of a de-graduation will not be visible the next year. In the case of Thailand the de-graduated sector was XVII - Vehicles, aircrafts, vessels and associated transport equipment. For Russia the sector was VI - Products of the chemical or allied. Another reason could be that the preference margins given by the GSP in these sectors for the relevant products are relative low compared to MFN bound rates. It could also be that the country just has a decreased competitiveness in the sector due to various other reasons.

A factor that could have affected the study is that even though products are GSP eligible, exporters might not always export under the preferential access because of compliance costs and rules of origin restrictions. This would inflict on the preciseness of the study. It is also important to point out that these decreases and increases in export don’t have to have anything at all to do with the GSP, since there is no causality determined and a lot of other determining factors as well. As previously noted, to compare with the European Union’s total imports is also a very weak counterfactual measurement.

6. Summary and Conclusions

In this paper I have studied the graduation process of the European Union with a special focus on the sector graduation. In my research of the graduation process I found out that it has gone through major changes throughout the years, from the early years of annually updated quotas till the index based criteria of the nineties and today's mechanism based on market shares with reviews every third year.

Upon looking closer at how trade volumes have been affected by the sector graduations the recent years, it seems reasonable to assume that the graduated sectors often have had problems remaining competitive.

Due to the changes in the graduation process, the GSP of today is much more reliable and predictable and it is clear that the graduation criteria have changed in favor of the beneficiaries. This might make it easier for investors and facilitate more investments. However at the same time as this improvement has occurred, an erosion of preferences due to multilateral trade negotiations and reductions in MFN tariffs has taken place. This has decreased the value of the preferences themselves and raises the question if the GSP scheme actually has been improved or if the improved conditions just are equalized by the erosion?

One of the main problems with the GSP has been that according to the enabling clause, developing countries are supposed to participate more fully in the GATT agreement when their development is progressing. This sounds reasonable, however the problem with this text is that there are no clearly defined criteria for this progress. The only specific criterion that is mentioned in the enabling clause is the LDC status. Thus it has been up to the developed preference donors to decide on such criteria throughout the years. If the eligible country increased their export too much, graduation basically occurred. Often through a predefined criterion, but also through safeguard clauses.

This has probably contributed to reducing the potential benefits from the GSP schemes, and it can be argued that this type of graduation process is based on protectionism more than the developing countries progress. Even if a certain sector has reached a good competitive level the country in itself might still be very poor and undeveloped.

As written in chapter 4 (The Process of graduation) the developing countries in UNCTAD have also opposed this type of graduation.

A more reasonable criterion for graduation seen through a fairness perspective could be some kind of criterion based on income, like GDP per capita. These types of criteria have also been used by the EU to a lesser extent.

Another problem with graduation is the risk a potential graduation carries. It can be hard for investors in the GSP-eligible country to be sure about how long the countries eligibility for the preferences might stand, and whether it is going to stand long enough to support long-term investment. This might deter investors from investing and hence reduce the countries gain from the preferential treatment. In addition to the fact that merely the existence of a graduation mechanism might scare away investors. The current EU GSP schemes also might be altered every three years and contains a safeguard clause which could contribute to the problem.

Graduation can also affect regional integration processes in the third world negatively through the problems with different rules of origin. If a country graduates, the rules of origin for products exported to the union might get different and stricter. A neighboring GSP eligible country which exports products to the EU might experience problems receiving the preferential treatment, if the exported products are using imported parts from the graduated country. This would impose problems for regional trade between the developing countries.

Despite these problems with graduation it might be a necessary evil, in the sense that it stops more developed countries from appropriating all benefits of the GSP and instead directs the preferences towards the neediest. Today the European Union's motivation for graduation relies on two arguments. First - it is a sign that the graduated countries exports are competitive on the EU market even without preferential access. Second - it ensures that the GSP benefits the countries in most need through the transfer of preferential access. According to the empirical analysis however, most countries which have had sectors graduated the recent years have seen a relative decrease in exports, and the sectors have been de-graduated again. Thus with the current criteria the graduated products have not managed to stay competitive. This contradicts one of the European Union's arguments for graduation. If the European Union doesn't wish to graduate sectors unless they are competitive then they would have to change the graduation criteria once again.

Regarding the argument of the transfer of preferential access to poorer countries, the idea sounds good and this might work since it reduces crowding out effects of the GSP. However as written previously it could also be the case that domestic firms and non GSP-beneficiaries manage to capture some of the market. Since the current criterion is that a country is not allowed to exceed 15 % of total exports of the product group to the union during three consecutive years, it actually only considers the performance of the product group on the market of the EU. Hence the country might still be much poorer then other remaining beneficiaries even though it is graduated in the product group.

According to the economic theory on trade preferences to the poorest in chapter three; in the long term, it might be better to keep providing countries with preferential access instead of rushing them to graduate. However this might mean a big short term loss for poorer small countries, since large countries might crowd out the smaller. One way of compensating the poorer countries could then be to increase the foreign aid to these countries instead. Since 2005 the WTO has been working on a program named “Aid for trade” which is aimed to help developing countries improve infrastructure and trade-related skills in order to be able to expand their trade. Something similar to this could be implemented to compensate the loss of the poorer countries. The role of foreign aid and other trade facilitating measures is also becoming more relevant because of the preference erosion due to the decline in MFN tariffs which minimize the preferential margins.

In a recent evaluation of the European Union’s GSP (Gasiorek et al. 2010) the evaluators discuss the possibility of import subsidies instead of GSP. This might also be another way of compensating the poorer countries and is an interesting topic for future studies.

Appendix - Annex 1

SECTION I - LIVE ANIMALS; ANIMAL PRODUCTS

SECTION II - VEGETABLE PRODUCTS

SECTION III - ANIMAL OR VEGETABLE FATS AND OILS AND THEIR CLEAVAGE PRODUCTS; PREPARED EDIBLE FATS; ANIMAL OR VEGETABLE WAXES

SECTION IV - PREPARED FOODSTUFFS; BEVERAGES, SPIRITS AND VINEGAR; TOBACCO AND MANUFACTURED TOBACCO SUBSTITUTES

SECTION V - MINERAL PRODUCTS

SECTION VI - PRODUCTS OF THE CHEMICAL OR ALLIED INDUSTRIES

SECTION VII - PLASTICS AND ARTICLES THEREOF; RUBBER AND ARTICLES THEREOF

SECTION VIII - RAW HIDES AND SKINS, LEATHER, FURSKINS AND ARTICLES THEREOF; SADDLERY AND HARNESS; TRAVEL GOODS, HANDBAGS AND SIMILAR CONTAINERS; ARTICLES OF ANIMAL GUT (OTHER THAN SILKWORM GUT)

SECTION IX - WOOD AND ARTICLES OF WOOD; WOOD CHARCOAL; CORK AND ARTICLES OF CORK; MANUFACTURES OF STRAW, OF ESPARTO OR OF OTHER PLAITING MATERIALS; BASKETWARE AND WICKERWORK

SECTION X - PULP OF WOOD OR OF OTHER FIBROUS CELLULOSIC MATERIAL; RECOVERED (WASTE AND SCRAP) PAPER OR PAPERBOARD; PAPER AND PAPERBOARD AND ARTICLES THEREOF

SECTION XI - TEXTILES AND TEXTILE ARTICLES

SECTION XII - FOOTWEAR, HEADGEAR, UMBRELLAS, SUN UMBRELLAS, WALKING STICKS, SEAT-STICKS, WHIPS, RIDING-CROPS AND PARTS THEREOF; PREPARED FEATHERS AND ARTICLES MADE THEREWITH; ARTIFICIAL FLOWERS; ARTICLES OF HUMAN HAIR

SECTION XIII - ARTICLES OF STONE, PLASTER, CEMENT, ASBESTOS, MICA OR SIMILAR MATERIALS; CERAMIC PRODUCTS; GLASS AND GLASSWARE

SECTION XIV - NATURAL OR CULTURED PEARLS, PRECIOUS OR SEMI-PRECIOUS STONES, PRECIOUS METALS, METALS CLAD WITH PRECIOUS METAL, AND ARTICLES THEREOF; IMITATION JEWELLERY; COIN

SECTION XV - BASE METALS AND ARTICLES OF BASE METAL

SECTION XVI - MACHINERY AND MECHANICAL APPLIANCES; ELECTRICAL EQUIPMENT; PARTS THEREOF; SOUND RECORDERS AND REPRODUCERS, TELEVISION IMAGE AND SOUND RECORDERS AND REPRODUCERS, AND PARTS AND ACCESSORIES OF SUCH ARTICLES

SECTION XVII - VEHICLES, AIRCRAFT, VESSELS AND ASSOCIATED TRANSPORT EQUIPMENT

SECTION XVIII - OPTICAL, PHOTOGRAPHIC, CINEMATOGRAPHIC, MEASURING, CHECKING, PRECISION, MEDICAL OR SURGICAL INSTRUMENTS AND APPARATUS; CLOCKS AND WATCHES; MUSICAL INSTRUMENTS; PARTS AND ACCESSORIES THEREOF

SECTION XIX - ARMS AND AMMUNITION; PARTS AND ACCESSORIES THEREOF

SECTION XX - MISCELLANEOUS MANUFACTURED ARTICLES

SECTION XXI - WORKS OF ART, COLLECTORS' PIECES AND ANTIQUES

Annex 2

Imports to the Union in the graduated and de-graduated sectors (value in Euros)

Graduations 2005, De-graduations 2008:	**Year**	2005	2006		2008	2009
Country/sector						
Algeria - Sector V		6578418117	8210636040		9166953591	12261549988
EU Total Imports - S V		71729968321	93289586858		1,02856E+11	84722638246
Brazil - Sector IX		339685235	339324867			
EU Total Imports - S IX		2904685656	3201475982			
China - Sector VII		4463757321	5128915011			
EU total Imports -S VII		26090671672	29947002901			
China - Sector IX		620142862	768049726			
EU total Imports - S IX		2904685656	3201475982			
China - Sector Xia		2275649978	2630947978			
EU Total Imports - S XIa		12430235113	13525786152			
China - Sector XIV		999478122	1098901960			
EU Total Imports -S XIV		4954020251	5559118550			
China - Sector XVI		25808896755	43687426847			
EU Total Imports - S XVI		1,1343E+11	1,68179E+11			
China - Sector XVII		2129827131	2627055152			
EU Total Imports - S XVII		52840455146	69849825312			
China - Sector XVIII		3940396683	4656535367			
EU Total Imports - S XVIII		18775429601	21611171935			
India - Sector XIV		360257567	395768897		378587458	371934018
EU Total Imports - S XIV		4954020269	5559118549		5060836446	4358023629
Russia - Sector VI		1656563304	1628561555		1984761697	1096267638
EU Total Imports - S VI		39037807215	41900003141		49961288932	39495238115
South Africa - Sector XVII		688421082	804571321		943083699	880514013
EU Total Imports - S XVII		52840455261	69849825380		75884935099	60499404114
Thailand - Sector XVII		1077530714	1163228932		1287221306	844582609

EU Total Imports - S XVII		52840455261	69849825380		75884935099	60499404114
Graduations 2009:						
Vietnam - Sector XII					2309213034	1892870051
EU Total Imports - S XII					15050467058	14391641482

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