

B SELECTED ISSUES IN TRADE AND TRADE POLICY

1. NON-RECIPROCAL PREFERENCES AND THE MULTILATERAL TRADING SYSTEM

(a) Introduction

A non-reciprocal preferential arrangement exists when one country offers access to exports originating from another country on terms that are more favourable than the existing tariff, without requesting reciprocal market access. Such arrangements differ from the system of most-favoured-nation tariffs as embodied in the General Agreement on Tariffs and Trade, where Members of the World Trade Organization can benefit from the tariff applied by other Members to their most-favoured nation. They also differ from reciprocal preferential arrangements, such as regional trade agreements where market access is offered to signatories of such agreements on a reciprocal basis.¹

The current system of non-reciprocal preferences has its roots in the trade politics of the 1960s and the search for ways to increase developing country participation in the trading system. Driven largely by the intellectual foundations of the discussions leading to the establishment of the United Nations Conference on Trade and Development (UNCTAD), the Generalized System of Preferences (GSP) was developed. The scheme allowed developed countries autonomously to grant non-reciprocal access to their markets for selected products from selected countries.² Since then, the concept of non-reciprocal preferences has expanded considerably to include schemes that target specific countries, such as those designated by the United Nations as least-developed countries (LDCs). The schemes can also be regionally based, such as the United States African Growth Opportunity Act (AGOA) or Australia's South Pacific Regional Trade and Economic Co-operation Agreement (SPARTECA).

Non-reciprocal preference schemes create a certain degree of tension in the multilateral trading system, which has triggered a vigorous debate on their overall value to developing countries. While generally welcomed on political grounds and by preference-receiving countries, they are also the subject of much criticism from non-preference-receiving countries concerned about trade diversion and academics concerned about their contribution to development. They are also criticized by those with systemic interests in the trading system who see such schemes as part of an erosion of the core principles of the multilateral trading system (Hudec, 1987).³ These tensions have been further amplified by recent calls to stall the process of multilateral liberalization in order to protect margins of preference. In the midst of this debate on the value of preferences, a surprising development is that such schemes continue to proliferate in a variety of forms, including the expansion of existing schemes to a larger group of countries. In fact, the World Bank has recently called for a global non-reciprocal scheme where developed countries would provide duty-free and quota-free market access to all products originating from all developing countries (World Bank, 2003a).

This Section focuses on the current debate about the "development" value of preferences and their impact on the multilateral trading system. The next three subsections will examine the economics of preferences, the pattern of preferential arrangements, and the implications of such arrangements for the multilateral trading system. The Section then closes with some summary observations.

¹ For more on the economics of regional trading agreements see Section IB.3 of WTO (2003a).

² The autonomous nature also implies that donor countries have the discretion to decide the list of eligible countries.

³ Low (2003) summarises Hudec's views against preferences in a succinct manner: "Hudec believes that an MFN-based regime is the only genuine protection available to developing countries. This is not just an argument he makes for advanced developing countries who are most susceptible to protection-driven discrimination, but for smaller countries as well that are likely to face more uncertainty and unpredictable elements of discrimination under multiple preferential agreements."

(b) Economics and politics of non-reciprocal preferences

Countries are affected by non-reciprocal preferences depending on whether they are the granting countries, the beneficiary countries or the non-beneficiary countries. The analysis that follows discusses the costs and benefits of preferences to these three groups of countries. It should be noted at the outset that a preference margin exists only because of the imposition of a positive MFN tariff by a preference-granting country. The non-reciprocal and autonomous nature of preferences means that decisions on what preferences to offer and to whom are taken by the granting countries largely with national considerations in mind – they are not designed with a primary focus upon accommodating the interests of beneficiary countries. This suggests that the political economy analysis guiding MFN reductions should, for the most part, remain immune to the issue of preference erosion. However, as will be discussed in subsection (d) below, the dynamics of the current round of multilateral negotiations may have an impact on how preference-granting countries determine their MFN tariffs.

An original rationale for non-reciprocal preferences was that additional market access would assist developing countries through trade, instead of aid. The slogan “trade rather than aid” described a situation where a transfer was made from developed to developing countries, but not in overt financial terms as in the case of aid.⁴ In the case of preferences, the transfer is from domestic producers and the government in importing developed countries to producers in beneficiary developing countries (Box IB1.1).

Box IB1.1: Rent transfer and non-reciprocal preferences

This box explores the basic economics of non-reciprocal preferences. Obviously, a country must have a tariff in place in order to grant a preference. This tariff raises the price of the protected good in the domestic market above the world price, thereby creating rents for domestic producers and revenue for the government. Preferential market access to imports originating from specified countries will result in a reduction in the rents obtained by domestic producers, some of which will be transferred to foreign producers in the preference-receiving countries. The government also stands to lose revenue.

The analytical framework used to investigate the impact of non-reciprocal preferences on preferential and non-preferential exporters is identical to that used to examine reciprocal preferences (Bora et al., 2002; Tangerman, 2002). In its simplest form, it is a three country framework with only a single traded good. One country imports the good while the other two are respectively the beneficiary and non-beneficiary of the preferential tariff rate. If it is further assumed that benefits accruing to the preference-receiving country depend only on the preference margin, because the preference does not affect the supply of the good at the world price, as the margin increases the price received by exporters will increase, as will the quantity they export and their welfare. Non-beneficiary exporters stand to lose, since the domestic price is still fixed by the world price. Their exports are “crowded out” by the exports benefiting from the preferences.

These general results can be modified by changing various assumptions, such as the responsiveness of supply to a given price change and the degree of substitutability between exports originating from beneficiary countries and those from non-beneficiary countries. Consider each of these in turn. First, the supply response. Increasing the preference margin would alter relative prices in favour of suppliers in preference-receiving countries. The extent to which they will be able to respond to the expanded market access will depend upon their supply response (the elasticity of supply). The higher the elasticity, the larger will be the response and correspondingly the larger will be the trade effect. This effect, however, is conditional on demand, which is captured by the cross-price elasticity of substitution (i.e. the degree of substitutability as relative prices change) between exports from preferred and non-preferred suppliers. The greater the substitutability, the greater will be the trade impact of the preference schemes. The more imperfectly substitutable the products, the lower will be the impact. At the extreme case, when products are not substitutable, then the granting of preferences will not have any trade diversion impact. This case, however, is highly unlikely.

⁴ For more information on the development of the GSP within UNCTAD see WTO document WT/COMTD/W/93, 5 October 2001.

The principal intellectual proponents of preference schemes have tended to view them as part of an import substitution policy. Preferential market access has typically been combined, therefore, with appeals to retain protection in the domestic market of the preference-receiving country. Preferences, then, are often regarded not only as a mechanism to transfer real resources from developed to developing countries, but as a component of industrial policy. The underlying approach was to mitigate foreign competition in the domestic market at the same time as seeking an exporting advantage *vis-à-vis* competitive counterparts in developed (and other developing) countries.

In sum, the possible benefits of preferences to developing countries include better access to developed-country markets, increased export volumes and prices, improved economic welfare, more jobs, and more rapid economic growth. Although the benefits of preferences are difficult to quantify, available estimates of preference margins show that they can amount to significant shares of the value of exports from the developing country concerned. However, analysis has shown that welfare gains are usually smaller than the preference margins. In certain cases, such as when preference margins are applied within tariff-rate quota schemes, the rents may accrue to firms in the importing country and therefore decrease the benefits to beneficiary countries (Tangermann, 2002).⁵

Trade preferences may not be devoid of costs to beneficiary countries. They may induce a shift in the pattern of production in the recipient country that is not consistent with its comparative advantage. This risk is compounded by the lack of predictability related to preferences. Preference-granting countries decide the breadth and scope of preference schemes, and changes to such schemes will result in adjustment costs as exporters try to survive without preferences.

Depending on the preference margin and export supply response in the recipient country, preferences may depress prices in the granting country's market, thereby creating opposition from producers in non-beneficiary countries as well as in the preference-granting country. Non-reciprocal preferences can also impact the trade policies of the recipients. Recent research has shown that they delay trade liberalization – GSP recipient countries are less likely to lower their tariff barriers compared to non-beneficiary developing countries or those that have been graduated out of GSP schemes (Ozden and Reinhardt, 2003). The reason for this is that in a world of reciprocity, it is exporters who lobby their governments to reduce their own tariffs in order to gain market access. If preferences are granted in a non-reciprocal manner, this incentive is lost.

While the immediate effect of preferences on beneficiary countries will generally be positive, the impact on the granting country will depend on certain factors that could actually make the country worse off. The reason for this ambiguity is the trade-off between the foregone tariff revenue and loss in domestic production on the one side, and the gain that consumers receive from lower priced imports on the other. The overall effect depends upon the specifics of each granting country and the specific commodities that benefit from preferential access (Box IB1.1).

The political economy of non-reciprocal schemes is as complicated as the economics. As shown below, such schemes are selective with respect to the countries and products that benefit from the enhanced market access. One factor is that products of export interest to developing countries are often excluded from preference schemes, in part because of domestic lobbying pressure. However, in a number of cases, access is granted in sensitive product lines, but only to a select group of countries. This selective access creates an incentive for those that benefit to lobby against a reduction in the MFN tariff and the expansion of non-reciprocal preference schemes to other beneficiary countries. At the same time, resistance to a reduction in MFN tariffs in granting countries may come from domestic groups that face adjustment costs due to the liberalization.

⁵ The distribution of rents in this case will depend on the system for allocating quotas.

Concern about preference erosion is not limited to the impact from MFN tariff reductions. Non-reciprocal preference margins can also be eroded through reciprocal regional trading agreements signed by a preference-granting country. A recent example was the request by Caribbean Basin Initiative (CBI) countries for market access parity into the United States, with Canada and Mexico. Canada and Mexico having previously been granted market access conditions under the North American Free Trade Agreement that were more favourable than those contained in the CBI.

The effect of non-reciprocal preference schemes on the third group of countries – non-beneficiary exporting countries – is fairly clear. Their exports are discriminated against by these schemes, causing them to lose trading opportunities.

Preferences also have implications for the multilateral agenda. They can exhaust negotiating capital, since developing countries have to balance their participation at the multilateral level with negotiating for preferences at the bilateral level. The result is that countries tend to pursue bilateral deals at the expense of participation at the multilateral level through the WTO (Brenton, 2003). Preferential market access may lower the incentive for developing countries to participate actively in multilateral negotiations, in part because they believe that they will not receive any further concessions in the multilateral process or because of concerns about preference erosion. This may create a conflict of interest between the recipients and the excluded developing countries.

Multilateral negotiations can also be affected through the exercise of power by preference-granting countries. Trade preferences could be used as a lever to obtain external support for their protectionist policies. Beneficiary countries have the incentive to support policies of granting countries and to lobby for the continuation of preferences. This can act as an impediment to efforts to advance the benefits of trade liberalization globally through the WTO (Topp, 2001).

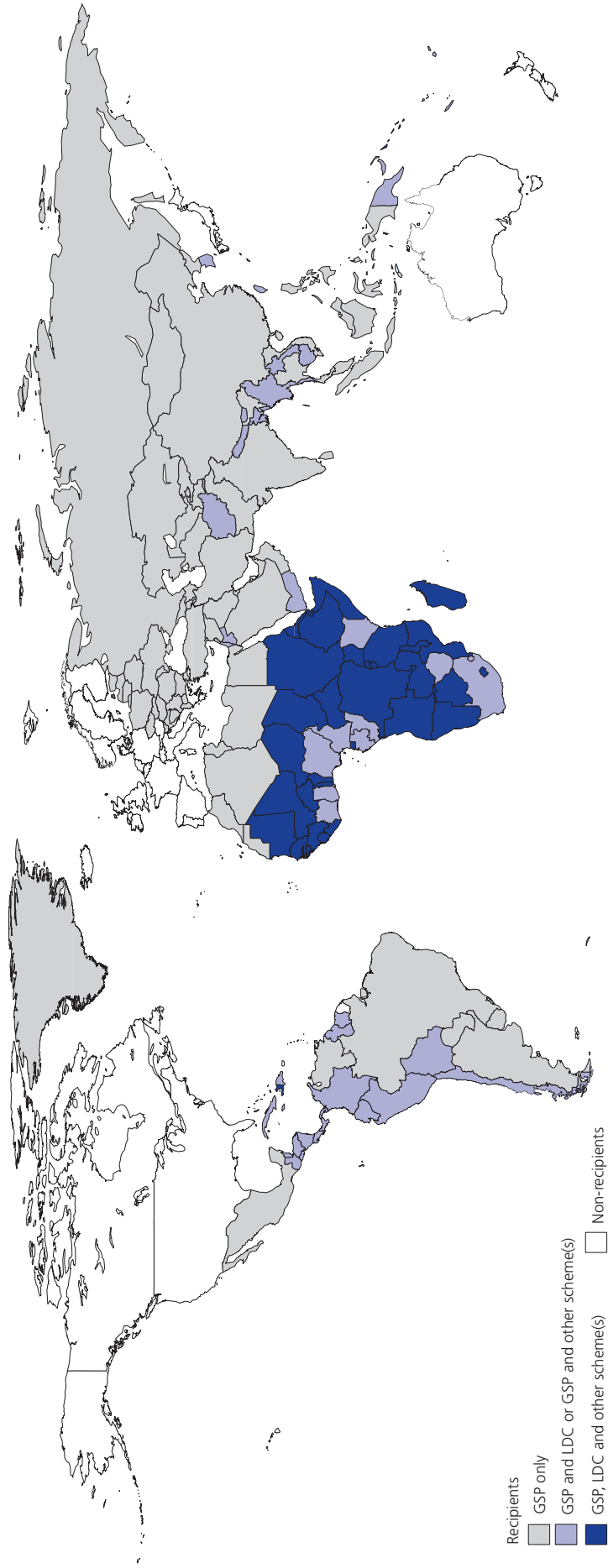
(c) The pattern of non-reciprocal preferences

The coverage and scope of non-reciprocal schemes have expanded since they were first initiated in the early 1970s.⁶ Today, a number of more specialized schemes exist that either target specific groups of countries based on their level of development, such as the least-developed countries, or are based on particular regions.

As with reciprocal regional agreements, growing numbers of non-reciprocal preferential schemes have produced a complex web of arrangements. Examples of recent schemes include the system of preferences offered to the Africa, Caribbean and Pacific countries by the European Union (ACP preference scheme), and the United States' scheme offered to the Caribbean, known as the Caribbean Basin Initiative. Chart IB1.1 illustrates this complicated landscape. Developed countries are the only countries that do not benefit from any type of scheme. Most countries benefit from at least one type of scheme beyond the GSP scheme.

⁶ Such preference schemes did not start with the GSP. In 1931 the United Kingdom offered non-reciprocal preferences to its colonies under the Commonwealth System of Preferences, which is still in place.

Chart IB1.1
Landscape of non-reciprocal preference schemes, 2002

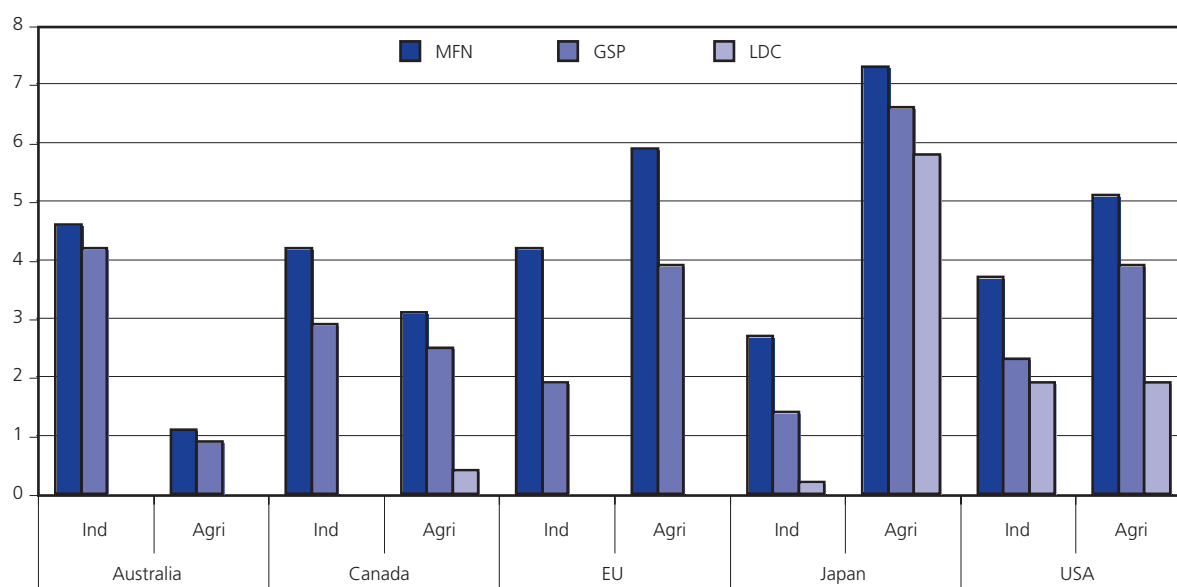


Note: For scheme coverage see Technical Notes.
Source: WTO, IDB.

(i) Enhanced market access?

Assessing the degree of enhanced market access arising from non-reciprocal preferences is a difficult task, since such schemes are selective in nature. They are rarely applied across the entire tariff schedule of a country, except in a few cases.⁷ From an overall perspective, it is important to distinguish between what is already offered by the way of MFN access and what is offered on a preferential basis. Many preference-granting countries already have low overall levels of protection, although their tariff peaks are predominantly in areas of export interest to developing countries. Furthermore, caution should be exercised when selecting the method by which to measure market access.⁸ Chart IB1.2 compares the average tariff rates for agriculture and non-agricultural products for a number of markets and a number of schemes. A discernable difference can be observed between the various schemes, which would indicate a positive degree of preferential market access for beneficiaries of the various schemes relative to the MFN tariff. There is also a cascading scale for preferences in favour of LDCs. The data presented in the Chart show that the overall level of market access for LDCs is better than that accorded to GSP recipients and relative to the MFN tariff values.

Chart IB1.2
Average applied tariff by tariff regime for major developed markets, 2002
(Percentage)



Note: As of 2003, LDC countries benefit from duty-free access to Australia for all products and to Canada for industrial products. Reference year for Australia's tariffs is 2001. See Technical Notes for calculation methodology.

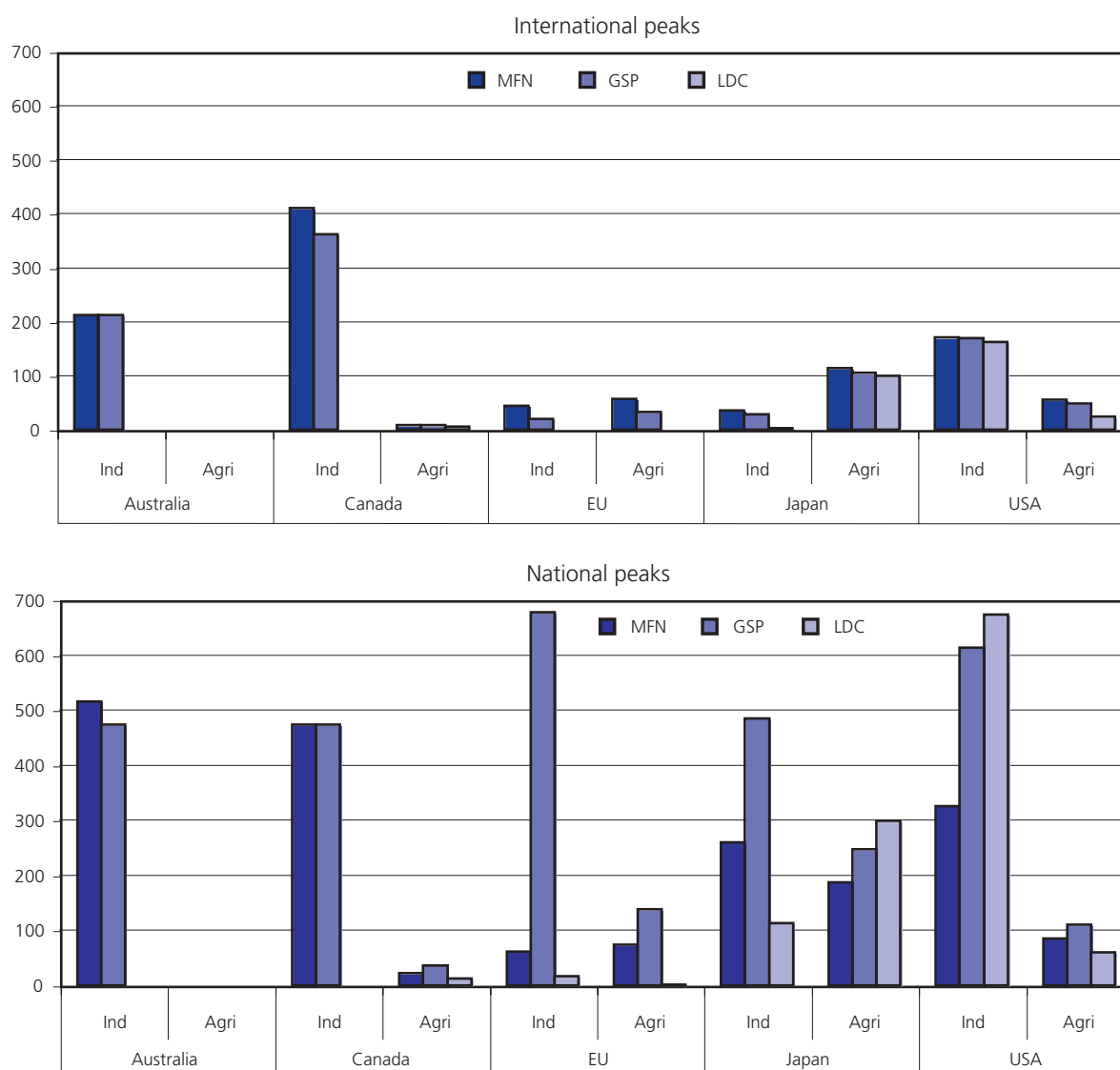
Source: WTO, IDB.

A reduction in the overall average tariff rate may not necessarily represent an increase in effective market access since developing countries, especially the LDCs, export a narrow range of products. Eliminating duties on products that beneficiary countries do not export will do very little to expand their trade. In fact, one of the problems with preference schemes is their tendency to exclude sectors that are politically sensitive.

⁷ For example Australia, Norway and Switzerland offer complete duty-free and quota-free market access for products originating from LDCs. The EU programme for LDC market access provides enhanced market access for all products except arms and munitions. Canada's program exempts dairy, meat, poultry and eggs from its preference scheme for LDCs.

⁸ For example, one could use the percentage of tariff lines that are duty free. However, a statement saying that 99 per cent of tariff lines are duty free may not give a true indication of market access. In reality a significant percentage of the imports originating from the targeted beneficiary countries could be classified in the remaining 1 per cent of tariff lines that are not duty free.

Chart IB1.3
 Number of international and national peaks by tariff regime for major developed markets, 2002



Note: As of 2003, LDC countries benefit from duty-free access to Australia for all products and to Canada for industrial products. Reference year for Australia's tariffs is 2001. See Technical Notes for calculation methodology.

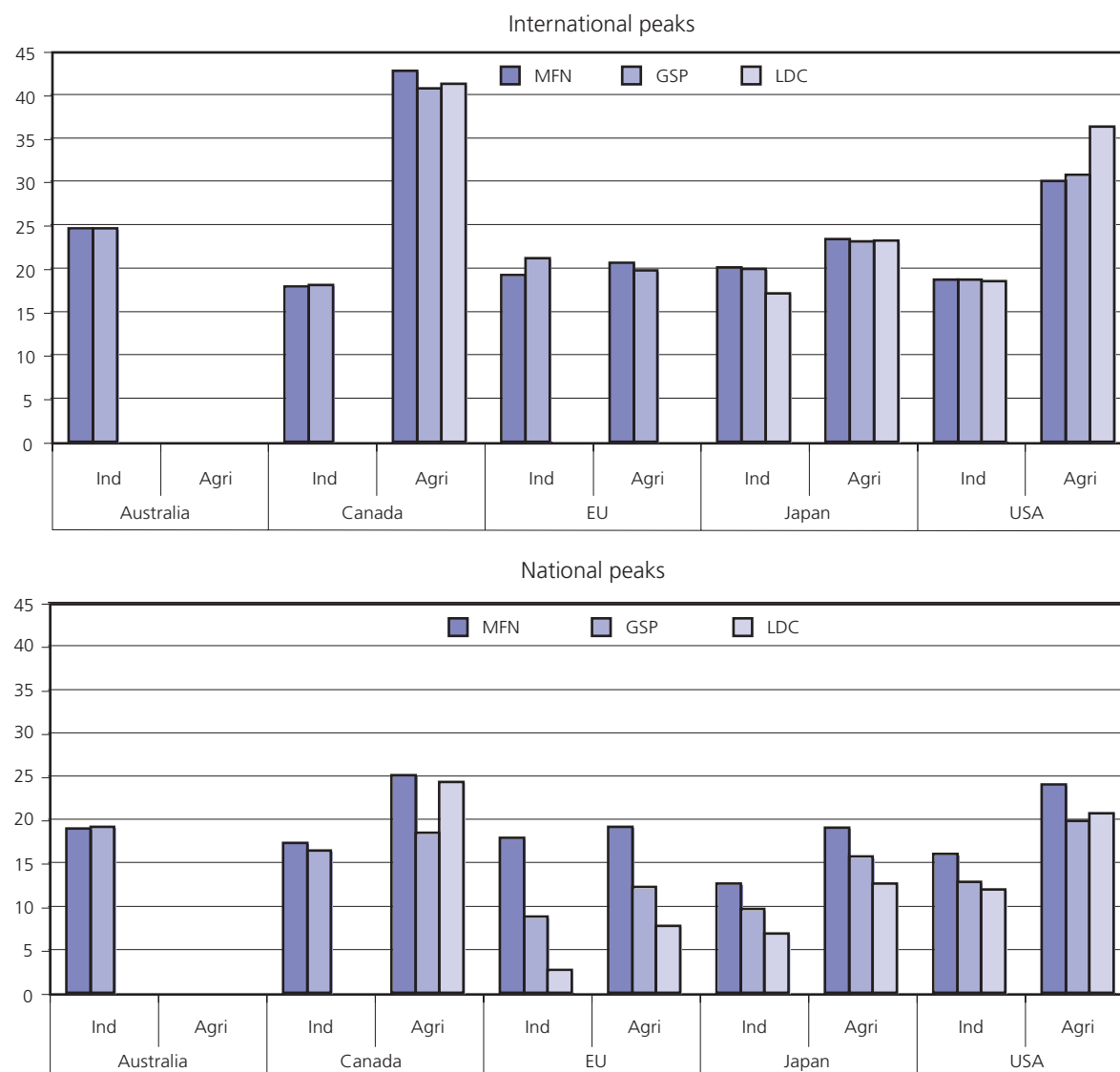
Source: WTO, IDB.

This point is illustrated in Chart IB1.3 and Chart IB1.4, which compare the frequency and average tariff rates of tariff lines that are either above 15 per cent (an international peak) or three times the national average (national peak). Chart IB1.3 shows that the number of international peaks is not significantly reduced in the various non-reciprocal schemes. Furthermore, given the methodology for calculating national peaks, this discrimination becomes more pronounced in Chart IB1.4 where the number of national peaks under the non-reciprocal schemes is higher than for MFN.⁹ Taken together, the two Charts indicate that preference schemes, in general, increase market access but do little to reduce the level of protection in highly protected sectors.¹⁰

⁹ As national peaks are calculated as three times the average of the tariff regime, for preferential schemes the value used is the average of the scheme in question, which is lower than the MFN average.

¹⁰ Sensitive product lines are those with high tariffs as defined by national and international peaks.

Chart IB1.4
Average tariff for international and national peaks by tariff regime, major developed markets, 2002
(Percentage)



Note: As of 2003, LDC countries benefit from duty-free access to Australia for all products and to Canada for industrial products. Reference year for Australia's applied tariffs is 2001. See Technical Notes for calculation methodology.

Source: WTO, IDB.

Table IB1.1 provides an indicator of eligibility for preferences. The first column shows the share of total imports entering Canada, the European Communities, Japan and the United States duty free in 2002, both under MFN and various preference schemes. Thus, for example, the Table indicates that Japan had the highest percentage of imports entering duty free on a MFN basis, at 58 per cent of total imports. In contrast, the United States had the lowest value, at 43 per cent. Japan also had the highest level of total imports eligible for duty-free treatment overall (MFN duty free and duty free under preferential schemes), at 62 per cent. The shares for Canada, the European Communities and the United States were 51 per cent, 56 per cent and 46 per cent respectively. A factor influencing the potential for granting preferential access is obviously the degree to which trade is already MFN duty free.

Table IB1.1 also indicates the impact of each individual scheme on the duty free imports from the beneficiaries of that scheme. For example, consider the GSP scheme of the European Communities. Of total exports from countries eligible for GSP treatment, 49 per cent were eligible for MFN duty-free treatment, 19 per cent for GSP, 2 per cent for LDC treatment, and 2 per cent for ACP country treatment. This meant that 72 per cent of all exports from GSP beneficiary countries were eligible to enter the EC market free of duty. A key point

to note about this Table is that it does not take into account the utilization of preferences. As shown in Table IB1.1, the AGOA scheme of the United States is the most successful in providing additional MFN duty-free treatment to beneficiaries. An additional 60 per cent of the exports of beneficiary countries enter the United States free of duty, contributing significantly to the overall figure of 91 per cent of exports from these countries that receive duty-free access in the United States.

Table IB1.1
Duty-free imports by major developed markets, non-reciprocal scheme and beneficiaries, 2002
(Percent of total imports from respective group of countries)

Duty Scheme	WORLD (MFN)	Group of countries eligible to selected non-reciprocal preferential scheme						
		GSP	LDC	CCC	ACP	CBI	AGOA	ATPA
Canada								
MFN	50	56	64	90	-	-	-	-
GSP	1	6	2	3	-	-	-	-
LDC	0	0	3	0	-	-	-	-
Commonwealth Caribbean (CCC)	0	0	0	6	-	-	-	-
Total Duty Free	51	62	68	99	-	-	-	-
Total Trade	100	100	100	100	-	-	-	-
European Communities								
MFN	47	49	51	-	63	-	-	-
GSP	8	19	2	-	11	-	-	-
LDC	1	2	47	-	5	-	-	-
ACP	1	2	0	-	14	-	-	-
Total Duty Free	56	72	100	-	93	-	-	-
Total Trade	100	100	100	-	100	-	-	-
Japan								
MFN	58	49	18	-	-	-	-	-
GSP	4	9	3	-	-	-	-	-
LDC	0	0	17	-	-	-	-	-
Total Duty Free	62	58	39	-	-	-	-	-
Total Trade	100	100	100	-	-	-	-	-
United States								
MFN	43	39	8	-	-	27	25	38
GSP	2	13	2	-	-	9	5	9
LDC	0	3	45	-	-	0	0	0
Caribbean Basin Recovery Act	0	1	0	-	-	12	0	0
African Growth Opportunity Act	1	5	0	-	-	0	60	0
Andean Trade Preference Act	0	0	0	-	-	0	0	11
Total Duty Free	46	60	54	-	-	48	91	58
Total Trade	100	100	100	-	-	100	100	100

Note: Italicised zero means percentage value is greater than zero but less than 0.5 per cent. See Technical Notes for calculation methodology.
Source: WTO, IDB.

While imports benefiting from preferences may be small in relation to total imports, the preferences may still be important to particular exporters. In order to gauge this, the share of exports to selected markets that enter with the benefit of a positive preference margin was estimated for all countries. The top 25 countries, based on the importance to their exports, is listed in Table IB1.2. For obvious reasons, such as the structure of the preference regime, the identified countries vary across the different markets. In general, the listed countries are part of the larger group of ACP and LDC countries, although it should be noted that some larger developing countries, such as China and India, also figure prominently.

Table IB1.2
Top 25 preference beneficiaries as a share of total exports to major developed markets, 2002
(Million dollars and percentages)

	Canada			European Communities			Japan			United States			Total			
	Exports eligible for preferences		Exporter	Exports eligible for preferences		Exporter	Exports eligible for preferences		Exporter	Exports eligible for preferences		Exporter	Exports eligible for preferences		Share of exports	Exports value
	Share of exports	Exports value		Share of exports	Exports value		Share of exports	Exports value		Share of exports	Exports value		Share of exports	Exports value		
Central African Rep.	88	0	Maldives	99	35	Lesotho	100	0	Angola	98	3032	Mozambique	91	525		
Antigua & Barbuda	85	1	Bangladesh	98	2944	Saint Lucia	100	0	Nigeria	98	5550	Tunisia	84	4509		
Barbados	71	3	Macao, China	96	639	Mauritania	93	39	Gabon	94	1242	Senegal	82	316		
Fiji	67	3	Bahrain	94	256	Latvia	87	15	Cameroon	82	134	Gabon	76	1321		
Guinea Bissau	52	0	Mozambique	94	519	Senegal	78	9	Congo, Dem. Rep.	81	154	Niger	75	14		
Panama	51	4	Trinidad & Tobago	91	376	Morocco	77	251	Congo	78	137	Gambia	74	17		
Zimbabwe	49	3	Solomon Islands	89	1	Dominica	63	1	Mozambique	72	6	Morocco	70	4377		
Kyrgyz Rep.	47	0	Pakistan	87	2317	Egypt	58	40	Malawi	66	45	Croatia	60	1392		
Gambia	45	0	Myanmar	86	329	Zambia	56	37	Gambia	64	0	Namibia	59	244		
Burkina Faso	39	0	Tunisia	85	4491	Bangladesh	55	61	Mauritania	64	0	Cyprus	58	297		
Korea, Rep. of	38	1162	Senegal	83	306	Bahrain	53	84	Saint Kitts & Nevis	61	28	FYR Macedonia	58	295		
Mexico	38	3062	Niger	82	13	Dominican Rep.	52	18	Zimbabwe	57	56	Bangladesh	57	3052		
Haiti	36	2	Madagascar	81	363	Haiti	50	0	Saint Lucia	55	9	Albania	56	76		
China	35	3517	Jamaica	76	355	Ecuador	45	82	Bolivia	51	78	Nigeria	56	6204		
Lithuania	35	6	Morocco	75	4098	Zimbabwe	38	48	Georgia	49	8	Angola	55	3086		
Niger	35	0	Namibia	75	240	Myanmar	37	41	Barbados	48	14	Kenya	54	538		
Sierra Leone	35	1	Cuba	74	219	Czech Rep.	32	58	Armenia	47	14	Moldova	54	114		
Armenia	32	0	Gambia	74	17	Gambia	32	0	Uruguay	46	71	Bahrain	53	395		
Slovenia	32	11	India	73	8614	Kenya	31	9	Belize	44	32	Madagascar	53	369		
Benin	30	0	Sri Lanka	72	866	Sri Lanka	30	50	Poland	44	474	Zambia	52	87		
Saint Kitts & Nevis	30	1	China	70	52364	Niger	29	0	Czech Rep.	42	505	Malawi	51	48		
Slovak Rep.	30	11	FYR Macedonia	68	290	Solomon Islands	29	6	Peru	42	805	Mauritius	51	726		
Thailand	30	343	Moldova	68	113	Trinidad & Tobago	26	1	Slovenia	38	113	Guinea Bissau	49	3		
Brazil	29	347	Suriname	67	69	Turkey	25	41	Slovak Rep.	36	90	St. Kitts & Nevis	49	32		
Dominican Rep.	26	19	Kenya	66	517	Poland	24	21	St. Vincent & Gren.	35	6	Pakistan	46	2464		
WORLD	5	9888	WORLD	17	135624	WORLD	6	21649	WORLD	3	33876	WORLD	8	201036		

Note: Italicised zero means a value that is less than \$500,000.

Source: WTO, IDB.

Table IB1.2 also indicates that in certain markets the preference dependency of exports is quite high. In some cases the value is 100 per cent, indicating a complete dependence on preferential access. Another interesting feature of the Table is that the preference dependency figure of the 25th ranked exporter varies across the markets. This suggests that the overall importance of preferences is greater in the European Union, for example, than in other countries, such as Canada. The share of preference-dependent exports in total exports of the country ranked 25th in Canada is 26 per cent (Dominican Republic). The comparable figure for the European Communities is 66 per cent (Kenya).

Not surprisingly, given the diversity of countries that benefit from non-reciprocal preferences, there is a considerable diversity in the types of products that benefit. Table IB1.3 identifies the main products that benefit from a positive preference margin across the countries that benefit the most in terms of total exports, from preferential market access. The principal products range from petroleum to labour-intensive products such as clothing and footwear. Resource-based products such as copper and iron are also present on the list.

Table IB1.3
Principal products of top 25 preference beneficiaries in major developed markets, 2002
(Million dollars and percentages)

Exporter to QUAD ^a	Exports eligible to preference (Value)	Eligible exports in total exports (Share)	Principal product (HS 2002)		
			Export (Value)	HS code	Description
Mozambique	525	91	405	760110	Aluminium (non-alloy), unwrought
Tunisia	4509	84	423	620342	Men's or boys' trousers, non-knitted, of cotton
Senegal	316	82	59	030759	Octopus
Gabon	1321	76	1232	270900	Crude petroleum
Niger	14	75	10	271111	Natural gas liquefied
Gambia	17	74	10	150810	Crude ground-nut oil
Morocco	4377	70	379	030759	Octopus
Croatia	1393	60	58	611011	Jerseys, pullovers, cardigans, waistcoats made of wool
Namibia	244	59	96	030420	Frozen fish fillets
Cyprus	297	58	48	870323	Motor vehicles (cylinder capacity > 1.500 cm ³ but ≤ 3.000 cm ³)
FYR Macedonia	295	58	31	720851	Flat-rolled products of Iron or non-alloy steel
Bangladesh	3052	57	526	610910	T-shirts, singlets and other vests of cotton, knitted or crocheted
Albania	76	56	10	640610	Footwear - uppers and parts thereof
Nigeria	6204	56	5224	270900	Crude petroleum
Angola	3086	55	2916	270900	Crude petroleum
Kenya	538	54	184	060310	Fresh cut flowers and flower buds
Moldova	114	54	18	721420	Bars and rods of iron or non-alloy steel
Bahrain	395	53	97	271019	Medium oils and preparations, n.e.s.
Madagascar	369	53	108	030613	Frozen shrimps and prawns
Zambia	87	52	37	740311	Refined copper
Malawi	48	51	40	240120	Tobacco, partly or wholly stemmed/stripped
Mauritius	726	51	185	610910	T-shirts, singlets and other vests of cotton, knitted or crocheted
Guinea Bissau	3	49	1	030749	Cuttle fish, frozen, dried, salted or in brine
Saint Kitts & Nevis	32	49	19	853650	Switches for a voltage ≤ 1.000 V
Pakistan	2464	46	167	620342	Men's or boys' trousers, non-knitted, of cotton

^a Canada, European Communities, Japan and the United States.
Source: WTO, IDB.

Table IB1.4
Highest preference margins by product in major developed markets, 2002
(Ranked by descending average value of preference margin for the QUAD^a)

Product	HS 2002 code	MFN Duty Rate QUAD ^a		Highest preference margins											
		Average	Max	QUAD		Canada			European Communities			Japan		United States	
				Average	Max	Average	Max	Average	Max	Average	Max	Average	Max	Average	Max
Preparations of vegetables, fruit, nuts or other parts of plants	20	13.5	131.8	12.9	44.2	5.6	17.0	17.5	33.6	4.9	29.8	6.7	44.2		
Footwear, gaiters and the like; parts of such articles	64	15.3	58.5	11.8	58.5	2.9	20.0	10.0	17.0	15.2	30.0	13.2	58.5		
Tobacco and manufactured tobacco substitutes	24	36.1	350.0	10.8	74.9	7.1	13.0	41.8	74.9	0.0	0.0	5.8	46.8		
Fish and crustaceans	03	6.8	23.0	9.1	23.0	0.5	5.0	12.2	23.0	0.5	10.0	0.9	15.0		
Preparations of meat or fish	16	12.3	238.0	8.8	97.4	5.2	12.5	15.8	26.0	4.6	21.3	4.9	97.4		
Ships, boats and floating structures	89	4.4	25.0	8.6	25.0	14.8	25.0	1.1	2.7	0.0	0.0	0.5	2.7		
Miscellaneous edible preparations	21	13.7	102.4	7.2	80.0	6.5	12.5	8.4	14.7	8.3	29.8	6.1	80.0		
Dairy produce	04	20.8	111.5	7.0	29.0	6.8	11.0	5.3	17.3	0.9	29.8	7.0	29.0		
Articles of apparel and clothing accessories, not knitted or crocheted	62	12.2	29.0	6.5	29.0	1.6	19.0	11.9	12.4	10.6	14.2	3.1	29.0		
Carpets and other textile floor coverings	57	7.4	15.5	6.5	15.5	12.3	15.5	8.0	9.2	7.5	10.1	0.7	4.8		
Articles of apparel and clothing accessories, knitted or crocheted	61	12.4	32.5	6.4	19.0	1.7	19.0	11.9	12.4	10.2	12.1	2.0	21.9		
Preparations of cereals, flour, starch or milk; pastrycooks' products	19	12.8	84.2	6.3	17.5	3.9	14.5	10.7	12.8	2.1	34.0	6.3	17.5		
Ceramic products	69	4.5	29.4	6.2	29.4	4.2	8.0	4.8	12.0	1.2	3.5	6.2	29.4		
Other made-up textile articles	63	9.6	21.5	6.2	12.4	3.8	18.0	10.1	12.4	6.6	12.1	2.6	11.7		
Clocks and watches and parts thereof	91	4.3	29.9	5.9	29.9	3.5	14.0	3.9	6.0	0.2	10.0	5.9	29.9		
Prepared feathers and down and articles made of feathers...	67	4.3	17.0	5.8	17.0	8.3	15.5	2.8	4.7	1.6	6.6	4.0	17.0		
Miscellaneous manufactured articles	96	4.6	48.2	5.8	48.2	6.4	15.5	3.3	7.7	3.1	6.6	5.4	48.2		
Edible vegetables and certain roots and tubers	07	5.7	29.8	5.8	29.8	2.6	19.0	8.9	15.2	1.0	12.8	5.5	29.8		
Articles of leather; saddlery and harness...	42	7.9	20.0	5.7	20.0	7.7	15.5	5.0	9.7	6.5	18.0	6.0	20.0		
Knitted or crocheted fabrics	60	8.5	19.0	5.5	12.6	1.6	16.0	8.7	8.8	7.8	11.8	1.9	12.6		
Glass and glassware	70	4.2	38.0	5.5	38.0	2.5	15.5	4.9	11.0	1.3	8.0	5.5	38.0		
Railway or tramway locomotives	86	3.3	14.8	5.3	14.8	5.8	11.0	1.8	3.7	0.0	0.0	4.7	14.8		
Plastics and articles thereof	39	4.7	10.0	5.3	8.4	4.2	10.0	5.9	8.4	3.6	7.4	4.6	8.4		
Tanning or dyeing extracts	32	4.4	9.2	5.2	9.2	3.2	7.5	5.4	6.5	3.1	4.4	5.1	9.2		
Animal or vegetable fats and oils and their cleavage products...	15	5.0	29.8	5.1	19.1	5.1	11.0	6.0	16.0	1.2	12.8	3.8	19.1		
Explosives or pyrotechnic products	36	5.0	7.5	5.0	7.5	7.1	7.5	6.3	6.5	4.7	6.4	3.0	6.5		
Aluminium and articles thereof	76	4.3	10.0	5.0	10.0	3.4	6.5	6.3	10.0	3.3	7.5	3.7	6.5		
Raw hides and skins (other than furskins) and leather	41	5.0	30.0	5.0	30.0	1.9	5.0	2.6	6.5	10.5	30.0	2.4	5.0		
Edible fruit and nuts; peel of citrus fruits or melons	08	5.3	29.8	4.9	29.8	1.3	12.5	6.8	20.8	1.7	22.5	4.3	29.8		
Man-made staple fibres	55	8.3	28.1	4.8	16.0	1.5	16.0	7.1	8.6	7.4	12.0	0.0	0.0		

^a Canada, European Communities, Japan and the United States.
Source: WTO, IDB.

Another way of identifying products that benefit from preferential margins is to examine the average preference margin across the various product classifications. Table IB1.4 presents data for the QUAD markets showing the average MFN duty rate and the average preference margin rate by the 2 digit level of the Harmonized System for product classification. The products are ranked in descending order on the basis of the average preferential margin across the four markets. Hence, prepared fruit and vegetables are listed first since they have the highest average preference margin – 12.9 per cent.¹¹ The list provides some indication as to the products that may be sensitive to an erosion of preferences and the degree of erosion that one might expect. The top ten products are predominantly products of export interest to developing countries, notably apparel, carpets, processed food, footwear and leather products.

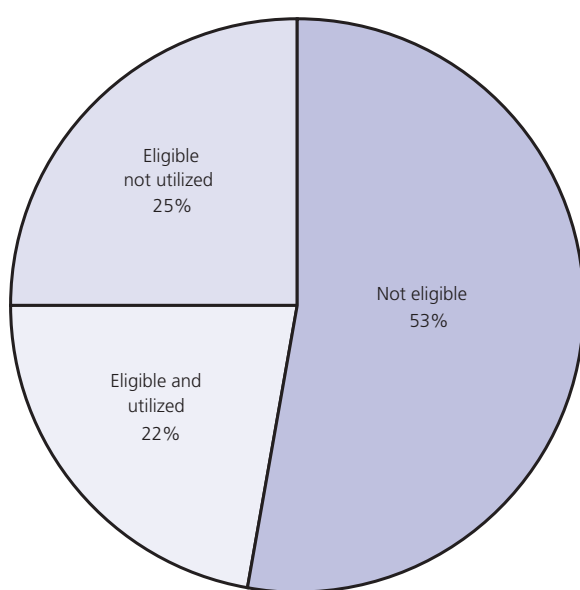
(ii) Limits to market access

The preceding subsection outlined the market access opportunities provided by preferential schemes. The analysis was conducted using tariff data. In reality, however, the granting of preferences does not automatically increase market access. A statutory preferential duty may not be applied at a customs point for a number of reasons, most of which relate to the inability of exporters to meet the required eligibility criteria. As a result, the “utilization” of preferences will not always be 100 per cent. In this context, the figures presented previously could be considered as the theoretical maximum in terms of preferential market access. The actual degree of market access could in some cases be considerably lower.

Unfortunately, accurate data on preference utilization is only available for certain markets. Nevertheless, one element of the implementation of the GSP program is the provision of data on GSP programmes to UNCTAD. As a result, reasonably accurate data on the use of the various GSP schemes are generally available. This is also true for other non-reciprocal preference schemes.

Despite the data difficulties, available information paints a picture of the efficacy of preference schemes and the limits of using only tariff data. Chart IB1.5 shows the results of allocating total GSP exports from 46 LDCs

Chart IB1.5
GSP exports originating from LDCs by type of treatment in QUAD markets, 2001
 (Percentage)



Source: UNCTAD.

to Canada, European Union, Japan and the United States by type of treatment. Three types of treatment are assumed: those products originating from LDCs that faced a duty but were not granted preferential market access, products that were granted and received preferential market access and finally products that were granted preferential market access but, for a variety of reasons, did not enter the preference granting country at the preferential rate. The overall finding is that in 2001 only 22 per cent of the exports of 46 LDCs to QUAD markets benefited from preferential market access. A further one quarter of their exports were eligible for preferential market access, but did not receive this treatment. The Chart, therefore, indicates a utilization rate of less than 50 per cent.

One of the most cited reasons for less than 100 per cent utilization of preferential rates is the “rules of origin” criteria that are used in the various schemes (Brenton and Manchin, 2003). Preferential schemes

¹¹ The preference margin is the absolute difference between the MFN rate and the preferential rate.

are discriminatory in nature and rules of origin are therefore required to differentiate between products from beneficiary countries and non-beneficiary countries. These origin rules have been criticized for being too stringent.

The way in which rules of origin are defined and applied plays an important role in determining the degree of protection they confer and the level of distortionary trade effects they produce. For example, in the textiles sector preferential rules of origin require “triple or double” manufacturing stages for a product to achieve the “substantial transformation” required for preference eligibility, while non-preferential rules of origin for the same products provides for goods to undergo assembly in a single country.¹² This, and other examples, have been used to suggest that rules of origin are being used as a strategic trade instrument: (i) to increase trade barriers towards non-contracting parties; and (ii) to attract investment into the market of the contracting parties.¹³

Rules of origin may be used to compensate local manufacturers for losses that are expected to arise following the implementation of trade liberalization (Hirsch, 2002). Local producers have an enhanced incentive to employ factors of production originating in the territories of the contracting states at the expense of foreign suppliers (i.e. trade diversion). The more restrictive the rules of origin, the more incentive producers will have to use local materials, thereby promoting local factors of production. If manufacturers outside the preferential arrangement face stringent rules of origin, they may change their investment strategy and shift their production lines into the preferential market in order to satisfy preferential origin rules.

A decision to relocate production lines or change sourcing would be determined by the gap between trade preferences accorded under alternative trade arrangements, the size of the preferential market, and the difference in production costs under the alternative patterns of production. When the difference in preference margins is large, there is more incentive for firms to relocate their production lines in order to meet preferential origin rules. The larger the preferential market, the greater the incentive to switch sourcing or investment patterns to comply with origin rules. This size of the market (in terms of purchasing power) explains the tendency for preferential arrangements involving the United States and the EU to have more stringent origin rules. Conversely, the smaller the gap between production costs, the greater the incentive to employ more factors from the preferential area and/or to transfer production lines into that area. Origin rules, therefore, may shift sourcing from low-cost intermediate goods producers from the rest of the world towards those in the preferential arrangement. In non-reciprocal preferential arrangements, this will be either to the preference-giving country or the beneficiary. In such a case, a donor country may use origin rules to protect its intermediate-good producers to the detriment of final-good producers. This may be achieved by donor-country content provisions.

Lesotho is a recent example of how relaxed rules of origin can improve the export prospects of a country. During the 1980s Lesotho enjoyed a number of advantages over South Africa in terms of trade agreements. Under the Generalised System of Preference scheme, manufactured goods from Lesotho enjoyed preferential duty regimes into Canada, the United States and other non-European countries. In addition, Lesotho was a signatory to the Lomé Convention, which allowed duty free-access of clothing into the EU. The rules of origin requirements for the European Union, however, required a “double jump” in processing when imported inputs are utilized. This means the conversion of imported fabric into sewn garments would not qualify as a product originating from Lesotho. As a result, Lesotho’s garment exports do not benefit significantly from preferential market access into the EU.

In contrast to the EU rules of origin, the scheme applied by the United States in the context of AGOA allows a “single jump” in processing. As a result, Lesotho’s exports of garments to the United States have increased

¹² See Inama (2002).

¹³ See Hirsch (2002).

dramatically in the past three years.¹⁴ Whether or not relaxing rules of origin in non-reciprocal schemes can be classified as “development friendly” is another point, which is not addressed in this paper. For example, Lesotho’s newfound export success has had some impact on the export performance of some of its competitors who do not benefit from the rules of origin derogation. Mauritius, for example, is not eligible for the derogation, and its exports of garments to the United States have declined as those of Lesotho have increased.

Inama (2002) has argued that the rules of origin are excessively stringent and do not reflect the industrial capacity of beneficiary countries, especially LDCs. He cites the “triple jump” transformation and/or the “double jump” transformation rules in textiles and apparel products, instead of a simple change in tariff requirements, as an example of rules that do not take the level of development in beneficiary countries into account. He notes that most of the rules of origin were set when the GSP schemes were first established, and since then have remained unchanged and, therefore, may reflect an uncompetitive and inefficient industrial model by insisting on vertically integrated production chains. He also argues that the diversity of rules applied by preference-giving countries with respect to the basic criteria (e.g. process and percentage criteria) makes it difficult for beneficiaries to calculate the allowable and non-allowable costs incurred in production. This creates problems since products may qualify in one market and not in a neighbouring market. The schemes’ complex and detailed origin criteria, direct consignment requirements, administration, documentation and verification imply substantial additional costs for GSP transactions, leading to lower utilization of the schemes.

With respect to standards, the principle issue is not the right to protect health, safety and the environment. Rather, the argument is that the benefits arising from preferences are reduced or nullified by the imposition of standards. While evidence shows that standards are affecting the market penetration of beneficiary exports in preference-granting countries, there is nothing to suggest that the application of strict standards is intended to nullify the benefits of preferences. The costs of developing and maintaining a certain level of quality, combined with testing and certification, can simply be beyond the capacity of many developing countries.

(iii) *Empirical evidence*

A large number of studies employ a broad range of methodologies that try to examine the trade impact of non-reciprocal preference schemes. The overall conclusion of this literature is that non-reciprocal preference schemes have a limited trade impact.¹⁵ Whalley (1990) concludes that “special and differential treatment has had only a marginal effect on countries’ economic performance, especially through GSP”.¹⁶ Another summary of the literature concludes that the GSP has led to “at best a modest increase in imports from beneficiary states” (Ozden and Reinhardt, 2003). Little has changed in terms of the scope of these schemes to alter such a conclusion, although one study by Rose (2002) concludes that GSP programmes have had a significant impact on trade.¹⁷ An OECD (2003c) assessment of GSP schemes concludes that where they have had a positive impact “the countries that have benefited most from preferences have been high-income developing

¹⁴ Mattoo et al. (2002) have estimated that Sub Saharan African exports to the US could increase by 8 -11 per cent due to the impact of AGOA. The overall increase in exports is expected to be \$100-140 million. They estimate that the increase could have been higher if the scheme had not imposed stringent rules of origin on apparel imports and excluded certain items, which are considered sensitive, from its coverage. They estimate that overall non-oil exports would have increased by \$0.54 billion without rules of origin restrictions. They argue that when the rules of origin are imposed on all beneficiaries in 2004, there will be an increase in transport and input costs due to switching input suppliers away from the cheapest source. They estimate that for Mauritius, between 2001 and 2004, AGOA will raise exports relative to the pre-AGOA period by 5 per cent. However, the increase in exports due to AGOA preferences would have been 36 per cent without the application of more stringent rules of origin. Madagascar is expected to witness more dramatic results, as during the 2001-2004 period exports are expected to increase by 92 per cent due to AGOA compared to the pre-AGOA period. However, during the 2005-2008 period, its exports will be lower by 19 per cent compared to the pre-AGOA situation, and if the less stringent rules of origin are applied the country is expected to experience growth that exceeds the current growth rates.

¹⁵ This literature is summarized in Bora et al. (2002) and Ozden and Reinhardt (2003). Some of the key studies include Clague (1972), Karsenty and Laird (1987ab) and Baldwin and Murray (1977) on the EC, Japan and United States. Ahmad (1978) focuses specifically on Canada.

¹⁶ The range of estimates of the increase in exports depends significantly on the modelling approach. On the upper end are estimates of a 20 per cent increase, while on the lower end the estimate is approximately 3 per cent. One general conclusion that can be drawn from the studies is that the scope for a positive effect on trade is limited to a few countries and a few sectors.

¹⁷ These results are described as “brutally contrarian” by The Economist magazine, and more work would be needed to validate this unique finding.

countries with pre-existing supply capacity, and some agricultural exporters receiving high income transfers because of high tariff and non-tariff protection”.

Many of these studies also focus on the source of the trade expansion. Here again, the estimates differ depending upon the modelling framework and assumptions. As indicated in Box IB1.1, one of the crucial assumptions is the degree to which products are differentiated. The more differentiated the product, the less trade will be diverted. Studies such as Ahmad (1978) assume a low degree of substitutability between beneficiary and non-beneficiary products, so the estimate for trade diversion is low.

(d) Implications for the multilateral trading system

Despite the irrefutable fact that non-reciprocal schemes are a deviation from one of the fundamental principles of the world trading system, the most-favoured-nation principle, they are still an essential part of that system. This is reflected in the legal framework, which was established to protect such schemes. Initially, legal protection was provided by special temporary waivers, as provided for under Article XXV of the General Agreement on Tariffs and Trade (GATT 1947). Legal cover for the GSP was later made permanent under the 1979 Enabling Clause.¹⁸ Preferential schemes not covered by the Enabling Clause still require a waiver under the WTO agreements.

Although this was not a specific amendment to GATT Article I, since it was a decision made by the GATT Contracting Parties, it had a similar effect. Specifically, it allowed for contracting parties to accord differential and more favourable treatment to developing countries, without according such treatment to other contracting parties. Paragraph 2 of the Enabling Clause outlined four specific types of treatment that were covered from legal challenges. These included: GSP schemes, differential and more favourable treatment with respect to GATT provisions concerning non-tariff measures, reciprocal agreements amongst developing countries and special treatment for the least developed among the developing countries.

Taken together, the provisions of the Enabling Clause were specifically designed to encourage developed countries to undertake positive market access initiatives towards exports originating from developing countries.

Perhaps as a result of the lower level of tariffs and an overall increase in the competitiveness of global markets, developing countries are now becoming increasingly concerned about the negative effects of non-reciprocal schemes if they are not beneficiaries. This concern has been manifested in two recent developments.

In the first case, India won a dispute settlement ruling against provisions under the EU’s non-reciprocal preference arrangements that grant developing countries combating illicit drug production additional trade preferences. The panel agreed with India that the special tariff preferences were inconsistent with the MFN obligation of the General Agreement on Tariffs and Trade (GATT Article I:1).¹⁹ The case was appealed by the EU to the Appellate Body and the panel’s finding was upheld, but on different grounds. The Appellate Body concluded that MFN was not applicable to the Enabling Clause and that preference-giving countries were entitled to make distinctions among beneficiaries on the basis of objective criteria that treated similarly situated countries similarly. The Appellate Body found that the EU arrangement lacked objective criteria with which to determine country eligibility for the additional trade preferences.²⁰

The second instance occurred when the Philippines and Thailand decided to take action in the context of a waiver for Lomé preferences (Box IB1.2). Eventually, they agreed to the waiver, but not until they extracted a concession from the EU, the preference-granting country, for their exports of canned tuna, which were suffering from the disadvantage of not having preferential market access.

¹⁸ The formal title of the Enabling Clause is the “Decision on Differential and More Favourable Treatment, Reciprocity and Fuller Participation of Developing Countries”. This decision was adopted under GATT in 1979.

¹⁹ WTO document WT/DS246/R.

²⁰ WTO document WT/DS246/AB/R.

Non-reciprocal preferences are also an issue in the current round of negotiations and have implications for the type of deal that may conclude the round. As indicated in Table IB1.4, preference margins can be significant in some products of export interest to developing countries. It then follows that preference-beneficiary countries would have an interest in shielding these preferences from any erosion. Indeed, formal proposals along these lines have been made to the Negotiating Group on Market Access, which deals with non-agricultural market access issues and the Special Session of the Committee on Agriculture, which deals with market access for agricultural products.²¹

Three options for addressing preference erosion have been put forward: a retention of preference margins, a delay in the erosion of preferences beyond the agreed reduction of MFN tariffs, and compensation for preference-beneficiary countries. For example, a group of African countries requested that “measures and mechanisms” be established to deal with preference erosion “with the aim of either avoiding or offsetting this problem, or compensating the affected Members”.²² In addition to being “duly compensated” for a loss of preferences, Mauritius requested that a competitiveness fund be established on the basis of contributions from the international financial institutions.²³

In response to the proposals on preference erosion, the Chairpersons of the negotiating groups dealing with agricultural and non-agricultural products proposed language for agreement by Members of the WTO in the lead up to the Fifth WTO Ministerial held in Mexico in September 2003. No agreement was reached at that Ministerial, hence no agreement was reached on how to handle the issue. The main thrust of the proposal in the agricultural negotiations was to delay the implementation of tariff reductions in products of significant interest to preference beneficiary countries.²⁴ The text on non-agricultural products took a different approach and left the issue open for further clarification.²⁵

At this stage of the negotiations it is difficult to pre-judge the outcome. On the one hand, non-reciprocal preference schemes require a legal waiver to co-exist with the multilateral trading rules. A condition of this co-existence is that they do not “prevent” MFN tariff reductions. As such, while there is broad sympathy with preference-beneficiary countries concerning the adjustment challenges they may face, it is not clear that their proposals will find broad support.²⁶

²¹ For a summary of the proposals to these two groups see WTO documents TN/AG/6 and TN/MA/12.

²² Submission by Ghana, Kenya, Madagascar, Mauritius, Nigeria, Rwanda, Tanzania, Tunisia, Uganda, Zambia and Zimbabwe (TN/MA/W/40, 11 August 2003).

²³ Submission by Mauritius (TN/MA/W/21, 7 January 2003).

²⁴ “In implementing their tariff reduction commitments, participants undertake to maintain, to the maximum extent technically feasible, the nominal margins of tariff preferences and other terms and conditions of preferential arrangements they accord to their developing trading partners. As an exception to the modality under paragraph 8 above, tariff reductions affecting long-standing preferences in respect of products which are of vital export importance for developing country beneficiaries of such schemes may be implemented in equal annual instalments over a period of [eight] instead of [five] years by the preference-granting participants concerned, with the first instalment being deferred to the beginning of the [third] year of the implementation period that would otherwise be applicable. The products concerned shall account for at least [20] per cent of the total merchandise exports of any beneficiary concerned on a three-year average out of the most recent five-year period for which data are available. Interested beneficiaries shall notify the Committee on Agriculture, Special Session accordingly and submit the relevant statistics. In addition, any in-quota duties for these products shall be eliminated. The preference-providing Members shall undertake targeted technical assistance programmes and other measures, as appropriate, to support preference-receiving countries in efforts to diversify their economies and exports.” (TN/AG/W/1/Rev.1)

²⁵ “We recognize the challenges that may be faced by non-reciprocal preference beneficiary Members and those Members that are at present highly dependent on tariff revenue as a result of these negotiations on non-agricultural products. We instruct the Negotiating Group to take into consideration, in the course of its work, the particular needs that may arise for the Members concerned.” (Job 03/150 Rev. 1).

²⁶ An argument that is central to the issue of preference erosion is adjustment assistance. In this regard, some discussion has taken place in various WTO groups about the role of the International Monetary Fund and the World Bank. In response to these discussions, the Managing Director of the IMF and the World Bank President sent a letter on 21 August 2003 to the Director-General of the WTO to clarify the roles that could be played by their institutions to assist developing countries’ concerns about the costs associated with adjusting to a more liberal environment (www.imf.org/external/np/sec/pr/2003/pr03140.htm).

Box IB1.2: Non-beneficiary concerns about preferential access: the case of canned tuna

An example of the concern of non-beneficiary countries about the consequences of preferences is the position that Thailand and the Philippines maintained at the Fourth WTO Ministerial Meeting in Doha in November 2001. These countries only agreed to join the consensus on the European Community request for a waiver to cover tariff preferences for African, Caribbean and Pacific states on the understanding that the EC would hold consultations with them on the impact of the scheme on their canned tuna exports. In specific terms, they wanted the EC to “examine the extent to which the legitimate interests of the Philippines and Thailand were being unduly impaired as a result of the implementation of the preferential treatment of canned tuna originating from ACP states”.

The waiver granted to ACP exporters would continue their exemption from the 24 per cent MFN duty that was applied to non-beneficiary exporters. Despite the 24 per cent margin, exporters from Thailand and the Philippines managed to penetrate the EU market. In 2002, Thailand exported approximately 63,000 tons of canned tuna to the EU at a value of €75 million. This fact, they argued, was evidence of their competitiveness in the EU market. Eliminating the preference margin would, therefore, yield positive benefits to their domestic economy.

Three rounds of consultations between the three Members were held after the Doha Ministerial, but no agreement was reached on how to resolve the issue. As a result, the two countries jointly requested the Director-General of the WTO to mediate the dispute. The Director-General appointed a mediator who delivered his opinion on 20 December 2002 that the European Community should open an MFN-based tariff quota of 25,000 tons for 2003 at an in-quota rate of 12 per cent *ad valorem*.

The mediator’s opinion was non-binding, which meant that the EC had the option to accept or reject it. In an expression of concern regarding the possibility that their preferential market access could be eroded, the ACP-EU Joint Parliamentary Assembly adopted a resolution on 3 April 2003 that called upon the EU to “refrain from adopting the mediator’s proposal”.

Despite this plea, the European Council decided on 5 June 2003 to accept the mediator’s proposal, based on the recommendation of the European Commission. European Council regulation No. 975/2003 adopted a tariff quota with country specific shares to Thailand (52 per cent), the Philippines (36 per cent) and Indonesia (11 per cent), with other countries sharing the remaining 1 per cent. This action appears to be the direct result of an initiative of non-beneficiary countries acting on their own behalf to counteract the discrimination and trade diversion arising from non-reciprocal preference schemes.

(e) Conclusions: the prospects for preferences

The evidence presented in this Section argues that despite the proliferation of non-reciprocal preference schemes, questions remain about their effectiveness in enhancing the industrialization and integration of developing countries into the trading system. First, the degree of actual preferential access resulting from these schemes is limited. In many cases, preference margins are quite small since the overall level of MFN protection in preference-granting countries is low. Second, even in cases where preference margins are significant, utilization is often significantly below potential.

Moreover, where meaningful preferences are granted, the degree of trade diversion is a concern for non-preference receiving countries. Preferences no longer command general support among developing countries. Finally what preferences remain will steadily be eroded by efforts to reduce MFN tariffs through successive rounds of multilateral negotiations, as well as by regional arrangements that cut across the existing patterns of preferences.

Taken together these developments imply that reliance on preferences is not a viable long-term strategy. If governments accept that they cannot count on preferences for the indefinite future, what strategy should they adopt to deal with the new reality? One approach to dealing with the loss of preferential market access would be to make every effort to increase utilization levels on products of interest to developing countries for as long as the schemes last. But such an approach would need to bear in mind the adjustment challenges that are likely to emerge later. Another approach would be to address the situation directly, and prepare domestic industries for future adjustment. Under this scenario, governments would not expend negotiating effort in trying to improve preference schemes or preserve preferential margins.

2. THE LIBERALIZATION OF SERVICES TRADE THROUGH THE TEMPORARY MOVEMENT OF NATURAL PERSONS

(a) Introduction

Globalization has been characterized by increasing trade in goods and services and increasing cross-border flows of investments, accompanied by a surge in the international movement of workers. The reduction of transport and communication costs, and the greater availability and lower cost of imported goods from their homeland have made it easier for people to move abroad. Migrants can read online newspapers from their home country, use cheap phone cards to keep in touch with their relatives, find the ingredients to cook their homeland recipes and travel regularly back home at relatively low cost. Although permanent migration accounts for most of the movement of workers across countries in developed countries, the temporary movement of workers has been growing the most over the last decade.

Today many different barriers to the movement of people remain. These include: stringent visa requirements, quotas, the application of economic needs tests (for example, employers might be required to search for a national employee before employing a foreign one), and limits on the recognition of professional qualifications. In the current round of services negotiations in the WTO, a significant number of Members have expressed keen interest in further facilitating the temporary movement of natural persons to supply services – the so-called Mode 4¹ of the General Agreement on Trade in Services (GATS).

The negotiations on Mode 4, which began during the Uruguay Round, resulted in Members scheduling commitments mainly on intra-corporate transfers of high-level personnel and business visitors. In this current round of services negotiations, developing countries stress the desirability of expanding the coverage of these commitments to other categories of workers.

GATS Article I:2(d) defines Mode 4 as “the supply of a service by a service supplier of one Member, through presence of natural persons of a Member in the territory of any other Member”. The Annex on Movement of Natural Persons Supplying Services under the Agreement specifies that two categories of measures are covered – those affecting natural persons who are “service suppliers of a Member” (i.e. self-employed suppliers who obtain their remuneration directly from customers), and those affecting natural persons of a Member who are “employed by a service supplier of a Member in respect of the supply of a service.” These natural persons can be employed either in their home country and be present in the host market to supply a service or be employed by a service supplier in the host country. In the latter case, there appears to be room for interpretation on whether foreign workers employed by a locally-owned firm are included or not in the definition of Mode 4 under GATS.²

Moreover, only temporary movement of workers is covered by GATS, as the latter excludes “natural persons seeking access to the employment market” and “measures regarding citizenship, residence or employment on a permanent basis”. Since “temporary” or “non-permanent” status in the host country is not specified in GATS, WTO Members have interpreted this notion differently in their schedules of services commitments, varying between three months and five years.

This Section first discusses the welfare consequences of the temporary movement of service providers, both for the originating and the receiving country, including the impact on merchandise trade and other modes of services supply. Second, it describes the barriers to Mode 4 exchange, and on the basis of multilateral commitments, assesses the degree of liberalization of Mode 4. Third, it provides new estimates on the magnitude of Mode 4 trade and compares it with cross-border services supply. The final subsection provides evidence on the patterns of Mode 4 movements.

¹ GATS identifies four modes for supplying services internationally. They are cross-border supply (Mode 1), consumption abroad (Mode 2), commercial presence (Mode 3) and the temporary movement of natural persons (Mode 4).

² The debate on the interpretation of this provision goes beyond the scope of this Section. See WTO document S/C/W/75.

(b) The economic impact of the temporary movement of service providers

Liberalization of Mode 4 trade can be expected to generate all the same types of gains as the liberalization of trade in goods. Indeed, the movement of natural persons is a mode for trading a service. It will increase global wealth, favour specialization and a more efficient allocation of resources, foster transfer of technology, encourage innovation, and offer consumers in each country a wider variety of services at lower prices. There are specific effects associated with the fact that it is people and not goods that are moving and that unlike migrations, the movement of people is temporary and not permanent.

(i) *Direct welfare effects of Mode 4 movements*

The economic consequences of liberalization of temporary movement of service providers are different for the originating country (exporter of services via Mode 4) and the receiving country (importer of services via Mode 4).³

Effects in the originating country

For the originating country, liberalization of Mode 4 movements generates benefits and costs. First, benefits can complement and facilitate trade under other modes. Direct personal contacts may help to expand trade in services under other modes by reducing information imperfections and enhancing the credibility of companies and individuals. For example, lawyers (self-employed or working for a law firm) moving abroad to provide their services can make themselves known and increase their credibility. This might then increase the services provided via other modes, such as online (cross-border activity, Mode 1), or may attract new clients who move abroad to purchase their services (consumption abroad, Mode 2). Alternatively, their movement abroad may trigger the idea of investing in the host country, or establishing an office abroad (commercial presence abroad, Mode 3).⁴ All these complementarities will contribute to economic activity and national wealth.

Second, Mode 4 mobility is also a way to reduce the pressure on labour markets and wages resulting from a high level of unemployment or an economic slump. In developing countries Mode 4 mobility can be seen as a strategy to fight unemployment. When a worker moves abroad, he will not be part of the originating country's workforce for the period of his stay abroad and this will sustain wages and reduce unemployment. The fact that Mode 4 only refers to temporary movement of persons is not a limit to this policy, as a new person can move abroad when a worker returns home.

Third, Mode 4 is a channel of technology transfer and development of human capital. During their stay abroad, service suppliers accumulate knowledge and experience, both professionally and in terms of the market of the host country. Upon return, they will make their experience available to their home country. They will contribute to their country's growth and development.

Fourth, Mode 4 is a source of financial inflows. Income earned abroad is in large part repatriated and contributes to increasing national wealth. Remittances play an important role in the economy of developing countries both because they are significant in value and tend to be more stable than private capital flows. For example, in 2001 workers' remittances to developing countries were equal to 42 per cent of total FDI inflows to those countries (World Bank, 2003a).

³ See also OECD (2003d).

⁴ The relationship between Mode 4 and the other modes to supply a service is discussed further in subsection (iii). Some evidence on these linkages between modes is also provided.

Finally, from the point of view of individual firms, mobility of workers under Mode 4 is a source of flexibility. Intra-firm transfers may facilitate the spread of the know-how and the standardization of management within a firm. Moreover, Mode 4 movement facilitates outsourcing: companies send people to manage their outsourced operations and service suppliers of the outsourced activity come to the head office to acquire a better understanding of the needs of the company they work for.⁵ Increased outsourcing opportunities help firms to adapt to demand fluctuations, reduce some of their costs and favour access to more qualified labour.

Movements of persons under Mode 4 also present some costs for the originating countries. First, if the person moving abroad is a skilled, dynamic and productive worker who is difficult to replace, the originating country faces a temporary production loss due to the lower average productivity of local workers. Second, for the period in which a skilled worker remains abroad, the investment in education undertaken by the individual or by the government is transferred abroad. Third, the originating country bears a cost in terms of forgone tax revenue.⁶ Highly-skilled workers earn the highest income and, in consequence, are also the ones paying high taxes. Finally, skilled workers may be in short supply in developing countries. Their movement abroad, even if temporary, may create wage pressure on the home labour market⁷ and in some cases greatly limit or effectively remove the supply of essential services.

It is worth noting that, unlike permanent migration, the temporary movement of skilled workers abroad does not constitute “brain drain” (loss of skilled workers) for the originating country, but rather it is a case of “brain circulation” or even accumulation of skills, as skilled workers who temporarily move abroad under Mode 4 will return to their country of origin with more knowledge and experience than before. However, it is possible that higher mobility under Mode 4 increases the probability that workers remain abroad for the long term. Temporary workers abroad may have their temporary work permits continually extended or converted into a permanent work permit.⁸ To the extent that the liberalization of temporary movements of workers increases the likelihood of migration, Mode 4 liberalization would also contribute to the “brain drain” and reduce the overall level of human capital in the originating country.

In sum, the overall impact of liberalization of Mode 4 mobility on the level of human capital of a country is ambiguous. It will depend on whether the skills gained from the persons who return to their country of origin after a working experience abroad exceed the skills lost from those workers who permanently migrate abroad.

Effects in the receiving country

From the perspective of the receiving country, temporary labour mobility can be used as a means of dealing with shortages of labour supply in some sectors and increasing firms’ flexibility. It may help to address problems generated by demographic specifics (such as insufficient population or ageing population), and to reduce illegal labour market activity.

Many countries recognize the importance of admitting foreign workers to meet labour shortages whether they are due to cyclical or structural factors, or both. The issues associated with labour shortage may be important because (i) human capital shortages can deter investment and thus have a negative effect on growth; and (ii) a lack of skilled workers when the demand for skilled workers is high will increase the latter’s wages relative to those of unskilled workers. As a consequence, income inequality within the country will increase. Higher consumer prices may result in lower welfare for the unskilled labour force. Mode 4 mobility can help to alleviate these problems.

⁵ Note the latter refers to Mode 4 entrants to the home country.

⁶ The magnitude of this effect will depend on the specific tax treatment of Mode 4 related incomes.

⁷ This cost can be minimised through appropriate regulation. For example, taking into account that nurses in South Africa and the West Indies are in short supply, the British Government has established a code of conduct (though not binding) banning the recruitment of nurses from these countries (OECD, 2003d).

⁸ A recent survey carried out by the United Kingdom Home Office, for example, shows that only 28 per cent of the 308 individuals interviewed, who were high-skilled workers holding a work permit, did not intend to extend their permanence in the UK beyond the expiry date of their current work permit.

For example, due to the recent economic boom in the information technology (IT) sector, Western Europe faced a shortage of IT specialists. This shortage created strong wage pressures, resulting in wage increases for IT specialists of over 60 per cent per annum. European firms responded by increasing their outsourcing to non-Western European IT service providers.⁹ To alleviate its shortage of technical workers, Germany, for example, initiated in 2000 a Green Card program that would allow (up to 20,000) IT experts from non-EU countries to work in Germany for up to five years.

As recognized above, liberalization of Mode 4 facilitates outsourcing. In particular, it makes a larger pool of service suppliers available to firms, reduces outsourcing costs and favours access to more qualified service suppliers. Outsourcing to self-employed service providers can help a firm to adapt to demand fluctuations. Therefore, it increases a firm's flexibility and favours a more efficient allocation of resources. This benefits the receiving country.¹⁰

Temporary movement of workers, including service suppliers, may help to alleviate problems caused by specific demographic challenges. For example, the phenomenon of an ageing population, characterizing most developed countries increases the demand for health and domestic services and poses risks to the sustainability of social security systems based on a "pay as you go" structure. The temporary movement of young foreign workers to developed countries may re-equilibrate the share of the working population.¹¹ Finally, to the extent that the temporary movement of service suppliers may represent an alternative to illegal immigration, liberalization of this mode of supply may reduce the size of the illegal labour market.¹²

One of the main concerns related to the liberalization of the temporary movement of workers, from the point of view of the destination countries, is that foreign workers would be in direct competition with nationals of the host country working permanently in the same occupations. The fact that Mode 4 relates only to "temporary" movements of workers weakens the argument only marginally, as various flows of temporary workers may follow one another. Connected to this is the fear of labour-recipient countries that Mode 4 mobility might be a preliminary step toward permanent migration¹³, and that it can lead to higher unemployment.

Indeed, service suppliers moving under Mode 4 might replace domestic workers. Yet this negative effect may be offset by positive effects. First, the income of foreign workers generates wealth in the host country, including in the form of domestic consumption and tax revenue. Second, there is a positive competition effect. More efficient foreign workers may replace less qualified domestic workers, while the latter may specialize in sectors where they have a comparative advantage, thus becoming internationally competitive in that specialization.

In conclusion, the liberalization of trade in services under Mode 4 can generate gains both for the importing and the exporting country. However, it also imposes some adjustment costs, arising from factors such as the temporary unavailability of skilled workers in the labour exporting country and competition between domestic and foreign workers in the labour importing country. In both cases an appropriate regulatory framework would ensure that the benefits of liberalization are obtained and that the flow of workers responds to the needs of the economy, thus minimizing the risk of disruptions in the domestic labour market.

⁹ Including in the form of cross-border supply of the service (Mode 1) and consumption abroad (Mode 2).

¹⁰ A similar argument has been made for the originating country.

¹¹ This argument also holds for permanent migration.

¹² This point has been made, for example, by President Bush in the presentation of the US new temporary worker programme on 7 January 2004. Highlights of the presentation can be found in <http://www.whitehouse.gov/news/releases/2004/01/20040107-3.html>.

¹³ Permanent migration imposes additional costs in terms of infrastructure (such as schools and housing) and social and cultural integration.

Empirical evidence

Estimates of the economic impact of trade liberalization suggest the possibility of annual gains from Mode 4 liberalization ranging between \$150 billion and \$200 billion (Winters and Walmsley, 2002 and Rodrik, 2002).¹⁴

Gains are estimated to accrue both to developed and developing countries, and would come mainly from the movement of low-skilled workers rather than high-skilled workers. The reason is that low-skilled workers are employed in more sectors of the economy, and the cumulative positive effects of liberalization of movements of unskilled workers are larger. The source of these gains is the narrowing gap between wages in rich and poor countries. Therefore, since services prices and wage differentials between developed and developing countries exceed a ratio of ten, whereas for merchandise trade this ratio is equal to two, the gains from liberalization of temporary labour mobility in services are, in general, expected to be greater than those from further liberalization of trade in goods (Rodrik, 2002).

Existing empirical literature on the economic effects of Mode 4 movement is very limited and neglects some important factors. On the one hand, gains (but adjustment costs as well) would be lower if legislation in a country impedes an adjustment of wages downward. In addition, effective gains might be limited by the capacity of absorption of service suppliers by developed countries' labour markets. On the other hand, existing estimates do not take into account the positive spillovers that the returnees would generate for their home countries, such as transfer of experience and investment of money earned abroad. When included, these longer term considerations would further increase gains from Mode 4 liberalization.

(ii) The relationship between Mode 4 mobility and merchandise trade

There are various channels through which the stay of people in a foreign country, both permanently and temporarily, may enhance merchandise trade flows:

- *Preference effect:* The presence of migrants increases the demand for foreign products. Migrants prefer goods they were used to consuming at home. Some of these products might be very difficult to find abroad, and they will import them from their country of origin.
- *Information effect:* Migrants possess knowledge about their country of origin that makes it easier for them to acquire information about profitable international trading opportunities and helps to reduce informal barriers to trade. In other words, migrants can help to reduce demand and supply matching costs. For example, since migrants know consumer preferences in their country of origin, they can inform exporters in the destination country about whether their product could be successfully marketed or whether it needs to be adapted to importers' preferences. Also migrants can help reducing network search costs. Migrants have better connections with the local business network. They can help producers of consumer goods to find better distributors, assemblers to find the best component suppliers and investors to find joint-venture partners.
- *Enforcement effect:* Migrants facilitate a stronger enforcement of international contracts. International transactions are traditionally based on confidence, as delivery and payment may occur at different places. Since migrants have a better knowledge of local business law and practices, uncertainties connected with transactions are reduced.¹⁵

¹⁴ Winters and Walmsley (2002) estimate the impact of an increase in developed countries' quotas on the inward movement of workers from developing countries equivalent to 3 per cent of the developed countries' total labour force. They find an aggregate gain of \$150 billion. Rodrik (2002) estimates the impact of the creation of a temporary work visa scheme, with a quota set at 3 per cent of the developed countries' labour force. Under this scheme, skilled and unskilled workers from developing countries would be allowed employment in developed countries for 3-5 years, to be replaced by a new wave of inflows upon return to their home countries. This system is found to yield a gain equal to \$200 billion annually.

¹⁵ See also discussion in Section IID.

Overall, the information and enforcement effect suggest a positive impact of cross-border movement of people on both imports and exports, whereas the preference effect only concerns imports.

A link between immigration, imports, and exports has been found by a number of studies that have used a gravity equation¹⁶ to analyse bilateral trade patterns. Most studies on the impact of labour mobility on trade flows base their empirical analysis on an augmented form of the traditional gravity model, where the effect of migration on trade flows is captured by adding a measure of the migrant stock to the conventional variables (GDP, distance, border, common language). All studies find a positive effect of migration on trade. Estimates of the impact of a 10 per cent increase in migrant population on exports range from 0.13 per cent to 2.5 per cent. The effect on imports range between 0.1 per cent and 3.1 per cent (see Table IB2.1 for an overview). Another recent study, using cross-province variations in international trade and immigration patterns for Canada, shows that the average new immigrant expands exports to his/her native country by 312 dollars per annum and expands imports by 944 dollars (Wagner et al., 2002).

Table IB2.1
Principal studies on the impact of migration on trade

Authors	Sample countries and period	Export elasticity	Import elasticity
Gould (1994)	US and 47 trade partners: 1970-86	0.02	0.01
Head and Ries (1998)	Canada and 136 partners: 1980-92	0.1	0.31
Dunlevy and Hutchinson (1999,2001)	US and 17 partners: 1870-1910	0.08	0.29
Girma and Yu (2002)	UK and 48 partners: 1981-1993	0.16 ^a	0.10 ^a
Combes et al. (2002)	95 French departments: 1993	0.25	0.14
Rauch and Trinidad (2002)	63 Nations: 1980, 1990	0.21 ^b	0.21 ^b
Wagner, Head and Ries (2002)	5 Canadian provinces and 160 partners: 1992-1995	0.08, 0.01	0.25, 0.09

^a Trade with non-Commonwealth countries.

^b Computed by Wagner et al. (2002) for homogeneous goods. Trade elasticity for differentiated goods is 0.47.

Source: Wagner et al. (2002).

Estimates obtained on the basis of dynamic models also support the prediction of a positive and significant effect of immigration on trade. One study shows that over time, a 10 per cent increase of immigrants to the United States will increase US exports to the country of origin by 4.7 per cent and US imports from the country of origin by 8.3 per cent (Gould as reported in Rauch 2001). Similar estimates for Canada show that a 10 per cent increase in immigrants from a given country increases Canadian exports to that country by 1.3 per cent and imports from the country by 3.3 per cent (Head and Ries, 1998). For the United Kingdom, an increase of 10 per cent in immigrants from a non-Commonwealth country has been estimated to increase UK exports (imports) by 5 per cent (1 per cent) in the long-run, while the effect is found to be insignificant for immigrants from Commonwealth countries (Girma and Yu, 2002).

It is worth noting that, although not very robust, there appears to be some evidence of a stronger link between movement of people and imports than between the movement of people and exports. The fact that information and enforcement effects affect both imports and exports, while the preference effect only affects imports might explain this finding. If this is the case, migration flows could be expected to be linked to a deterioration of the balance of payments.

¹⁶ A "gravity equation" seeks to explain relationships in terms of particular characteristics of trading partners, such as income levels, geographical proximity, historical, linguistic or cultural ties, and so on.

Regarding the temporary movement of people, theoretical considerations suggest that the impact of Mode 4 mobility on trade may be different from that estimated by the literature on migration discussed so far. As far as imports are concerned, a worker moving abroad temporarily might have a higher propensity than a permanent migrant to import from his country of origin, as he or she has probably not yet adapted to local products (stronger preference effect). As regards exports, on the one hand a worker who temporarily works abroad might not stay long enough to acquire the appropriate knowledge of the local market (destination market) to set up new trade links (weaker information effect). On the other hand, (if he stays long enough) on his return to his home country, he might begin to import a product that he has discovered during his stay abroad. Or, a short stay abroad might be needed to establish links with foreign distributors and importers (stronger information effect). Overall, the final effect of Mode 4 mobility on exports may theoretically be higher or lower than that of migration. The question requires empirical analysis.

Existing studies on the impact of labour mobility on merchandise trade flows have measured labour mobility using data on migration. Since Mode 4 only refers to temporary movements of persons providing a service, these studies can only provide a rough indication of the impact of Mode 4 mobility on trade. They fail to capture both the “temporary” nature of this type of labour mobility and the fact that it relates only to movements of workers who provide a “service”.

Using a gravity model of trade augmented for the temporary movement of workers, the impact of Mode 4 on bilateral merchandise trade for the United States has recently been estimated.¹⁷ The study finds a positive and significant effect of temporary movements of service providers on merchandise trade. The results suggest that a 10 per cent increase in temporary movement of persons to provide services increases US imports by 2.8 per cent and exports by 2.5 per cent (Jansen and Piermartini, 2004). Both figures fall in the upper range of the estimates relative to migration flows, and there appears not to be a significant difference between the impact of Mode 4 movement on exports and on imports.

(iii) The relationship between trade in services under Mode 4 and under other modes of supply

Liberalization of Mode 4 is likely to affect services trade under other modes. The impact will depend on whether Mode 4 is a substitute or a complement for other modes of supply of a service, or if it is simply the only mode available to deliver the service. There are circumstances where a service can be provided under several modes. For example, a law firm can assist a foreign client by offering consultancy online (Mode 1), or it may request its client to travel for an appointment to the firm’s headquarters (Mode 2). Alternatively, the firm may decide to open a partnership abroad (Mode 3), or it may temporarily send a lawyer abroad (Mode 4). In these cases, liberalization of trade under Mode 4 may be expected, other things being equal, to have a negative impact on trade under other modes. Trade under Mode 4 may replace trade under other modes, unless the other modes for supplying a service are also liberalized.

There are other circumstances when the physical presence of the service supplier is necessary to provide the service. The supply of restoration, repair, construction, most health and social services (e.g. midwives or nurses) are all examples where there is a need for proximity between the supplier and the consumer to supply the services. To the extent that the consumer is immobile, in these cases, there is not a clear direct relationship between Mode 4 and other modes to provide a service.

On the other hand, there are circumstances where temporary movement of people may actually complement trade in services under other modes. In these cases, a positive relationship between liberalization of temporary movement of persons who provide a service abroad and services trade under other modes can be expected. For example, direct preliminary contacts with a client might be needed for a lawyer to acquire credibility and establish a permanent business link which can eventually lead to other advisory work provided online (Mode 1) or can attract new clients to travel abroad to consult that lawyer (Mode 2).¹⁸ Also, liberalization of Mode 4 facilitates

¹⁷ Data on Mode 4 used in the study are obtained from national statistics as explained in Subsection IB2.d.(ii).

¹⁸ The business visitor category in many WTO Members’ schedules envisages precisely this type of movement.

offshore outsourcing by allowing firms to send people to familiarize themselves with their service suppliers and manage outsourced operations. The service will then be supplied online (Mode 1).

Similarly, it is plausible to expect complementarities between the temporary movement of persons who provide a service and commercial presence abroad (Mode 3). First, direct contacts established with clients in a foreign country via Mode 4 may provide the incentive to set up an affiliate there, or previous direct relationships with executive managers of a foreign company may be a prerequisite for decisions on acquisitions or mergers. Second, a company that has an affiliate abroad may need to send workers there (intra-firm transfer) to standardize the management, to spread know-how, or to provide some temporary assistance. Third, a local company may sign a construction contract with a foreign company, involving movement of workers (Mode 4), including unskilled workers, and the establishment of a commercial presence (Mode 3). Fourth, market access barriers to the movement of natural persons, such as visa conditions requiring that a commercial presence is established, can render Mode 3 and 4 complementary. Insofar as liberalization of Mode 4 increases temporary movement of persons who move to provide a service, it may also enhance trade under Mode 3 and vice versa.

The experience of the IT industry in India indicates that Mode 4 is associated both with more inward and more outward foreign investment. During the 1990s there was a large flow of Indian professionals to the United States, the bulk of whom were IT specialists. Over the same period, multinationals and non-resident Indian investment in the Indian IT industry has risen, and the share of US-based non-resident Indians' collaborations in India's IT sector has reached a significant 40 per cent. Many Indian IT professionals who have worked in the United States have had a significant influence on the decision of US multinationals to set up activities in India. At the same time, the large flow of knowledge and technology spillovers, including associated with Mode 4 exports, has facilitated the development of the IT industry in India. Subsequently, Indian IT companies, such as Wipro and Infosys, have established subsidiaries abroad or partnerships, thus engaging in Mode 3 exports (Rupa Chanda, 2003).

Overall, theoretical considerations suggest that the relationship between trade in services under Mode 4 and under other modes is ambiguous. The impact of liberalization of Mode 4 on trade in services under other modes is likely to differ across sectors and economic activities, and it will depend on whether substitution or complementary effects dominate. Whether the overall impact of liberalization of Mode 4 on trade under the other modes is positive or negative is therefore a question that requires empirical investigation.

A recent study estimates the relationship between trade in services under Mode 4 and under the other modes (Jansen and Piermartini, 2004).¹⁹ Bilateral trade in services under the various modes is modelled on the basis of the traditional gravity equation augmented by a measure of temporary movement of workers. Table IB2.2 presents the results of these estimates. It is found that a 10 per cent increase in the temporary movement of people increases services imports (exports) under Mode 1 by 3.1 (2.9) per cent, and it is linked to higher foreign direct investment inflows (8.3 per cent) and outflows (3.5 per cent). These flows are taken as a proxy for trade in services under Mode 3. Lack of data makes it very difficult to establish causality between Mode 4 and FDI flows. The relationship between FDI and Mode 4 runs in two directions – larger temporary movement of persons leads to larger flows of FDI and vice versa. The large coefficient for the relationship between Mode 4 and Mode 3 reflects the fact that at present liberalization of Mode 4 is generally linked to commercial presence abroad. No significant relationship is found between services trade under Mode 2 and Mode 4.

Table IB2.2
The relationship between Mode 4 and the other modes of services trade

	Mode 1		Mode 2		Mode 3	
	imports	exports	imports	exports	imports	exports
Mode 4	0.31***	0.29***	0.18	-0.05	0.83**	0.35*

Note: ***, **, * denotes when the coefficient is significant at the 1, 5, 10 per cent significance level, respectively.
Source: Jansen and Piermartini (2004).

¹⁹ Due to the lack of data, this study only refers to the United States and the United Kingdom.

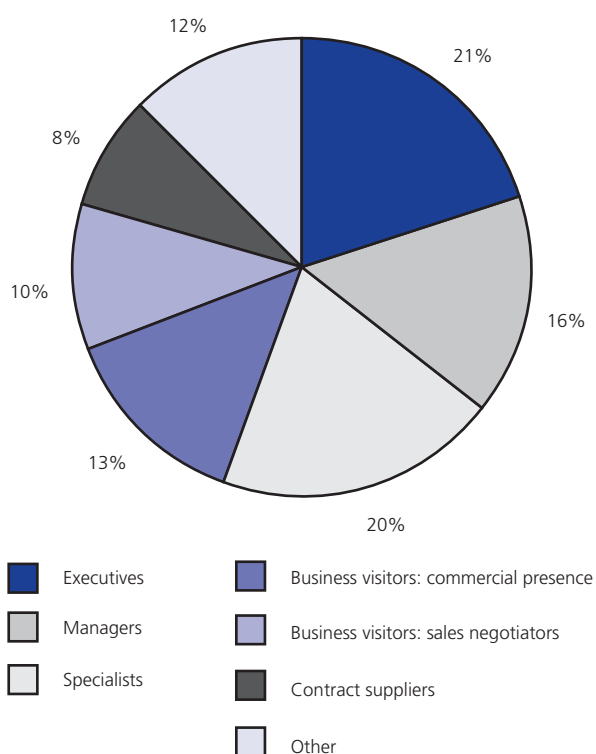
(c) Restrictions to the temporary movement of natural persons and liberalization efforts under GATS

Economic, social and cultural considerations have induced governments to intervene to restrict the mobility of workers across countries. There are a variety of measures that constitute barriers to Mode 4 trade.²⁰ With a view to protecting local labour markets, many countries have introduced quantitative restrictions on the movement of workers and/or economic needs tests. The latter imply that domestic employers have to prove that no domestic worker is available to do the relevant job in order to be able to employ a foreign worker. Such procedures are time consuming and costly for employers, making it significantly less attractive to hire foreign workers as opposed to domestic ones. The issuance and renewal of visas and work permits is often cumbersome and expensive, resulting in costs for both employers and foreign employees.

Double taxation burdens placed on foreign workers and the non-portability of pension and other social contributions lower the attractiveness of temporary employment abroad. Skilled foreign workers also often face difficulties to obtain appropriate recognition of their qualifications, educational degrees, training and experience.

In the Uruguay Round, Members undertook commitments to liberalize trade in services including on the movement of natural persons. The results of these negotiations form part of the General Agreement on Trade in Services (GATS). The structure of the GATS allows Members to specify the categories of persons

Chart IB2.1
Mode 4 commitments: breakdown by categories of natural persons
(Percentage)



Note: Percentages are based on the number of entries by WTO Members that have made commitments on Mode 4 in the horizontal section of their GATS schedules.
Source: WTO.

(as service suppliers) in respect of which it wishes to grant access. Members decide in the course of negotiations whether they want to liberalize particular categories of temporary foreign labour supply and are entitled to do so partially or conditionally if they so wish. Any conditions attached to agreed liberalization measures are laid down in the so-called "national schedules of specific commitments."

The GATS thus provides Member Governments with a flexible mechanism to liberalize the movement of natural persons in the sense that it offers a wide range of tools to specify the exact contours of this liberalization. Commitments lead to a higher level of predictability and transparency in Mode 4 trade. Unilateral schemes of Mode 4 liberalization, for instance, have the disadvantage that they can be revoked whenever the receiving country wishes.

In 2004, 108 out of a total of 147 Members had made horizontal commitments for the liberalization of the temporary movement of natural persons.²¹ A majority of these Members chose to specify certain categories of natural persons to which their commitment applied. Approximately 15 per cent of all schedules did not specify any categories but merely referred to general requirements for entry. The number of categories of natural persons referred to in the remaining 85 per cent

²⁰ See also World Bank (2003a).

²¹ A horizontal commitment applies to a list of specified economic sectors. The remaining 39 Members have thus not made any commitment at all or only specific commitments, i.e. commitments limited to one sector.

of schedules is very limited and mainly refers to high-skilled workers. Categories include i) intra-corporate transferees (ICTs) who may be executives, managers, or specialists; ii) business visitors; iii) contract service suppliers; and iv) other high-level management officials/specialists not clearly indicated as ICTs. Chart IB2.1 illustrates how the total of 328 entries by Members is distributed over the different categories. Only a very small fraction of scheduled entries under GATS could be considered to refer to low-skilled workers.²² The chart also reveals that intra-corporate transferees account for the highest proportion of commitments, at 69 per cent. This reflects a strong link between Mode 4 liberalization and wider FDI attraction objectives.

An interesting feature of the liberalization of temporary movement of natural persons under GATS is that the term “temporary” is not defined in GATS. Only about one third of the Members have specified maximum periods of stay for persons covered by Mode 4 in their schedules of commitments.²³ Specified periods tend to be longer for intra-corporate transferees, with 88 per cent of commitments allowing either at least 36 months or not specifying a time limit (Table IB2.3). On the other hand, business visitors are allowed to enter for considerably shorter periods: 60 per cent of commitments for this category restrict entry to less than three months. This is in line with the nature of the task to be performed.

Table IB2.3
Mode 4 commitments by allowed duration of stay and by category of natural persons
(Number)

Duration of stay	Intra-corporate transferees			Business visitors	Contract suppliers	Other
	Executives	Managers	Specialists			
Less than 36 months	10	10	13	58	12	0
36 months or more	28	29	30	1	0	1
Unspecified	42	58	58	34	0	16
Total	80	97	101	93	12	17

Note: Entries in GATS schedules containing Mode 4 commitments in the horizontal section on duration of stay, as of April 2004.
Source: WTO.

It has been mentioned above that Governments may impose a variety of restrictions on the movement of natural persons. In their schedules of specific commitments, Members are required to inscribe those regulatory measures that are either “market access” restrictions or discriminatory (national treatment inconsistent) measures. As the presence of each type of natural persons affects labour markets differently and, more generally, has different economic effects on recipient countries, limitations tend to be stated in terms of categories of workers.

As most commitments under Mode 4 refer to intra-corporate transferees, it is hardly surprising that this category contains the largest number of market access limitations. Pre-employment is the most common condition affecting intra-corporate movements. Frequently, commitments require that the transferee must have been working for the company for at least one year prior to his transfer to the host country. Domestic minimum wage restrictions, which prevent firms from paying lower wages to foreign workers, are also important. Normally these are tied to other similar measures related to domestic work conditions, such as working hours and social security regulations. These measures seek to avoid damaging effects in the host economy, like downward pressures on wages or increases in unemployment. They reveal that countries are willing to allow firms to move employees from abroad only where these are indispensable for strategic business reasons. Numerical quotas are also common in the category of intra-corporate transferees. References for establishing quotas include a firm’s total or senior staff, or even a country’s total workforce. Links with Mode 3 (commercial presence of firms in the host economy) also figure among the entry restrictions. Economic needs tests (ENTs) are also frequent for this category. It is interesting to note that for most Members maintaining ENTs, criteria for the application of the tests have not been specified. Technology transfer clauses are present

²² Definition of low-skilled workers as in WTO (1998a).

²³ Note that this lack of definitional clarity makes it difficult to measure Mode 4 flows, as the definition of “not permanent” workers in national and international statistics on labour movements does not necessarily correspond to the one specified in Members’ GATS schedules. See subsection (d) and (e) on the measurement of Mode 4 flows.

in around a quarter of commitments referring to this category. They suggest that some form of spillover or productivity effect is expected from the presence of foreign natural persons. Finally, some Members have specified that they reserve the right to suspend commitments in the event of labour-management disputes.

Table IB2.4
Entry restrictions by category of natural persons
(Number)

	Intra-corporate transferees			Business visitors	Contract suppliers	Other
	Executives	Managers	Specialists			
Economic needs tests	5	20	24	0	0	6
Pre-employment	39	37	40	6	0	1
Link to Mode 3	7	12	12	0	0	0
Numerical limits	20	20	25	4	0	8
Minimum wage	15	15	15	0	1	0
Absence of disputes	4	7	6	4	1	1
Technology transfer	8	9	13	0	0	2

Note: Entries in GATS schedules containing Mode 4 commitments in the horizontal section with market access limitations, as of April 2004.
Source: WTO.

The most common national treatment limitations scheduled by Members relate to fiscal measures. Most important is the restriction on the granting of subsidies only to domestic nationals, which particularly affects intra-corporate transferees and business visitors. Such limitations may act as important factors in discouraging foreign workers from working in the host economy. Real estate limitations restrict foreigners from buying property in the host economy. Mobility restrictions – geographical as well as sector-based – prevent multinational employees from moving between firms. Both aim at preventing international workers from staying for long periods, highlighting the temporary character of GATS Mode 4 commitments.

Table IB2.5
Discriminatory measures by category of natural persons
(Number)

	Intra-corporate transferees			Business visitors	Contract suppliers	Other
	Executives	Managers	Specialists			
Real estate	10	11	10	10	1	5
Subsidy	25	26	26	39	1	2
Foreign exchange	1	1	1	0	0	0
Borrowing	0	0	0	0	0	1
Taxation	4	6	7	2	0	1
Mobility restrictions	2	2	2	4	0	0

Note: Entries in GATS schedules containing Mode 4 commitments in the horizontal section with national treatment limitations, as of April 2004.
Source: WTO.

To sum up, the particularities and levels of Mode 4 liberalization under GATS vary across Members. Nonetheless, a number of common features can be extracted. The first main feature is the limited degree of liberalization overall. Current commitments refer to a limited number of specific and detailed categories of workers. Furthermore, Mode 4 commitments are characterized by a relatively high number of restrictions concerning market access and national treatment. The second main feature is the strong bias towards movement of skilled service providers. Only a small fraction of the categories of natural persons referred to in existing commitments can be identified as covering low-skilled workers. Last but not least, Mode 4 liberalization under GATS reflects a strong link with the wider objective of attracting foreign investment, as the highest number of commitments has been made for intra-corporate transferees.

(d) Importance of Mode 4 flows

Since the entry into force of GATS in 1995, no comprehensive statistical framework for the measurement of the movement of natural persons has been developed. At present, there exists no systematic data collection by regional or international organizations for data on temporary labour movements. Countries follow different classifications and compilation methodologies, thereby hindering cross-country comparability. This lack of reliable and comparable international statistics makes it difficult to measure the importance of Mode 4 trade flows.

(i) *Measuring Mode 4 trade with BOP data*

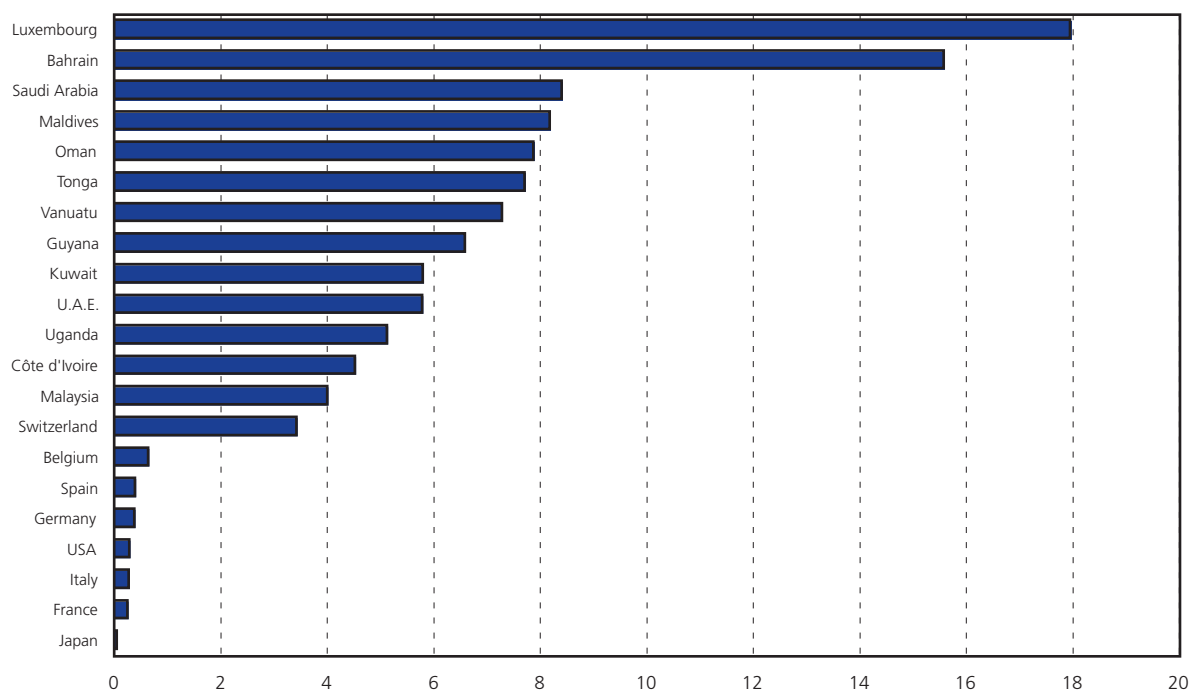
The Balance-of-Payments (BOP) indicators “compensation of employees” and “workers’ remittances” provide, for a large number of countries, internationally comparable quantitative information on the movement of workers across countries (for definitions, see Box IB2.1).

The ratio of the sum of payments of compensation of employees’ and of workers’ remittances to GDP sheds some light on the impact of the use of a foreign labour force on the economy (Chart IB2.2). For Luxembourg, this ratio reached 18 per cent of GDP in 2002, mainly due to compensation paid to its large number of border workers. Chart IB2.2 reveals that employing a foreign labour force is economically significant in Arab Gulf countries, where the ratio varies between almost 6 per cent for Kuwait and 16 per cent for Bahrain. It is worth noting that, in 2002, Saudi Arabia and the United Arab Emirates ranked second and third as world contributors of remittances. By contrast, in the United States, which is the leading source of remittances in the world, hiring of foreign workers represented a share of only 0.3 per cent of GDP.

Chart IB2.2

Ratio of compensation of employees’ and workers’ remittances payments to GDP, 2002

(Percentage)



Source: IMF (2004) and national statistics.

Box IB2.1: Balance of payments and Mode 4

The BOP current account indicators “Compensation of employees” and “Workers’ remittances” cover labour-related income flows between the residents of an economy and the rest of the world, whereby a person is considered as resident when he or she stays for a year or more.

i) Compensation of employees comprises “wages, salaries, and other benefits, in cash or in kind, and includes those of border, seasonal, and other non-resident workers” (BPM5, p.169).

Limitations for measuring Mode 4:

- Temporary workers employed in any economic sector are covered (i.e., not specifically in the services sectors) thus overestimating Mode 4.
- Limited to workers staying abroad for less than one year, while Mode 4 covers employment of up to 5 years.
- Includes border workers.
- The country of origin of the foreign workers is rarely specified.
- Covers categories of workers excluded from Mode 4 (i.e., local employees of embassies).
- It does not distinguish whether a foreign worker is employed by a foreign or domestic company in the host country.

ii) Workers’ remittances refer to current transfers of migrant workers who are employed in a foreign economy in which they are residents (BPM5, p.302).

Limitations for measuring Mode 4:

- Remittances represent only the portion of workers’ compensation saved and sent back to the home country.
- Also covers transfers made by permanent migrants, which are excluded from Mode 4;
- A significant portion of remittances do not flow through official channels and may not be recorded in the figures at all.
- They relate to foreign workers employed in any economic sector, not specifically the services sectors.

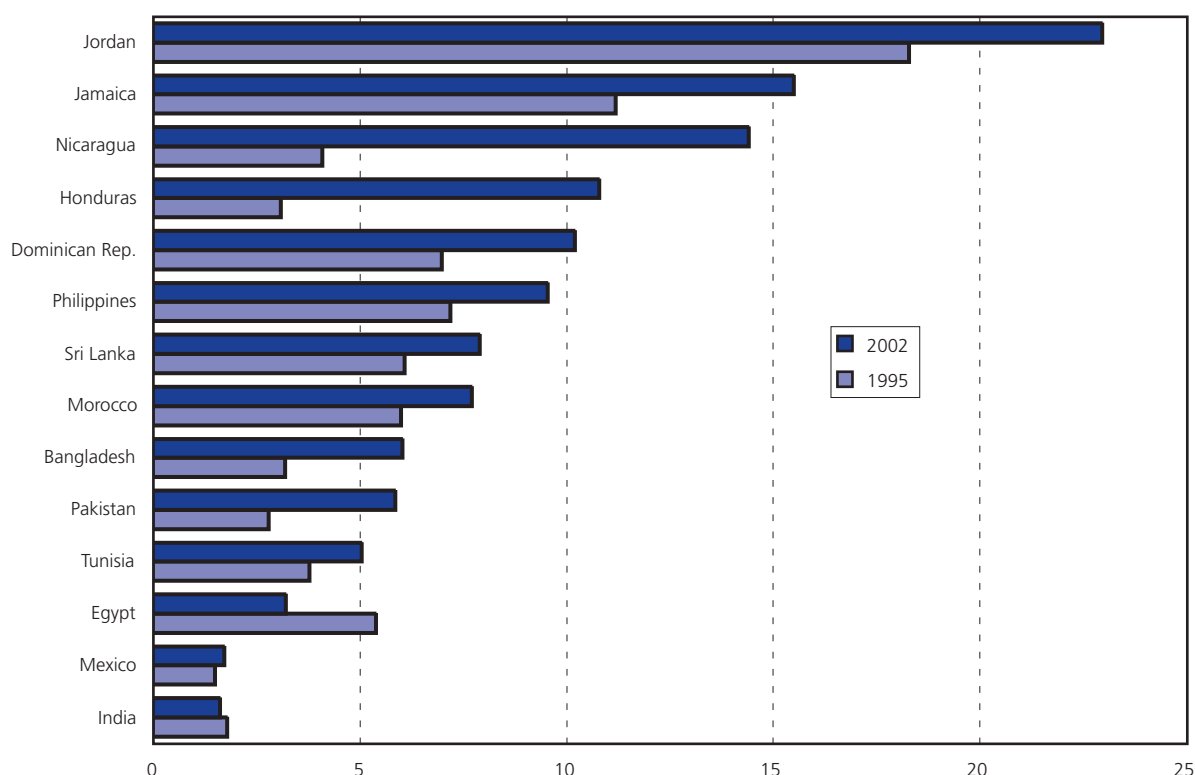
Within the BOP capital account *migrants’ transfers*, covering the flow of goods and changes in financial assets associated with international migration, could also provide supplementary indirect information in relation to Mode 4.

Source: IMF, Balance of Payments Manual, 5th edition 1993 (BPM5).

Chart IB2.3 shows the growing importance of remittances and compensation of employees for selected developing countries in relation to their GDP. In general, in comparison to 1995, the ratio has increased for almost all the countries represented in the Chart.

In 2002, Jamaica’s and the Dominican Republic’s ratios to GDP peaked at 16 and 10 per cent, respectively. These ratios represented a contribution to GDP which is comparable to the weight of tourism in these countries. Compared to 1995 figures, these ratios have increased on average by 40 per cent. A marked upward trend can also be observed for other countries in Latin America. A similar scenario applies to several labour-exporting countries in Asia and Africa. In 2002, for Bangladesh and Pakistan, this ratio doubled (up to 6 per cent of GDP) and in the Philippines, Morocco and Tunisia it increased by 30 per cent.

Chart IB2.3
Ratio of compensation of employees' and workers' remittances receipts to GDP, 1995 and 2002
 (Percentage)



Source: IMF (2004) and national statistics.

(ii) Measuring Mode 4 trade using national statistics

The BOP statistics on compensation of employees' and workers' remittances allow an international assessment of the impact of labour migration on the economy of major labour importing and labour exporting countries. However, these indicators do not provide specific information on foreign workers employed in services.

Labour, migration, and census statistics of selected countries often provide a higher level of detail on the employment of foreign workers. In some instances, they only contain the total number of foreign workers in services, mainly employees, and their distribution among various economic sectors. Others specifically identify foreign employment in services on a temporary basis. In some cases, it is also possible to gather information regarding the number of temporary foreign workers by economic activity and/or occupation, and their estimated average earnings, which makes it possible to estimate the size of a country's Mode 4 trade in services.²⁴

For the present study, workers covered by the definition of Mode 4 of the GATS are considered to be those working in services industries or holding a service-related occupation both in domestically-owned and in foreign firms for a maximum period of five years.

For a restricted number of developed countries, the number of temporary work permits/visas granted in a specific year to foreign workers can help in assessing the magnitude of these transactions.²⁵ As most data available refer to 2000, this year is taken as a reference.

²⁴ When analysing national labour and migration statistics, it is important to note the distinction between "stock" and "flows". Stock data indicate the number of foreign workers in a country at a precise time of the year. Inflows cover, in a specific year, only newly arrived foreign workers but not those who had previously entered the country and continue to be employed.

²⁵ Data generally refers to visa or work permits granted, yet this might not reflect the true number of employed foreigners.

In the United States, the H-1B visa for “Professional workers in specialty occupation”, such as computer specialists or fashion models from foreign countries, is also mentioned in the US schedules of GATS commitments within Mode 4. Initially, H-1B visas are granted for a period of up to three years, but can be extended for an additional three years. This analysis concentrates exclusively on H-1B visas granted for initial employment.

In 2000, some 136,800 new petitions were approved for initial employment, mainly in computer-related occupations.²⁶ The second largest group was electrical/electronics sector workers, industrial engineers, and architects, followed by specialized administrative occupations, such as accountants and specialist auditors in related services industries. According to Table IB2.6, the United States appears to have been affected by a lack of computer and information technology experts, a gap that was filled mainly by Indian temporary workers.²⁷ Additional information regarding foreign workers’ occupations is contained in the Appendix Table IB2.1.

Although these data may present some limitations, statistics on occupations and average compensation earned by H1-B visa holders allow an estimate of the overall value of these inflows. US imports of services delivered by newly entered professionals in special occupations are estimated at about \$6.5 billion in 2000, approximately 0.1 per cent of the GDP of the United States.²⁸ Of this amount, some \$3.6 billion was generated by foreigners who were already living in the United States when they were granted the temporary employment visa (often previously students).

Table IB2.6
United States: Computer-related Mode 4 imports
by major country, 2000^a
(Numbers and million dollars)

	Approved H-1B petitions	Mode 4 imports (Value)
Total services	136787	6500
Computer-related (All origins)	74551	3730
India	50827	2540
China	5725	260
Philippines	1217	60

^a Fiscal year.

Source: US Immigration and Naturalization Services (2002) and WTO estimates.

Estimates show that in 2000 services imports through the movement of this non-EU temporary workforce amounted to nearly \$2.5 billion, equivalent to 0.2 per cent of the UK’s GDP (Table IB2.7). Overall, newly arrived Indian workers created services worth nearly \$550 million. More than half of this was generated by computer analysts and programmers. However, the impact of these inflows was not significant in terms of total employment, as newly arrived foreigners represented some 2 per cent of employees in the sectors concerned.

Although data on the number of foreigners working in the United Kingdom are available, estimated in 2002 at 1.4 million individuals, it is very difficult to determine exactly what proportion of these would be covered by the Mode 4 definition. In 2000, the United Kingdom granted some 64,500 new work permits and first permissions for up to five years to non-EU workers.²⁹ One third of them covered short-term employment of less than one year. The majority of the permits which may fall under the definition of Mode 4 were granted to workers in computer-related, management, and business services industries.

²⁶ Data refer to fiscal year 2000 (1 October 1999 to 30 September 2000).

²⁷ In fiscal year 2003, the number of H-1B petitions approved for initial employment was 105,314. The occupational breakdown is not yet available. In fiscal year 2002, petitions approved for initial employment in computer-related occupations continued to represent the largest group, however, their number declined significantly from 74,551 to 25,637. US Department of Homeland Security (2003a, 2003b).

²⁸ WTO estimates.

²⁹ It should be noted though that self-employed temporary workers are not included in this category of work permits. Work permit extensions, which are granted for an additional five years, or requests for changing employers are not included in this analysis. In 2000, some 13,500 extensions and 7,300 change of employment applications were approved. According to national sources, on average, a quarter of long-term work permit holders, have settled permanently in the United Kingdom. All categories of temporary entrants in the United Kingdom are allowed to apply for permanent settlement after four years of work in the country (UK Home Office, RDS, 2001).

By contrast, in selected Arab Gulf countries, foreign workers represent between 67 and 90 per cent of total employment in the private sector.³⁰ In 2000, in Saudi Arabia, Kuwait, Oman and Bahrain, the private sector employed some 3.4 million foreign workers, of which, on average, 80 per cent were engaged in services-related activities. Although statistics are not available for the United Arab Emirates, the high ratio of workers' remittances to GDP suggests the presence of a large foreign labour force.

In general, half of the foreigners present – originating primarily from India, Pakistan, the Philippines, and Arab countries – work in the region for less than five years. For example, a Filipino worker's average length of employment is two years. According to WTO estimates, in Saudi Arabia, Kuwait, and Bahrain this temporary workforce, which may fall under the definition of Mode 4, amounts to more than one million people. Its contribution to total employment is significant. In Saudi Arabia, some 700,000 Mode 4 foreign workers represent more than one third of total employment (national plus foreign) in private services industries, more or less evenly spread among different activities. In Bahrain, the estimated stock of Mode 4 workers accounted for 65 per cent of total employment in private services industries. Temporary foreign workers are concentrated in the wholesale and retail trade, and hotels and restaurants, accounting for over half of total services-related employment. Workers in the construction industry account for a further 23 per cent of that total. For details on the sectoral distribution refer to Appendix Chart IB2.1.

It is estimated that in 2000, the value of imports of commercial services through the temporary movement of persons exceeded \$5 billion in Saudi Arabia, and \$1.4 billion in Kuwait. These estimates represent 3 per cent of GDP for Saudi Arabia and 4 per cent for Kuwait. For Bahrain, imports of commercial services were estimated at some \$700 million in 2001, amounting to about 9 per cent of the country's GDP and more than half of the remittances sent by foreigners to their home countries that year.

(iii) *The relative size of service trade via Mode 4 and Mode 1*

No trade in services data are available broken down by modes of supply. However, the recently-developed "Manual on Statistics of International Trade in Services" (European Commission et al., 2002) proposes, as a first step, a number of simplified rules which enable a rough approximation of trade in services to be made by modes of supply on the basis of available balance of payments and foreign affiliates trade in services (FATS) statistics.³¹

On the basis of this approach, the value of total US imports of computer services delivered through Mode 4 by newly arrived H-1B computer specialists is roughly double the size of the estimated cross-border delivered services (Chart IB2.4). This would suggest that Mode 4-created trade can be of considerable importance in specific services sectors.

Table IB2.7
United Kingdom: Computer-related Mode 4 imports by major country, 2000
(Number and million dollars)

	Temporary work permits	Mode 4 imports (Value)
Total services	64574	2500
Computer-related (All origins)	10470	460
India	5973	260
United States	1404	61
China	108	5

Source: Research, Development and Statistics Directorate, UK Home Office (2001).

Table IB2.8
Stock of Mode 4 foreign workers in selected Arab Gulf countries, 2000

	Number of workers	Percentage of services employment	Mode 4 imports (million dollars)
Saudi Arabia	700000	35	5100
Kuwait	272250	...	1500
Bahrain ^a	81600	65	700

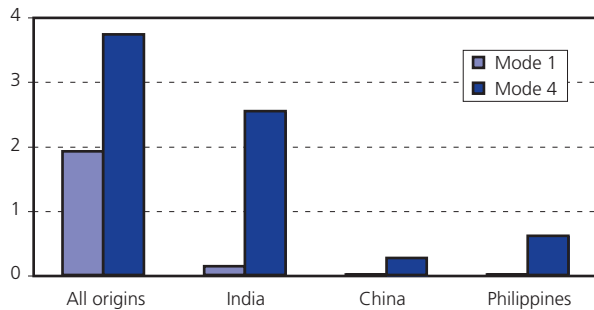
^a Refers to 2001.

Source: WTO estimates based on national statistics.

³⁰ Saudi Arabia Department of Statistics; Kuwait Ministry of Planning; Kingdom of Bahrain, 2001; Oman Ministry of National Economy, 2002.

³¹ Certain BOP services transactions can be allocated to more than one mode of supply, e.g. computer and information services, and other business services could be delivered through Mode 1 or Mode 4.

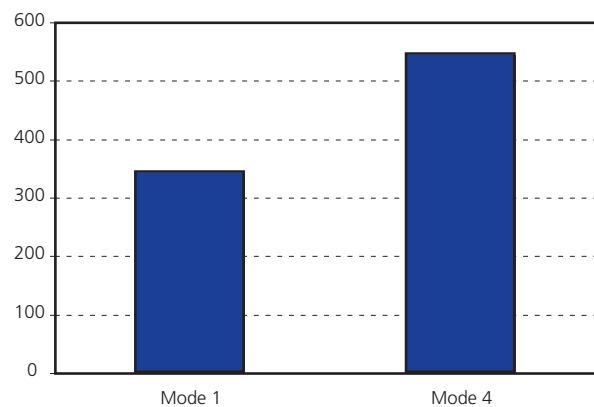
Chart IB2.4
United States: Computer services imports by mode of supply and selected country, 2000^a
(Billion dollars)



^a Refers to the fiscal year.
Source: IMF (2004) and WTO estimates.

Kingdom from India were around \$850 million.³⁴ A comparison by estimated modes of supply reveals that UK imports from India via Mode 1, which is estimated at some \$340 million, were significantly lower than those through Mode 4 (Chart IB2.5).

Chart IB2.5
United Kingdom: Commercial services imports from India by mode of supply, 2000
(Million dollars)



Source: OECD (2003e) and WTO estimates.

through Mode 4 can be greater than cross-border trade (Mode 1). These preliminary conclusions point to the economic importance for developing countries of the movement of natural persons as a mode of supplying services internationally.

An analysis of computer-related services flows between the United States and various developing countries appear to support this observation. In 2000, computer and information technology services imported cross-border by the United States from India reached only \$135 million.³² According to WTO estimates, the total imports of computer services delivered by Indian professionals amounted to some \$2.5 billion. Similarly, United States cross-border imports of computer services from China and the Philippines were almost insignificant, at \$9 million and \$10 million respectively.³³ Estimated computer-related services delivered through Mode 4 in 2000 by Chinese and Filipinos are, respectively, some \$260 million and \$60 million. In 2000, total imports of commercial services of the United

In sum, the limited availability of data on temporary foreign workers allows estimates for service trade under Mode 4 for only selected labour importing countries and in some cases covers only a fraction of the foreign temporary working population. However, despite these limitations, estimates appear to contradict the common belief, at least for specific sectors, that commercial services trade through Mode 4 is small. In the case of the United States, for example, computer services imports through Mode 4 were in 2000 substantially higher than those estimated to have been delivered through Mode 1. The same finding applies to the exports of computer services of various developing countries to the United States.

Furthermore, the example of India has stressed that estimated commercial services exports

³² US Department of Commerce (2004), Bureau of Economic Analysis.

³³ US Department of Commerce (2004), Bureau of Economic Analysis.

³⁴ OECD (2003e).

(e) Who moves where?

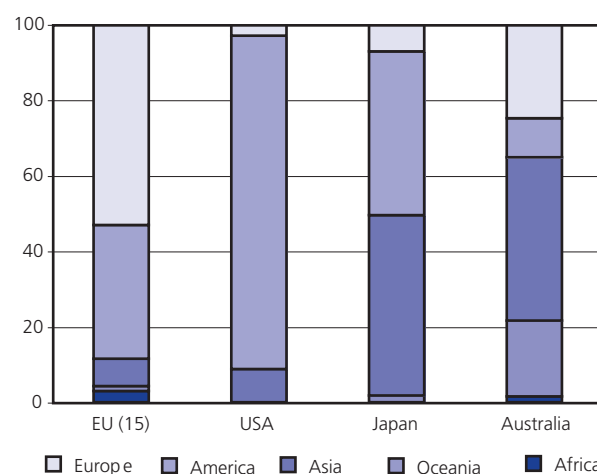
(i) Short-term labour migration: when proximity plays a role

The geographical breakdown of the BOP indicator on compensation of employees provides information on the key regions and countries of origin of temporary migrants working abroad for less than one year (Chart IB2.6). An overview of the largest industrialized economies by region would suggest that, in general, the biggest share of compensation is paid to employees from countries within the same region. In the case of the European Union, for example, more than half of its extra-EU payments, amounting to some \$5.5 billion, are paid to workers originating from other non-EU European states, while payments to American workers represent about 30 per cent. For the United States, over 90 per cent of its payments are for employees from other countries in the region. Japan offers a more diversified scenario, with half of the total compensation paid to Asia and most of the rest to North and South American countries. Australia has significant shares of workers from Asian, Oceanian and European countries.

An analysis of labour-related income flows by economic group shows that short-term labour migration takes place, in varying degrees, among developed countries as well as between countries at different stages of development.

In addition to geographical proximity, a key factor in determining the temporary movement abroad of workers is the presence of bilateral or regional agreements facilitating their entry in the host country. For example, the importance of transition economies as providers of short-term labour to the EU is due to bilateral agreements signed mainly by Germany with a number of Central and Eastern European countries since 1991.³⁵ Chart IB2.8 suggests that the presence of specific labour agreements has facilitated larger temporary movements. In 2000, about 230,000 Polish workers were employed seasonally in agriculture, forestry, hotels, and catering (OECD-SOPEMI, 2002).

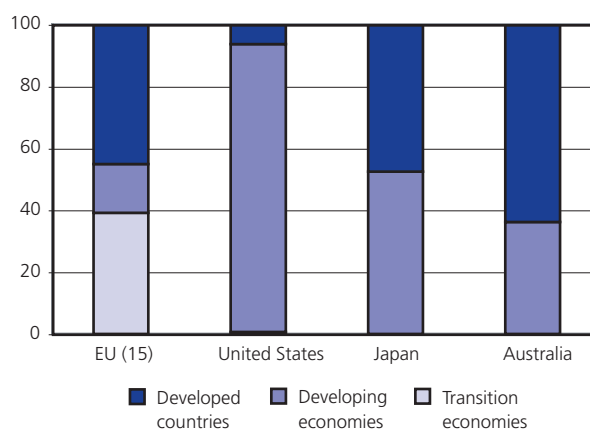
Chart IB2.6
Temporary foreign workers in selected economies by region, 2000
(Percentage)



Note: Based on payments of compensation of employees. Europe includes Western Europe and transition economies. America includes North America and Latin America. Data for EU (15) exclude compensation paid to workers from EU member states. For USA, Asia includes also Oceania and Africa.

Source: National statistics.

Chart IB2.7
Temporary foreign workers in selected economies by economic area, 2000
(Percentage)

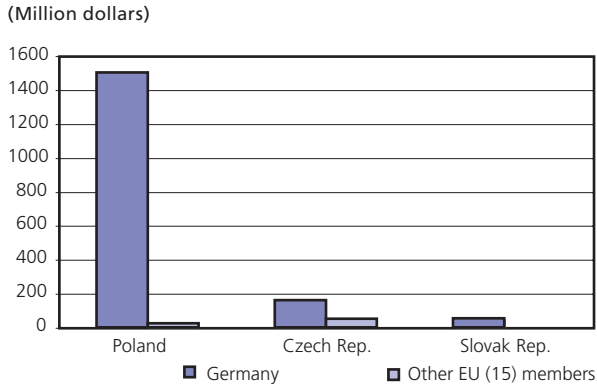


Note: Based on payments of compensation of employees. Data for EU (15) exclude compensation paid to workers from EU member states.

Source: National statistics.

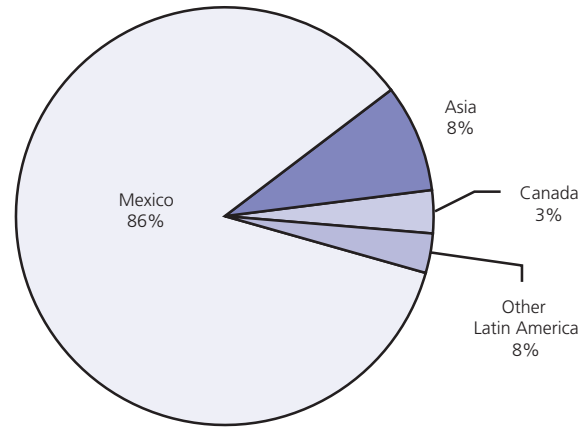
³⁵ Agreements exist with Poland, the Czech Republic, the Slovak Republic, Bulgaria, Romania, Hungary, Croatia, and Slovenia.

Chart IB2.8
Temporary foreign workers in Germany and in other EU members from selected transition economies, 2000
(Million dollars)



Note: Based on payments of compensation of employees.
Source: Eurostat.

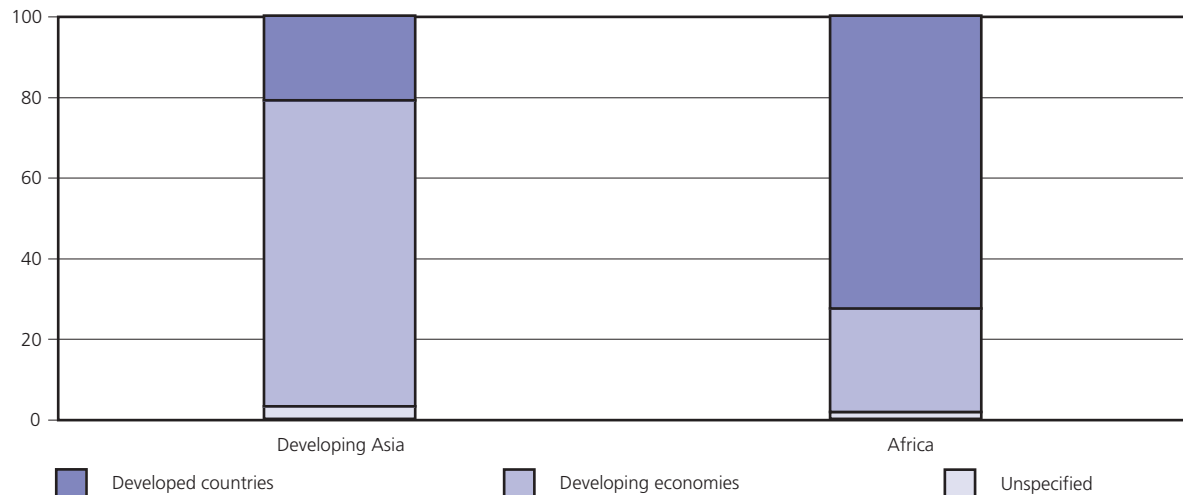
Chart IB2.9
United States: Payments of compensation of employees by origin, 2000
(Percentage)



Note: Based on payments of compensation of employees. Compensation to Asia includes also Africa.
Source: US Department of Commerce (2003).

In the United States, compensation is paid primarily to temporary Mexican workers. According to US immigration statistics, Mexicans were the main beneficiaries of short-term employment visas followed, at a distance, by Jamaicans. These workers held mainly low-skilled occupations in agriculture, and as services workers in private households and hotels and restaurants. Compensation to Canadian workers represented 3 per cent of the total.

Chart IB2.10
Workers' remittances receipts of developing Asia and Africa by economic area, 2000
(Percentage)



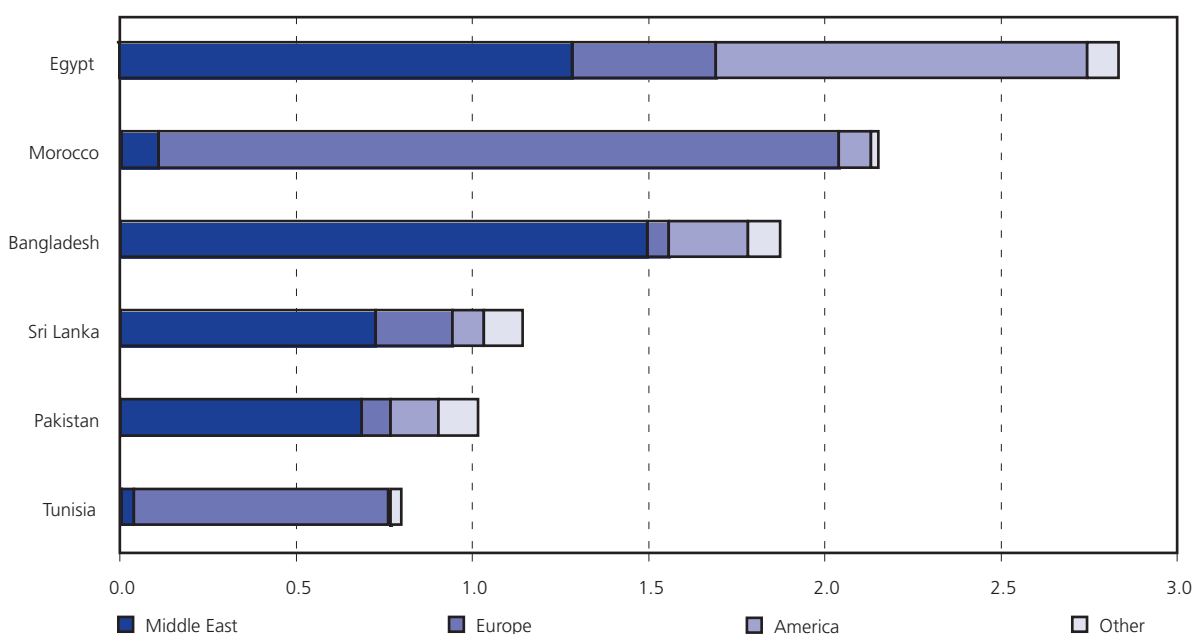
Source: WTO estimates based on national statistics.

(ii) International labour migration: not simply a North-South issue

The geographical breakdown of workers' remittances received by selected developing countries suggests that labour migration is not a straightforward North-South issue. While some developing economies, such as North African countries, benefit largely from money sent home by their nationals employed in developed countries, others receive their largest portion of remittances from other developing countries.

Chart IB2.11 shows that between 60 and 80 per cent of the total remittances of Bangladesh, Sri Lanka and Pakistan originate from the developing Middle East, predominantly the Arab Gulf countries. For example, one third of Pakistan's total remittances originated from Saudi Arabia alone. This share reached 50 per cent in the case of Bangladesh. For these countries, remittances from developed regions, such as Europe and North America, although present, have marginal importance. By contrast, in North Africa, Moroccan and Tunisian remittances originated predominantly from Europe, mainly France and Italy. Finally, more than 40 per cent of Egyptian remittances originated from Arab Gulf countries, and the rest from the United States and European countries.

Chart IB2.11
Workers' remittances receipts of selected developing countries by region, 2000
 (Billion dollars)



Source: National statistics.

National statistics confirm these migration patterns. The vast majority of contract workers from India, Bangladesh, and Sri Lanka went to the Middle East, mainly to Saudi Arabia, Kuwait, and the United Arab Emirates for temporary employment. According to the Philippines' data, at the end of 2001 more than 40 per cent of the nearly 3.1 million Filipinos employed temporarily abroad were concentrated in the Arab Gulf region, mainly in Saudi Arabia (Commission on Filipinos Overseas). Within South East Asia, Thailand represents an exception. Its workers' main destinations abroad were other Asian countries, primarily Chinese Taipei, where they were employed in industry (Thailand National Statistical Office, 2000; Chinese Taipei Census Bureau). Details regarding the country of origin of remittances for selected developing countries are contained in Appendix Table IB2.2.

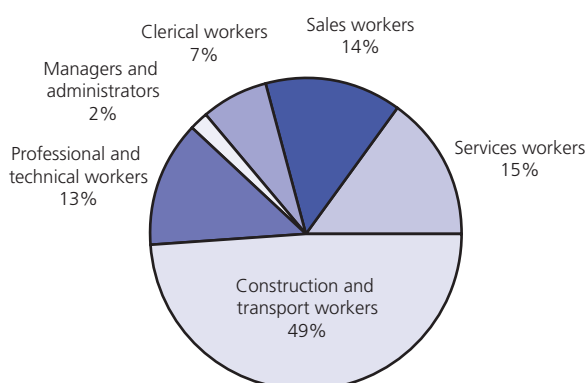
(iii) Skills and occupations of temporary foreign workers

In developing economies: the Arab Gulf countries

Data on education levels of migrant workers indicate that the average temporary migrant worker from South East Asia is low-skilled. For example, half of the Sri Lankan workers departing for the Middle East were mainly women in housemaid jobs, while professional and middle-level workers accounted for only 3 per cent (Sri Lanka, Bureau of Foreign Employment). The share of those on low-skilled jobs was even higher when analysing the outflows to other countries. Similarly, half of the estimated 220,000 Bangladeshis abroad in 2000 were in low-skilled jobs, 11 per cent in semi-skilled, 35 per cent in skilled, and 4 per cent in professional occupations. The share of low-skilled Bangladeshis abroad increased further in 2001 (Bangladesh, Bureau of Statistics, 2003).

According to Arab Gulf country statistics, the large majority of temporary foreign workers, which appear to be covered by Mode 4, are under secondary school level in terms of education and employed in low-skill jobs (Saudi Arabia Department of Statistics; Kuwait Ministry of Planning; Kingdom of Bahrain, 2001; Oman Ministry of National Economy, 2002). Within the services sectors in Kuwait, the share of foreign workers is particularly high in construction and transportation industries, engaged as transport equipment operators, loading and unloading manpower, etc. It can be safely assumed that a large share of the money sent home through remittances is generated by this low-skilled population. Services and sales occupations together employ some 20 per cent of the temporary foreign labour force in Bahrain, and up to around one third in Kuwait and Saudi Arabia. In Kuwait, services workers are mostly engaged in social, community, and personal services, employed as private guards or in hotels and restaurants, as cooks, waiters, and building caretakers.

Chart IB2.12
Mode 4 workers by occupation in selected Arab Gulf countries, 2000
(Percentage)



Note: Countries included are Bahrain, Kuwait, Oman and Saudi Arabia.
Source: National statistics.

Temporary clerical workers, such as secretaries and receptionists, are comparatively not very numerous and the highest shares are found in Kuwait and Bahrain. In the region, on average, only 15 per cent of temporary foreign workers are professionals, administrators or managers. In Kuwait, they range between 9 per cent in construction activities (mainly engineers and architects) and 20 per cent in banking, insurance, real estate, and other business services. Administrators and managers are concentrated particularly in the banking and financial sectors, but also in the wholesale and retail trades, and hotels and restaurants. The health sector offers exceptional employment possibilities for skilled and highly-skilled persons. In private healthcare in Kuwait, 70 per cent of the physicians, more than half of the dentists and virtually all the nurses are foreigners. Similarly, in Oman, 80 per cent of the doctors and almost 70 per cent of the nurses employed in the country came on contracts from abroad.

In developed economies: the UK experience

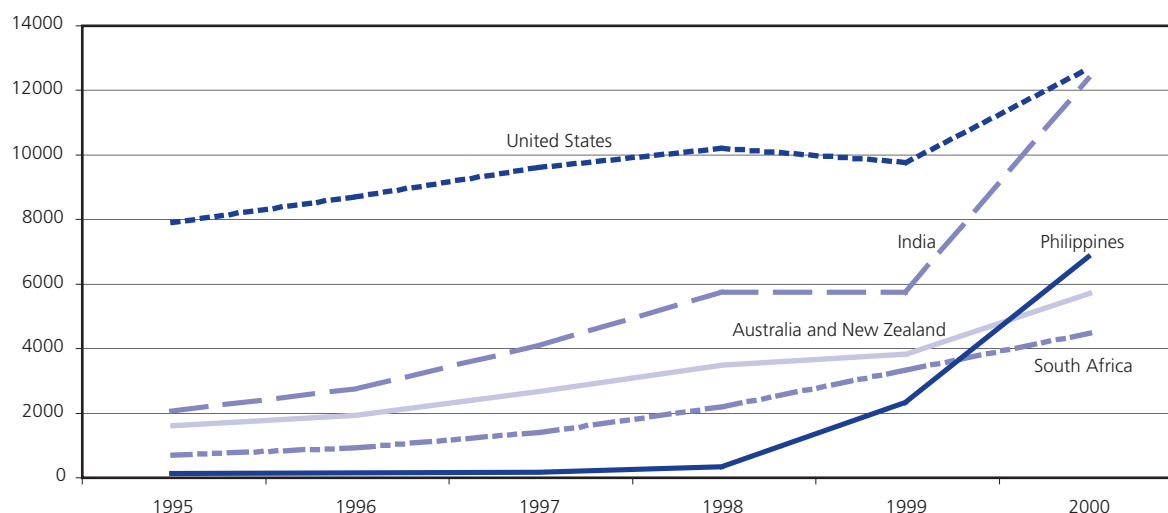
If temporary labour migration among developing countries appears to be characterized to a large extent by low-skill employment, developed countries' statistics show rising inflows of temporary skilled and highly-skilled workers from developing countries. For example, an analysis of UK temporary work permits by country suggests that, between 1995 and 2000, developing countries such as India, the Philippines and, to a lesser extent South Africa, have emerged as suppliers of temporary labour (Chart IB2.13). In particular, the number of permits granted to Indian workers rose from 1,827 to 12,726 permits over five years, and between 1999 and 2000, it more than doubled. Thus, almost the same number of Indians and US foreign workers were employed in the United Kingdom in 2000. The number of permits granted to Filipino workers jumped from some 270 to over 6,700 in three years (UK Home Office, RDS, 2001). By contrast, the contribution from non-EU developed countries has remained steady or even declined.

The need to hire temporary skilled workers from very distant countries may be due to the lack of suitable nationals or to a time lag between training of national workers in specific skills and current labour market needs. The breakdown by occupation shows that half of the foreigners were recruited in associate professional positions, mainly health staff, such as nurses in both the public and private sectors. In particular, the number of temporary work permits granted to health and medical establishments has jumped from 1,774 in 1995

Chart IB2.13

Temporary work permits granted in the United Kingdom by selected country, 1995-2000

(Number)



Source: Research, Development and Statistics Directorate, UK Home Office (2001).

to more than 14,500 in 2000. Around half of the health associates staff “exported” to the United Kingdom were Filipinos, followed by Indians. It is worth noting that the Philippines’ data on the type of skills exported abroad reveal that the number and share of associate professional and technical workers, primarily women, has doubled, while employment in foreign countries in low-skilled jobs has declined (Philippines Overseas Employment Administration).

Computer analysts and programmers, mainly from India, represented the second largest group of associate professional workers. Similar to the Philippines in health services, Indians have specialized in the export of information technology skills. Professional software and computer engineers, teachers, and financial services specialists ranked third. China and, to a lesser extent Malaysia, have emerged as suppliers of researchers.

Data relating to foreign managers and administrators, primarily originating from the United States, are likely to include intra-corporate transferees. In 2000, some 11,000 foreigners from non-EU countries were transferred to the United Kingdom (Final Report to the Home Office, 2001). Detailed information on the occupational breakdown of foreign temporary workers in the United Kingdom is contained in Appendix Table IB2.3.

Table IB2.9

Temporary work permits for services-related occupations granted in the United Kingdom by selected country, 2000

(Number)

	Total	of which				
		USA	India	Philippines	China	Malaysia
Total	64144	12654	12292	6772	1541	866
Managers and administrators	13487	5247	1203	55	211	139
Professional occupations	15187	1767	2947	247	285	348
Engineers and technologists	6626	932	2616	222	147	147
Associate professionals and technical occupations	33715	5493	7879	6442	885	329
Computer analysts and programmers	10470	1404	5973	82	108	73
Health associate professionals	14477	188	1301	6327	179	136
Personal and protective occupations	1587	38	194	28	125	43
Other occupations	168	42	69	-	35	7

Source: Research, Development and Statistics Directorate, UK Home Office (2001).

It is important to note that as from 2003, the United Kingdom has launched a new short-term work permit, the "Sectors Based Scheme", which permits the hiring of foreign workers aged from 18 to 30 for a maximum of one year for low-skilled occupations in the hospitality sector (such as bar staff, chefs, housekeepers, kitchen assistants, etc.) and selected food manufacturing industries.³⁶ These sectors are currently facing recruitment difficulties domestically.

(f) Conclusions

The discussion presented in this Section indicates that the gains from further Mode 4 liberalization could be significant. Like liberalization of trade in goods, liberalization of Mode 4 may increase welfare by offering consumers in each country a wider variety of services at lower prices. The welfare effects of Mode 4 trade liberalization are not only limited to its direct effects, but also include its effects on merchandise trade and trade in services under other modes. Data analysis presented in this Section find that these effects are significant.

The assessment of WTO commitments under Mode 4 shows that up to the present Mode 4 liberalization has been rather limited and to a large extent restricted to high-skilled labour. Nevertheless, estimates of the value of services trade under Mode 4 suggest that for some sectors and for some countries it is already large, and more important than services trade under Mode 1.

The Section has also shown that where bilateral or regional agreements exist, the movement of low-skilled workers has tended to be significant. Extending categories and skill-levels in Members' offers during the present GATS negotiations could therefore have important effects on the temporary movements of labour and on the welfare of both the sending and receiving countries.

³⁶ For 2003-2004, the quota under this scheme is set at 20,000 permits. Foreign workers must leave the United Kingdom for at least two months before another permit can be granted (Work Permits UK).

Appendix Table IB2.1
United States: Approved H-1B petitions for initial employment by occupation, 2000
(Number and percentage)

Occupations	Number	Share
Total	136787	100
Computer-related	74551	55
Architecture, engineering and surveying	17086	13
Administrative specializations	11468	8
Education	7210	5
Medicine and health	4734	4
Managers and officials n.e.s.	4366	3
Social sciences	3103	2
Life sciences	2921	2
Misc. professional, technical, and managerial	2734	2
Mathematics and physical sciences	2364	2
Art	1847	1
Writing	906	1
Law and jurisprudence	755	1
Fashion models	614	0
Entertainment and recreation	449	0
Museum, library and archival sciences	186	0
Religion and theology	68	0
Unspecified	1425	1

Source: US Immigration and Naturalization Services (2002).

Appendix Table IB2.2
Origin of workers' remittances received by selected developing countries, 2000-2001
(Million dollars)

	Pakistan	Bangladesh	Sri Lanka	Morocco	Tunisia	Egypt
Total	1022	1882	1160	2161	796	2843
Middle East	692	1502	730	115	43	1288
Saudi Arabia	304	920	...	54	23	681
United Arab Emirates	190	144	...	53	8	302
Kuwait	123	247	...	1	1	222
Oman	38	84	...	3	4	11
Bahrain	24	44	...	4	2	13
Qatar	13	63	...	1	4	44
United States	135	226	78 ^a	84	4	1049
EU (15)	156	1879	695	301
of which France	81	56	...	977	419	49

^a Refers to North America.

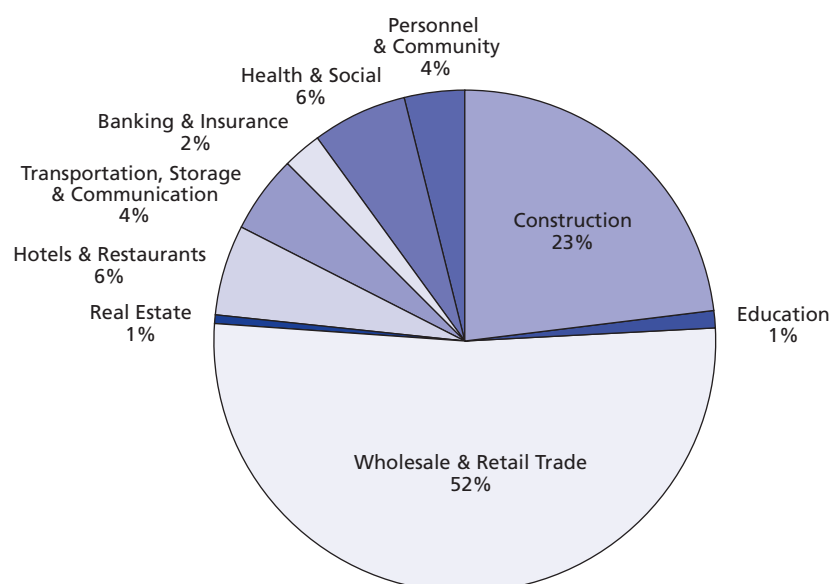
Source: State Bank of Pakistan; Central Bank of Sri Lanka; Bangladesh Bureau of Statistics; Morocco, Office des Changes; Central Bank of Tunisia; Central Bank of Egypt.

Appendix Table IB2.3
United Kingdom: Temporary work permits granted by services industry, 1995 and 2000
 (Number and percentage)

	Number		Share	
	1995	2000	1995	2000
All services	20584	59791	100	100
Health and medical services	1774	14516	9	24
Computer services	1827	12726	9	21
Administration, business and managerial services	4041	9026	20	15
Financial services	3194	6997	16	12
Entertainment and leisure services	2919	4235	14	7
Education and culture	1901	3832	9	6
Telecommunications	458	2228	2	4
Hotels and restaurants	320	1751	2	3
Sporting activities	544	989	3	2
Retail and related services	2826	927	14	2
Law related services	258	881	1	2
Transport	333	780	2	1
Construction and land services	182	751	1	1
Real estate and property services	5	94	0	0
Security and protection services	2	58	0	0

Source: Research, Development and Statistics Directorate, UK Home Office (2001).

Appendix Chart IB2.1
Mode 4 workers in services industries in selected Arab Gulf countries, 2000
 (Percentage)



Note: Data for Education, Hotels & Restaurants and Real Estate refer only to workers in Saudi Arabia.
 Source: WTO estimates based on national statistics.

3. GEOGRAPHICAL INDICATIONS

(a) Introduction

Geographical indications (GIs) are a form of intellectual property covered by the TRIPS Agreement. Put simply, a GI refers to the use of a region's name by producers from the area in order to protect their reputation or to safeguard the expectations of consumers that have come to associate certain qualities with a product's geographical origin. A major reason for the importance attached by some to the international protection of GIs is the expansion in global trade. In various international agreements, countries have seen the need to cooperate internationally to preserve the role of GIs as conveyors of information for consumers and give support to their role as marketing tools. Under TRIPS, WTO Members are obliged, among other things, to provide the legal means for interested parties to prevent the use of indications deceiving consumers as to the geographical origin of a good or constituting an act of unfair competition. For GIs for wines and spirits, the TRIPS Agreement affords additional protection.

At present, one important area of debate at the WTO is the possibility of extending the stronger GI protection for wines and spirits to a broader range of products. Negotiations are also under way on the establishment of a notification and registration system for geographical indications for wines and spirits. This chapter seeks to contribute to a better understanding of these complex debates. It begins by defining and locating the concept of GIs in its historical context. Some main characteristics of various forms of GI protection at the national level are presented. A brief description of the nature of possible problems regarding the protection of GIs in foreign markets follows. Finally, some elements of TRIPS Article 23 on the additional protection for GIs for wines and spirits are highlighted. Relevant economic concepts surrounding the GI topic are then examined, in particular the issues of product differentiation and information asymmetries between producers and consumers. Thereafter, an illustrative analysis of the price premia on products protected by GIs is carried out in order to obtain a rough notion of the value of such indications. The final Section concludes.

(b) What are geographical indications?

(i) *Historical and definitional aspects*

In the pre-industrial age, when food and agricultural products were the principal output of economies, certain regions developed specialities and an excellent reputation for their produce. These qualities were presumed to be the unique outcome of the climate, soil, other natural resources or the skill of the people in those locales. GIs, like trademarks, represent an intellectual property right over the use of a distinctive sign. One of their purposes is to inform consumers of the special characteristics of certain products related to their geographical origin. Unlike with patents or copyrights, for example, other producers cannot be prevented from undertaking to copy the product or work in question. But only producers from the area are given the right to use the GI as a means to denote the specific qualities related to geographical origin and preserve the collective goodwill derived from that connection. While manufactured or industrial products can also be afforded GI protection, the vast majority are agricultural products, mostly food and beverages. Those non-agricultural products which enjoy GI protection typically include handicrafts, jewellery and textiles.

In many countries, special systems for the protection of GIs at the national level existed before multilateral agreements were developed. The differences in approach among countries are, to an important extent, related to historical developments. In some countries, the renown of certain products goes back centuries and their continued importance reflects the intertwining of commerce, history, culture and regional or local pride. Currently, there are a number of international agreements dealing with various forms of indications of geographical origin (Box IB3.1), under which member countries afford protection in their own territories to indications of other members. The main multilateral agreements of relevance are the Paris Convention for the Protection of Industrial Property (166 contracting parties), the Madrid Agreement Concerning the International Registration of Marks (74 contracting parties) and the Madrid Protocol relating to that Agreement, the Madrid Agreement for the Repression of False or Deceptive Indications of Source on Goods (33 contracting parties), the Lisbon Agreement for the Protection of Appellations of Origin and their International Registration (20 contracting parties) and the

TRIPS Agreement (147 members). While the Paris Convention is about 120 years old, 67 states (about 41 per cent of the total membership) only became members in the 1990s. And of course, the TRIPS Agreement came into force only on 1 January 1995. The strong growth of global trade in the last decade was an important factor leading to increased cooperation on these and other matters of intellectual property.

The TRIPS Agreement is the first multilateral agreement providing an explicit definition of the term “geographical indication”. In Article 22.1, GIs are defined as “indications which identify a good as originating in the territory of a [WTO] Member, or a region or locality in that territory, where a given quality, reputation or other characteristic of the good is essentially attributable to its geographical origin”. Earlier multilateral agreements, notably the Paris Convention, the Madrid Agreement (on false/deceptive indications of source) and the Lisbon Agreement, have focused on “indications of source” and “appellations of origin” respectively. An indication of source designates a specific geographical location as being the origin of the product in question. While a GI as defined under TRIPS also identifies a good as originating in a place, it is, in addition, required that a given quality, reputation or other characteristic of the good is “essentially attributable” to its geographical origin. Some consider the definition of “appellation of origin” under the Lisbon Agreement to be similar to GIs, but to have higher requirements in regard to one aspect or another (Addor and Grazioli, 2002).

Within national legislation, the “multilateral” terminology is not necessarily used in its pure form. As suggested above, international agreements had to capture a wide range of existing national practices that included more precisely defined or stringent concepts over and above the requirements that were agreeable internationally. With regard to national definitions, there are three main categories: (i) definitions following closely the language of Article 22.1 of the TRIPS Agreement; (ii) definitions modelled on that used in the Lisbon Agreement; and (iii) more specific national definitions, many of which include the essential elements of the definition contained in the TRIPS and Lisbon Agreements, namely that the product has distinctive characteristics which are due to its geographical origin. Some of these definitions are combined with particular product/production requirements.

Box IB3.1: Key provisions in some international agreements on indications of geographical origin

1883 Paris Convention for the Protection of Industrial Property

(revised in 1925, 1934, 1958 and 1967 and amended in 1979)

- some of its provisions are incorporated in the TRIPS Agreement through Article 2.1;
- includes the protection of “indications of source or appellations of origin” (Article 1.2);
- countries of the Union undertake to accept for filing and to protect collective marks belonging to foreign associations even in the absence of industrial/commercial establishment (Article 7*bis*);
- prohibits the “direct or indirect use of false indications of the sources of the goods” (Article 10.1) but no special provisions therein for the protection of appellations of origin; only *false indications* covered by Article 10 and no protection provided for cases when the indication is used in translated form or accompanied by terms such as “kind” or “type” or when it is deceptive, i.e. when it may mislead the public;
- originally signed by 11 countries, the Convention now has 166 contracting parties.

1891 Madrid Agreement Concerning the International Registration of Marks *(revised in 1900, 1911, 1925, 1934, 1957, 1967 and amended in 1979)* and the ***1989 Madrid Protocol*** *relating to that Agreement*

- establishes a procedure for the international registration of marks – protection afforded to a mark is based on national registration; the mark is protected for 10 years renewable indefinitely; if it is cancelled for some reason in the country of origin within five years from international registration, the international mark will also be cancelled;

- 74 states are contracting parties.

1891 Madrid Agreement for the Repression of False or Deceptive Indications of Source on Goods
(revised in 1911, 1925, 1934 and 1958)

- aims at the repression not only of false but also deceptive indications of source: “all goods bearing a false or deceptive indication by which one of the countries to which this Agreement applies, or a place situated therein, is directly or indirectly indicated as being the country or place of origin shall be seized on importation into any of the said countries” (Article 1(1));
- 33 states are contracting parties.

1958 Lisbon Agreement for the Protection of Appellations of Origin and their International Registration (revised in 1967 and amended in 1979) and the **1976 Regulations** under that Agreement (amended in 2002)

- countries undertake to protect in their territories the appellations of origin of products of the other countries of the Special Union, recognized and protected as such in the country of origin and registered at the International Bureau of Intellectual Property referred to in the Convention establishing the World Intellectual Property Organization (Article 1);
- ‘...“appellations of origin” means the geographical name of a country, region or locality, which serves to designate a product originating therein, the quality and characteristics of which are due exclusively or essentially to the geographical environment, including natural and human factors.’ ‘The country of origin is the country whose name, or the country in which is situated the region or locality whose name, constitutes the appellation of origin which has given the product its reputation’ (Article 2);
- protection shall be ensured against any usurpation or imitation, even if the true origin of the product is indicated or if the appellation is used in translated form or accompanied by terms such as “kind”, “type”, “make”, “imitation” or the like (Article 3);
- once protected in a country, an appellation of origin cannot be deemed to have become generic in that country, as long as it is protected as an appellation of origin in the country of origin (Article 6);
- 20 states are contracting parties.

WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)

- defines GIs as “... indications which identify a good as originating in the territory of a Member, or a region or locality in that territory, where a given quality, reputation or other characteristic of the good is essentially attributable to its geographical origin” (Article 22.1);
- establishes, in Article 22, a minimum standard of protection for all geographical indications mandating Members to provide the legal means for interested parties to prevent the use of GIs in a manner which misleads the public as to the true origin of the good as well as acts of unfair competition;
- provides additional protection for wines and spirits. Members are obliged to provide the legal means to interested parties to prevent use of a GI identifying wines for wines (respectively spirits for spirits) not originating in the place indicated even where the true origin is indicated or the GI is used in translation or accompanied by expressions such as “kind”, “type”, “style”, “imitation” or the like. Thus, in principle, there is no need to show that the public has been misled as to the true origin of the good or an act of unfair competition occurred (Article 23);
- provides a series of exceptions, most notably in relation to continued and similar use of GIs for wines and spirits, prior good faith trademark rights and generic designations (Article 24).

(ii) *Legal means of protection*¹

Countries employ differing legal means of protection for GIs. They can be broadly categorized into horizontal laws focusing on business practices, trademark law and special means of protection.² While not specifically providing for the protection of GIs, laws focusing on business practices prohibit actions which can involve the misuse of indications. Examples of laws relating to business practices include laws on the repression of unfair competition or the protection of consumers in regard to the labelling of products. Trademark law can provide protection against unauthorized use by third parties of GIs registered as collective, certification or guarantee marks where such use would result in a likelihood of confusion. Finally, special means of protection refer to laws or provisions specifically dedicated to the protection of GIs.

Horizontal laws focusing on business practices

In practically all countries, GI protection is available under horizontal laws focusing on business practices. This category of means of protection covers laws which, while not specifically providing for the protection of GIs, prohibit business practices which can involve the misuse of GIs. While a broad range of laws of this nature exists, many of them relate to the repression of unfair competition or the protection of consumers,³ either in general terms or more specifically in regard to such matters as the labelling of products, health protection and food safety. In some Members, provisions of common law also apply, in particular in relation to passing off. In legal proceedings under such laws, the question at stake will normally be whether the practices proscribed by the law have occurred, not whether a particular term should be determined to have the status of a protected GI.

Under unfair competition and consumer protection law an important factor is the extent to which the geographical term in question is known as an indicator of geographical origin to the public. If it is not so known or it has become a generic term, protection is not granted. Similarly, in those countries where "passing off" relief is available, complainants are usually required to demonstrate that (i) their product has acquired goodwill with the purchasing public, (ii) misrepresentation by the defendant is likely to lead the public to believe that the products offered are those of the plaintiff and (iii) damages or a likelihood of damages result from such use (Cornish, 1996).

Collective and certification marks

In some Members, GIs may be protected within the trademark system as collective, certification or guarantee marks against unauthorized use by third parties. While these terms are used somewhat differently in different countries, generally speaking, a collective mark protects a specific sign which belongs to a group of enterprises and is used by its members for their goods or services. A certification or guarantee mark protects a specific sign which belongs to a legal entity supervising or laying down standards for goods or services. Regulations governing the use of such marks must be submitted as part of the registration procedure.

The regulations for collective marks define the group of companies eligible to use the mark. In some countries, these regulations must include a provision to the effect that any person whose goods or services originate in the geographical area concerned and fulfil the conditions set out in the regulations shall be eligible to become a member of the association and shall be admitted to the group of persons having authority to use the mark. In the case of certification/guarantee marks, common characteristics are established that may

¹ Large parts of this subsection are based on WTO (2003b).

² See WTO (2003b). Annex A in this document contains examples of GIs in WTO Members and references to national legislation. See also O'Connor (2003), WIPO (2002a), Blakeney (2001) and Ladas (1975) for further examples and analytical discussions of legal means of protection.

³ Depending on the jurisdiction, one body of law may comprise elements of the other. For analytical purposes, the following distinction has been made: laws focusing on unfairness *vis-à-vis* competitors address acts which concern the establishment, the goods, or the industrial or commercial activities of a competitor. Laws focusing on misleading consumers address acts which relate to misleading allegations concerning the goods of the person who makes the allegations. In respect of this distinction see also the guide to the application of the Paris Convention by Prof. G.H.C. Bodenhausen, in particular pp. 145-146, as quoted in WTO (2003b):9, footnote P.

relate to materials, production methods, geographical origin and/or other criteria (OECD, 2000a).⁴ Normally, certification/guarantee marks may not be used by their owners or any company with which the owner has close economic ties. Given that their primary purpose is not to distinguish one product or service from another, but to perform a guarantee function or certify certain characteristics, it is normally required that they be accessible to anyone who meets the conditions for use.⁵

In a number of countries, an important consideration for the trademark office when a collective, guarantee or certification mark consists solely, or essentially, of a geographic term is to satisfy itself of the authority of the applicant to control the use of the term, i.e. the ability to ensure that the conditions of eligibility are complied with. In the United States, for example, the authority which exercises control over the use of the term normally is a government body or a body operating with governmental authorization.

Special means of protection

The forms of protection in this category cover those under laws specifically dedicated to the protection of GIs or those under provisions providing for special protection of GIs contained in other laws, for example on trademarks, marketing, labelling or taxation. Generally speaking, the protection provided is stronger than that available under the other two categories of means of protection. Usually, but not in all cases, there is a requirement for prior recognition of a GI as a condition of protection. Procedures in this connection vary considerably, from essentially informal and political procedures to a registration-type system with procedural steps and criteria clearly defined in advance. In some countries, several systems co-exist with different although sometimes overlapping coverage, with tests for eligibility of differing severity, and rights of differing scope.

As a function of the specific definitions used at the national level, various criteria may be applied to determine eligibility for special protection for GIs. A central element usually is the demarcation of the area covered by a GI. This may be done by specifying eligible geographical units in accordance with political/administrative classifications or by defining geographical areas, such as groups of vineyards. Alternatively, some countries focus on criteria of a more qualitative nature aimed at establishing the homogeneity of the cultivation conditions within the area and the distinctiveness of those conditions *vis-à-vis* other areas. Other criteria are aimed at ensuring that the product comes from the designated area. Practices vary. For example, Article 2.2 of the European Council Regulation (EEC) No. 2081/92 stipulates that, for so-called "protected designations of origin" (PDO), the entire production process has to take place in the defined geographical area, whereas for "protected geographical indications" (PGI), it is sufficient that either production, processing or preparation are carried out in the respective place.

In many countries, it is also necessary that the product has specific characteristics linked to its origin. At least some of them do not explicitly call for a causal link between the geographical origin of the product and its characteristics. Special characteristics are the most common requirement. Not all definitions explicitly allow for reputation as a specific characteristic related to the geographical origin of a product. Some, especially those based on the Lisbon Agreement, note the role that human factors can play in regard to the characteristics of products that are linked to their origin. In certain countries, such requirements are only taken into consideration at the time the decision on the protection of a GI is taken. Subsequently, the response to quality and consumer expectations are left to the market-driven behaviour of those entitled to use the GI. In many cases, however, ongoing requirements regarding production methods and product specifications are established as a condition of use of the respective GI, and systems are put in place to monitor compliance (OECD, 2000a).

⁴ For instance, the US Certification Mark for Stilton Cheese (Registration Number 0921358, see <http://tess2.uspto.gov/bin/gate.exe?f=doc&state=87jj80.4.3>, site visited on 9 December 2003) certifies that "the cheese is blue moulded or white cheese produced within the country boundaries of Leicestershire, Derbyshire and Nottinghamshire, England, with no applied pressure, forming its own crust or coat and made in cylindrical form, from full cream milk produced by English dairy herds."

⁵ This implies that, for instance, the US "certification marks for products such as Florida oranges or Idaho potatoes can be used by any grower who meets the published standards for such a product" (Beresford, 2000). See also WIPO (2002b) and WIPO (2002c).

(iii) *Protection of GIs in foreign markets*

As mentioned earlier, a number of international agreements, including the TRIPS Agreement, lay down minimum standards of protection of GIs that their members have to make available to the GIs of other members. In some cases, this matter is also regulated through regional agreements (e.g. in the context of the Cartagena Agreement of the Andean Community) or bilateral agreements (such as between the European Communities and Australia concerning wines). Some of these treaties also include a national treatment obligation. At present, a WTO panel is examining the question of the way the TRIPS national and MFN treatment rules apply in regard to GIs.

In the course of international trade, the situation may arise that producers, recognized at home as having rights in a GI, export their products to markets where local makers already use the same indication. They may also face competition from those producers in third countries. It may be that in foreign markets a domestically protected GI has already been registered as a trademark,⁶ is a GI in its own right, or is considered generic.

Trademarks

It is conceivable that entitlement to use an indication is claimed in respect of the same or similar products by different parties as a trademark and as a GI respectively. The question of how to deal with such conflicts is one that is not yet fully resolved at the international level. In national law, three broad approaches can be found: first, giving priority to those who first had rights in the jurisdiction concerned in that term (commonly referred to as the principle of "first in time, first in right");⁷ second, providing for co-existence of the trademark and the GI; and third, providing for GIs to prevail over earlier trademarks. The TRIPS Agreement addresses the issue of possible conflicts between GIs and prior trademark rights in one of the exceptions to GI protection provided for in Article 24. A WTO panel is presently considering how this provision, together with related trademark provisions, should be interpreted.

In many jurisdictions, it is not possible in the first place to register geographical names as trademarks, which are meant to distinguish the products of one enterprise from those of a competing firm. A geographical term may, in most cases, be considered too descriptive of the origin, nature or quality of goods and, hence, be unsuitable for trademark purposes. WIPO (2000a) states that "geographical terms cannot serve as individual trademarks, unless they have acquired distinctive character through use, or their use is fanciful and, therefore, is not deceiving as to the origin of the goods on which the trademarks are used". One could think of "Mont Blanc" writing instruments as a famous example.

In some countries, any GI may benefit from protection against registration as a trademark without having to satisfy the tests mentioned above relating to distinctiveness and likelihood to confuse, deceive or mislead the public as the geographical origin or the identity of the goods to which it applies, provided that the sign for which trademark registration is sought consists exclusively of a protected GI or of an indication which may serve, in trade, to designate the geographical origin of goods. Such signs could be seen as being inherently non-distinctive. In the European Union, for instance, a Court of Justice decision precludes registration of a trademark consisting exclusively of a geographical name of a place that is currently associated with the category of goods in question or may potentially be capable of denoting geographical origin for that category. In the evaluation of possible future developments, different factors are enumerated that need to be taken into account, namely the category of goods itself, the characteristics of the place and the degree of familiarity of actual consumers with the geographical name (ECJ, 1999). Many countries also have special regimes for certain GIs which provide protection against the registration as trademarks of signs which consist of or comprise the GIs in question without the need to consider the sorts of tests referred to above (WTO, 2003b).

⁶ In considering the relationship between trademarks and GIs, it is important to keep the following two issues apart: (i) the possibility of registering a GI under trademark law as a collective/certification mark, and (ii) the potential conflict of a GI with an earlier trademark essentially consisting of or containing geographical terms.

⁷ An exception to this principle is made if the prior right was acquired in bad faith, for instance if an employee registers a trademark that has been in use for some time by his employer. See also Stern (2003).

Homonymous indications

International trade can also lead to a situation, where two products of the same class are sold carrying GIs that are spelt or pronounced alike despite referring to different parts of the world. Both of these “homonymous” indications designate the true geographical origin of a product. Parallel use of the same name without further qualifications runs the risk of misleading consumers who expect to see the specific characteristics of the respective products. In many national legislations, this is usually not permitted and practical means have to be found to differentiate the homonymous indications from each other in an equitable manner for both producers and such that consumers are not misled.⁸

The producers (about 40) of wine named after the municipality “Champagne” situated in the Swiss canton of Vaud criticized the deal between the European Community and Switzerland (as part of their bilateral agreement on agricultural trade) for obliging them to abandon the right to use the name “Champagne” on their wines. In 2002, the Swiss wine-growers brought a case before the European Court of Justice (still ongoing) in which they demand annulment of this decision (ECJ, 2002). Another much cited case (subject to periodic, hitherto inconclusive consultations between the two countries) is the one of Rioja wines, referring to both an area in Spain and in Argentina (Addor and Grazioli, 2002).

Generic terms

Generic terms are not capable of distinguishing goods from different sources (firms or geographical origins). They describe the kind or type of goods belonging to one category. Such names therefore cannot be registered under either trademark law or a special system for the protection of GIs. According to TRIPS Article 24.6, Members are exempted from protecting GIs “with respect to goods or services for which the relevant term is identical with the term customary in common language as the common name for such goods or services in the territory of that Member”. In establishing whether a name for which an application for protection is received has become generic or not, the authorities in charge (such as a trademark office) have to make a judgement as to the situation prevailing in their country. Guidance in the form of specific regulations listing terms to be considered generic appears to exist only in some jurisdictions and for a limited range of products. In all other instances, national courts decide on a case-by-case basis whether a name of geographic significance has indeed lost its original meaning and serves to designate the class of goods as a whole (WIPO, 2002b). Members of the Lisbon Agreement have eschewed this possibility for appellations of origin registered under the Agreement, which they cannot deem to have become generic, as long as they continue to be protected in the country of origin (Article 6).

(iv) Additional protection for GIs for wines and spirits

WTO Members are obliged to provide the legal means to achieve the level of protection laid out in TRIPS Articles 22.2 to 22.4 for all⁹ GIs, as defined in Article 22.1, and a “higher” level of protection for wines and spirits as per Articles 23.1 to 23.3.¹⁰ Certain exceptions are provided for in Article 24. Primarily, the protection afforded to wines and spirits goes further in the following sense: TRIPS Article 23.1 creates the obligation to provide the legal means to interested parties to prevent use of a GI identifying wines for wines (respectively spirits for spirits) not originating in the place indicated even where the true origin is indicated or the GI is used in translation or accompanied by expressions such as “kind”, “type”, “style”, “imitation” or the like. This also implies that there is no need to show that if an indication suggests that the good in question originates in a geographical area other than the true place of origin, the public has been misled as to the true origin of the

⁸ This approach applies to wines and spirits pursuant to TRIPS Article 23.3.

⁹ No product groups are excluded.

¹⁰ TRIPS Article 24 contains a number of exceptions to the obligations under both Article 22 and Article 23 aimed at safeguarding existing uses by other parties. More specifically, Article 24.4 relates to the continued and similar use of GIs for wines and spirits by whomever has used that indication on any goods or services continuously for at least ten years – or less if in good faith – before the date of the Marrakech Agreement establishing the WTO. Concerning the question of extension of product coverage beyond wines and spirits, the question has been raised whether a similar provision would be envisaged with regard to a prior time period.

good or an act of unfair competition occurred. Most Members have put in place special means of protection to comply with these obligations, often involving some kind of registration or recognition requirement at the national level.

Pursuant to TRIPS Article 23.4 and paragraph 18 of the Doha Declaration (WTO document WT/MIN(01)/DEC/1), negotiations are currently under way on the establishment of a multilateral system of notification and registration of GIs for wines and spirits. These negotiations have proven rather difficult with positions ranging from those wishing to impart some kind of legal force to registrations and others seeing the register more as an information tool, e.g. an instrument for reference when making decisions regarding GIs under domestic law. Of key concern is, for instance, the question whether inclusion of a GI in the multilateral register would result in a rebuttable presumption of eligibility for protection at the national level. Some contest such an approach as creating new substantive obligations and as not being consistent with the principle of territoriality of intellectual property rights and the national freedom for determining the way of implementing the TRIPS Agreement, as recognized in Article 1.1. They see value in making readily available to all WTO Members the information notified by others and provided through a register for use in national decision-making processes relating to the protection of GIs. Related to these controversies are many more legal aspects and practical implications, such as the need for, and if so the nature of, a procedure to oppose inclusion of a GI into the register, or the costs involved in such a system both in relation to their magnitude and their distribution amongst the government, producers, consumers and the administering body. There is also controversy around the question of whether notifications and registrations of GIs would have any effect on WTO Members opting not to participate in the system (WTO, 2003c).

Many of the arguments advanced in the ongoing debates on GIs are anchored in differing interpretations of the relevant legal texts and negotiating mandates. Very little if any theoretical and empirical evidence has been brought to the fore to substantiate claims regarding the value and costs of GI protection for economic agents. This is discussed next.

(c) Economic theory and geographical indications

This subsection reviews the economic literature that may be relevant to the topic of GIs. Not much economic research has been undertaken that directly deals with GIs. This discussion is therefore confined to economic concepts that are useful in understanding the purpose and effects of GIs in the marketplace. In most of the relevant economic literature no attempt is made to compare economic thinking with existing legal approaches. As a consequence the terminology used does not necessarily correspond to that used in the legal literature.

In economic terms, an important role played by GIs is that they help consumers to distinguish between products coming from a particular region and similar products that come from a different region. This safeguards the expectations of consumers who have come to associate certain product characteristics with a product's geographical origin. GIs may therefore have a role to play in markets for differentiated goods suffering from a market failure called "information asymmetry". The term "differentiated goods" refers to the fact that goods belonging to the same product group, like red wine, may differ in certain characteristics, for instance, taste or quality. "Information asymmetry" describes a situation where consumers are not able to observe all the characteristics they consider relevant in a good, such as its taste, before purchase. As a consequence, some "tool" is necessary to signal the characteristics consumers may consider relevant, and GIs are one possible option. The remainder of this subsection provides a more detailed discussion of the concepts of product differentiation and information asymmetry.

(i) *Product differentiation: products that are similar may not be identical*

Products belonging to the same product category may have different characteristics. A Mercedes and an Opel are both cars, but most consumers would agree that they are not the same. Chocolate ice cream and strawberry ice cream belong to the product category ice cream, but they clearly differ in taste. The notion of products appearing in different varieties is common in the economic literature. Numerous economic models contain elements of product differentiation, some of them being very popular in trade theory.¹¹

Economists distinguish between vertical and horizontal product differentiation.¹² In the former case, all consumers agree on the preferred mix of characteristics and, more generally, the preference ordering. A typical example is quality. Probably everybody agrees that higher quality is preferable – for instance that a Mercedes tops an Opel in a wide range of attributes. However, a large number of consumers may still purchase the latter. Consumers' income and the prices of the cars determine their ultimate choice. Similarly, a smaller and more powerful computer is preferable to a larger, less powerful one. At equal prices, all consumers would probably go for the first one. In the case of horizontal differentiation, however, the optimal choice at equal prices depends on the particular consumer. Preferences vary in the population. Colours are an obvious example. One consumer prefers a red t-shirt, while another buys the same t-shirt in blue. Flavour is another often-cited example. Some people systematically prefer chocolate over strawberry ice cream; for others the opposite is true.

In general, companies compete not only against firms offering the same product variety, but also against companies supplying different varieties of goods belonging to the same product group. For instance, even though Mercedes and Opel are rather different cars targeting different consumer segments, the price a Mercedes can command in the market is not completely independent of the price of an Opel and vice versa. Depending on factors like entry conditions into the market, costs for producing different product varieties and tastes of consumers, the level of competition can be high or low in markets of differentiated goods.

Although for the sake of economic analysis, it is often useful to make a clear distinction between vertically and horizontally differentiated products, in practice many products differ along both dimensions. Cars appear in different colours and vary in fuel consumption. The first characteristic cannot be ranked ("horizontal"), while other things being equal, fuel efficiency is a plus ("vertical"). The rest of the subsection will limit itself to a discussion of vertically differentiated goods. This is because the literature on information asymmetry typically focuses on vertical product differentiation.

(ii) *Information asymmetry: products that look identical may not be identical*

Consumers differ and they appreciate characteristics of products in different ways. The availability of different varieties of products in the market should therefore be welcomed. In general, it can be presumed that markets provide the varieties demanded by consumers and that they are supplied in the appropriate quantities. Yet, this is not always the case. If, for instance, consumers have only imperfect information about the characteristics of a product upon purchase, there tends to be an undersupply of "quality" in markets of vertically differentiated goods. In this context, the term quality is typically used in a very broad sense, referring to any relevant good characteristic that can be ranked according to objective criteria, such as fuel consumption in the above-mentioned example of cars or power in the case of personal computers.

Economists have classified goods into three categories according to the degree of information available to consumers when purchasing a good. In the case of so-called search goods, e.g. dresses, quality can be ascertained by consumers before purchase. In other cases, the quality is learned only after the good is bought and consumed. This is the case, for instance, with the taste of food or the quality of a restaurant. The literature refers to these goods as experience goods.¹³ For still other goods, certain quality aspects (e.g. the amount of

¹¹ One may think, for instance, of the literature on intra-industry trade (e.g. Krugman, 1980).

¹² See Tirole (1993) for a discussion of vertically and horizontally differentiated product spaces and modelling approaches that have been used.

¹³ See Nelson, 1970.

fluoride in toothpaste or whether beef is BSE infected) are rarely learned, even after consumption. This last type of product is referred to as credence goods in the economic literature.¹⁴ Again, most goods cannot merely be classified in one or the other category, as they possess characteristics that are learned before purchase, after purchase or never.¹⁵ In the case of a loaf of bread, for instance, the loaf's size is a search good characteristic, its taste an experience good characteristic and its calorie-content a credence good characteristic. For economic analysis, however, the pure classification is quite useful. Only in the case of experience and credence goods do economists speak of a market distortion due to information asymmetry. In the case of experience goods repeat purchases offer some consumer control over quality and market mechanisms exist that guarantee the supply of a significant range and level of product qualities. In the case of credence goods, the information problem is more acute and government intervention is often required to reach an acceptable supply of product quality.¹⁶ The following paragraphs will discuss these issues in more detail.

Repeat purchases and the incentives of producers to maintain quality

If consumers cannot distinguish the quality of different product varieties before buying and consuming the product, they will be reluctant to pay different prices for products that, to them, look the same.¹⁷ If, for instance, a bottle of wine just looks like another bottle of wine and consumers do not have any reason to expect one of them to contain a higher quality wine, it would be rational for them to buy the cheaper of the two bottles. This is a problem for high quality producers who probably face higher production costs than producers of lower qualities. In a market of experience goods high quality producers must, therefore, find a way to lure consumers into testing their product, but at the same time, prices must in the long-run be such that production is profitable. When introducing their product in the market, producers may consequently decide to offer their high quality product at the same price as competing low quality varieties, which probably implies that they incur a loss during the initial sales period. Alternatively, they could invest in publicity and try to create the image of a high quality product from the outset. The latter approach may allow producers to demand a higher price in initial sales periods, but it also entails an investment and hence a cost.

Once consumers have tried the product and experienced it as being of superior quality, they should be willing to accept a higher price in comparison to other varieties when returning to the market. In order for it to be profitable for producers to supply high quality, their product must command a higher price for two reasons. First, production costs are likely to be higher for high than for low quality varieties. Second, they must be able to demand a mark-up over these costs in order to recover the loss incurred or investment made during the initial sales period. The mark-up also has another function. It discourages producers from cheating their consumers by suddenly lowering product quality. Supplying lower quality would lead to extraordinary profits in the immediate period of sales, but would ruin the producer's reputation as a high quality provider in the future and thus lower his future profits. In other words, the mark-up gives an incentive to producers to maintain quality. Consumers can therefore expect producers to meet their reputation and provide today the product quality they provided yesterday.¹⁸

¹⁴ The term was first used by Darby and Karni (1973). Note that credence goods have been analysed above in the context of services: the timeliness of a doctor's intervention, the quality of a lawyer's advice and the timeliness and quality of car repair are typical examples of credence good characteristics.

¹⁵ An additional category that has received attention in the literature is the group of "status goods". In the case of status goods not only the characteristics of a good count to the consumer, but also (at least to some consumers) the effect these characteristics have on third parties (prestige). Depending on the importance of the prestige factor, consumers may not be bothered about not having the "real thing", as long as others believe that the product is "real". The information asymmetry is different – it is third parties who are not informed, but this is typically not assumed to be a market failure (see Grossman and Shapiro, 1988a).

¹⁶ See for instance Tirole (1993), chapter 2.

¹⁷ See Shapiro (1983) and Klein and Leffler (1981) for models of repeat purchase.

¹⁸ This does not necessarily imply that the quality provided by producers is perfectly constant. They may decide to make from time to time slight adjustments to product quality in the light of changing market conditions, like the entry of new competitors or changing income conditions of consumers. Yet, when doing so, producers will always keep in mind the investment they made in building a reputation for their products and the effect any adjustment in quality will have on future purchases.

Time plays an important role in models of repeat purchase. Consumers have to learn the quality of a product sufficiently quickly and to renew their purchase sufficiently often in order for producers to have an incentive to provide quality. If these conditions are not met, producers are not able to recover investments made in high quality. Instead, it would be profitable for producers to offer the lowest quality, as they would not expect extra profits from repeat purchase in the future.¹⁹ This is the reason why it is more likely to find high quality restaurants in areas of town that cater for a stable population than in tourist areas, where the restaurants' clients change every day.

The more time that passes between one purchase and the next the more serious is the problem of under-provision of quality and quantity in the relevant market. Markets may disappear completely in the extreme case of one-off purchases, i.e. purchases of durables that are not repeated. As consumers do not know the quality of the good when purchasing, the purchase price must be independent of the actual quality of the good. Instead, the price is likely to reflect the average quality consumers expect to find on the market. As it is not profitable for high quality producers or suppliers to put their products on the market under these circumstances, they withdraw. As a result the average quality supplied declines and with it the price consumers are willing to pay. Intermediate quality producers will now also withdraw from the market and this dynamic continues until only low quality products or no products at all are supplied.²⁰ In fact, the more time passes before consumers learn about the quality of a good and/or return to the market for a new purchase, the more the relevant market starts to look like a market for credence goods. Government intervention in the form, for instance, of quality controls, minimum quality standards or safety regulations can, in these cases, be desirable, as they may have the effect of ensuring higher product quality and/or more product varieties in the market.²¹

Legal protection against free-riding by third parties

The type of regulatory intervention by the government mentioned above is not necessary in most markets of repeat purchase. As discussed before, repeat purchase guarantees that producers have an incentive not to cheat consumers and meet the reputation of high quality they built in the past. Yet, in order for this to happen, consumers must be able to recognize the product they have consumed before. If all bottles of wine looked alike – a bottle of green glass containing a red liquid – consumers would be unable to “reward” the producers of high quality wine or to “punish” those offering low quality. This is why producers make their products recognizable to consumers, for instance, through labels in the case of wine.²² Labels will indicate the name of the producer or the region of production and provide consumers with valuable information that the quality of the wine is likely to be identical to the one they previously bought.²³

Trademarks or brand names are probably the most frequent devices used by producers to communicate information to consumers and make their products easy to identify.²⁴ In the words of Landes and Posner (2003), a trademark conveys information that allows the consumer to say to himself: “I need not investigate the attributes of the brand I am about to purchase because the trademark is a shorthand way of telling me that the attributes are the same as those of the brand I enjoyed earlier”. This hints at yet another reason why consumers may be willing to pay a mark-up for a branded good. The brand name reduces consumers'

¹⁹ This incentive to cut quality is referred to in economics as a problem of “moral hazard” on the producer side.

²⁰ This line of argument is based on Akerlof (1970). In this particular model the market (for used cars) disappears completely, a result that is to a large extent based on the assumption that suppliers cannot adjust the quality they offer. Instead they only have the choice between selling the car to others or “consuming” it themselves.

²¹ See, for instance, the discussion in Tirole (1993).

²² Such devices may not be necessary if the consumer buys directly from the producer, for instance because the producer is located close to the consumer's home and known to him, e.g. the local bakery store.

²³ It appears that most economic models of repeat purchase implicitly assume that some mechanism exists in order to make products of the same producer recognizable. Trademarks and protection against counterfeiting have been explicitly modelled in Grossman and Shapiro (1988b).

²⁴ The terms trademark and brand name are used here as rough synonyms, like in Landes and Posner (2003). Empirical research by Png and Reitman (1995) confirms that in the case of service stations branded dealers are more likely to carry products for which cheating on quality is an issue, i.e. products that suffer from information asymmetries.

search costs.²⁵ Instead of having to search for the specific characteristics they appreciated in the product they previously bought, they only need to look out for the brand name. This is less complicated and thus less time consuming.²⁶

In order for trademarks to fulfil their role, third parties must be prevented from using the same mark. As explained before, high quality producers demand a mark-up over costs in order to recover investments made in reputation-building. Producers who have not made this investment could supply the same, high quality product more cheaply and push original producers out of the market if they were allowed to use the same trademark. Alternatively, they could decide to supply low quality products under the same trademark. This way, they would make excessive profits during a short period of time, as consumers would still be willing to pay a high price for the product carrying the trademark.²⁷ When consumers return to the market, however, the reputation of the original producer is ruined. Legal protection of trademarks is therefore necessary in order to prevent free-riding by third parties that would inevitably destroy the information capital embodied in a trademark.²⁸

The protection of GIs follows the same logic. It prevents producers outside the area from using the same GI and, thus, from free-riding on the reputation built by producers in that region. The guarantee that products carrying the GI originate in the area indicated is also supposed to convey information on certain product characteristics. Production in the respective region may, by definition, lead to specific qualities of the product that are essentially attributable to geographical origin, for instance, in relation to climatic factors.²⁹ But it may also be that the intervention of individual producers from the area has an additional impact on the characteristics of the final product – for example, through the specific method used to transform milk into cheese, grapes into wine or raw meat into ham. To the extent that the latter is the case, regional producers sharing a distinctive sign need to agree on certain characteristics of the final product or the production techniques to be used if the sign is to remain meaningful to consumers.³⁰ Given that, typically, more than one producer has the right to use the same GI, the potential of free-riding also exists within the relevant producer group, and a producers' association, for instance, needs to find a way to ensure that the significance of its GI is not ruined by the opportunistic behaviour of individual members.³¹ If such possible coordination problems are appropriately dealt with, GI protection affords producers in a region the same advantages that are discussed in the economic literature for trademark owners. They can appropriate the benefits of investing in certain product qualities and maintaining them in the long-run. As a result, the economy as a whole benefits from higher product quality on average and a larger product variety.³²

²⁵ See Landes and Posner (2003) for a more detailed discussion of this mechanism. Their approach is based on Ehrlich and Fisher (1982).

²⁶ Although the discussion in this subsection continues to focus on vertically differentiated goods, it is *a priori* possible to apply the argument presented in this paragraph to the case of horizontally differentiated goods.

²⁷ Such a strategy can be profitable for producers who are able to produce the low quality but not the high quality product or can do so only at a higher cost than the original producer who has developed the trademark.

²⁸ Trademark owners are also protected against confusingly similar signs. It would, for instance, not be possible to brand sneakers as being "Nike-like" or sell stereo systems with the indication "Spanish Sony".

²⁹ For an example of how the link between climate and product characteristics may be described see, for instance, the European PDO for Comté cheese, which "is produced from raw cows' milk from the local breed 'Montbéliarde'. The herd is fed on pastures or hay from the delimited area in the Jura mountains. The particular flora due to the soil and climate of that semi-mountain area, the local breed the milk of which has a specific ability to be processed into cheese, producers' skills in elaboration and maturing taking advantage of natural germs, confer on this cheese its genuine and distinctive characteristics among cheeses of the same category" (Vital, 2000: 52).

³⁰ To the extent that consumers are interested in credence good characteristics, government intervention may also be desirable, as discussed previously.

³¹ Quality control and prevention of free-riding are typically achieved through the existence of some kind of monitoring body consisting in a group of producers or producer representatives. The mere existence of such a monitoring and coordination mechanism carries the risk of non-competitive behaviour by the relevant producer group, as discussed in OECD (2000a).

³² An increase in average quality does not imply that lower and thus cheaper products disappear from the market, which would potentially hurt low-income consumers. There are also exceptions to the result that trademark protection for experience goods leads to higher product quality and thus higher overall welfare, as shown in Grossman and Shapiro (1988b).

(d) Impact of GI protection on price

In this Section, empirical evidence regarding the impact of GIs on price is examined. In theory, consumers may be willing to pay a higher price for goods with protected GIs because this removes uncertainty regarding the origin and quality of products bearing those indications. They are assured that these products come from the right region and have the desired quality. Consumer surveys tend to confirm this increased willingness to pay. The 1999 EU consumer survey, for example, found that 40 per cent of consumers were willing to pay a 10 per cent premium for origin-guaranteed products (EU Commission, 2003). Torelli (2003) reviews the survey literature on Italian consumers and concludes that consumers are generally willing to pay a higher price for products with protected regional appellations in order to have greater guarantees of quality. However, he also cautions that the responses to the survey may be exaggerated and may not predict how consumers will actually behave in the marketplace.

There is some anecdotal evidence about the premia attached to protection for indications of geographical origin. For example, Rangnekar (2003) reports that Jamaican blue mountain coffee received a premium of 14.50 dollars per kilo in comparison to benchmark prices of Columbian milds. The EU Commission (2003) has also stated in its reports that French cheeses with GIs are sold at a premium of 2 euro per kilo over French cheeses without GIs, French "Poulet de Bresse" has a market price 4 times higher than regular French chicken, and Italian "Toscana" oil has sold at a premium of 20 per cent since it was registered as a GI in 1998.

Some econometric work has been undertaken on regional origins and wine prices. The primary econometric tool used in the analysis is the hedonic pricing model (Rosen, 1974). This is a technique that allows the price of a product to be decomposed into contributions made by its various characteristics.³³ Applied to wine, it would allow estimation of the value of such important features as geographical origin, variety, vintage, etc., whose sum make up the price of the wine. Combris, Lécocq and Visser (1997) used a hedonic pricing model to test the importance of labels on Bordeaux wines, which includes information on their regions of origin, as against experts' opinions of wine quality. They find that Bordeaux wine prices are influenced by the information contained in labels on the bottles. Similarly, Landon and Smith (1998) show that the reputation of Bordeaux wines, including their regional origins, plays a very large role in explaining their prices. For example, Table IB3.1 shows that a Pomerol will fetch 15 dollars more per bottle than an average Bordeaux.

Table IB3.1
Impact of regional classification on price of Bordeaux

Regional classification	Real dollar marginal effect on price
Graves	10.08**
Margaux	5.48**
Pauillac	11.84**
Pomerol	15.15**
St. Emilion	8.04**
St. Estèphe	11.86**
St. Julien	9.43**

** Significant at the 5% level.
Source: Landon and Smith (1998).

Using a similar approach, Schamel (2000) found that regional reputation was an important factor in determining the price of Cabernet Sauvignon in the United States market. Bombrun and Sumner (2003) examined an extensive list of California wines and found that wines with coastal region appellations commanded higher prices than those with just the California appellation. So holding other characteristics constant, wines with a "Napa Valley" appellation were priced 61 per cent higher than wines with a "California" appellation. Schamel and Anderson (2003) extended this analysis to the case of Australian wines and found that regional origin was

becoming a more important determinant of prices over time (1992-2000), with average premia of up to 31 per cent in 2000. The coefficients in Table IB3.2 show the percentage difference between wines of different grape varieties and regional origins relative to a benchmark bottle of Shiraz produced in the Barossa Valley. Hence, a Pinot Noir is cheaper by 22 per cent compared to a Shiraz from the Barossa Valley, while a wine produced in Canberra is 25 per cent more expensive.

³³ In hedonic models, the observed market price of a product is the sum of the implicit (unobserved) prices paid for each attribute of the product. The assumption of these models is that the preferences (utility functions) of consumers depend on the attributes of a product. Producers, in turn, have cost functions which depend on the attributes of the product. In equilibrium, markets determine the implicit (unobserved) prices of these characteristics.

Not all the empirical work on wines has used hedonic models. Using a conjoint analysis framework,³⁴ Gil and Sánchez (1997) compared consumer preferences for different wine attributes in two Spanish regions, Aragón and Navarra. The authors used three wine attributes in the test: price, origin and grape vintage year. They found that consumers in both regions assigned more importance to the origin of the wine than to grape vintage or price.

The statistical evidence from these studies, involving a range of quality wines grown in different continents and hemispheres, supports the conclusion that consumers use regional names to infer quality and pay a significant price premium for those wines from areas with established reputations. But in the case of the Australia study, Schamel and Anderson go further and argue that the introduction of legislation in 1993 to allow registration of GIs for wines was an important contributing factor to this trend by increasing the returns to regional promotion of wines. At the same time, Table IB3.2 shows that wine consumers discriminate by grape varieties, which are also capable of commanding mark-ups.

Beyond the case of wines, this report looks at the specific example of Darjeeling tea. While the original intention was to analyse the evidence for a wider range of products (including various types of blue cheeses, Jasmine rice, Cava and Champagne) which enjoy GI protection, the lack of data for many products was a major constraint. Hence, beyond the specific conclusions that may be drawn from an examination of Darjeeling tea, there is a clear need to broaden the quantitative analysis to include more GI products in the future.

Darjeeling tea is a specialty tea grown in the West Bengal region of India. Darjeeling tea is grown on about 19,000 hectares of hilly land (from 700 to 2,000 metres), with production estimated at a little over 5,000 metric tons in 2002. About 70 per cent of production is exported, with the major export markets being the UK, Germany, Japan, the United States, the Netherlands and France (Rao, 2003). In 1983, a Darjeeling logo was created. This logo was registered as a certification mark in India in 1986. Registration of the logo as a certification mark in major export markets occurred later – in 1988 in the United States and 1997 in the United Kingdom. The Indian Tea Board has also separately registered the word “Darjeeling” as a certification mark.³⁵

Table IB3.2
Impact of regional classification on price of Australian wines

Variety	Price effect
Pinot Noir	-0.223**
Chardonnay	-0.288*
Riesling	-0.42*
Sauvignon Blanc	-0.336*
Semillon	-0.324*
Regional classification	Price effect
Great Southern	0.267*
Margaret River	0.276*
Other WA	0.233**
Adelaide Hills	0.301*
Clare Valley	0.234*
Coonawarra	0.177***
Eden Valley	0.152***
Other SA	-0.194**
Canberra	0.253*
Hunter Valley	0.163*
Riverina	-0.280**
Other NSW	0.252*
Bendigo	0.376*
Grampians	0.218**
Macedon Ranges	0.322*
Mornington Peninsula	0.310*
Pyrenees	0.280**
Yarra Valley	0.212*
Other Victoria	0.266*
Northern Tasmania	0.259*
Southern Tasmania	0.386*

*** Significant at the 1% level.

** Significant at the 5% level.

* Significant at the 10% level.

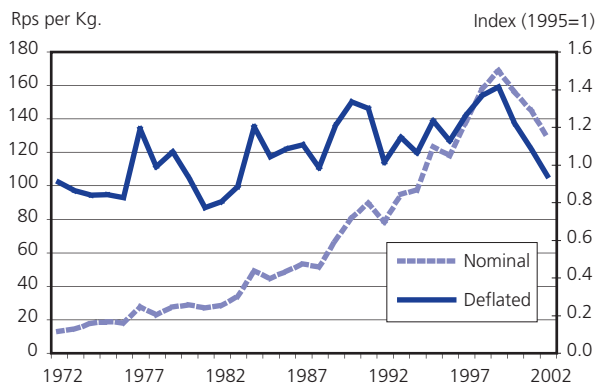
Source: Schamel and Anderson (2003).

³⁴ Conjoint analysis is a technique to measure the importance of various attributes of a product in the consumer's purchasing decision. As the name implies, it is used when the consumer's choice depends on the joint effects of the product attributes. Unlike traditional surveys, the design of conjoint analysis is more rigorous and requires respondents to make tradeoffs that are similar to those in the market. Unlike the hedonic pricing model which produces a set of implicit prices for different attributes of the product, the output of conjoint analysis is a ranking of the product attributes and the consumer's willingness to make tradeoffs among the attributes. See Green and Srinivasan (1978).

³⁵ See Das (2003).

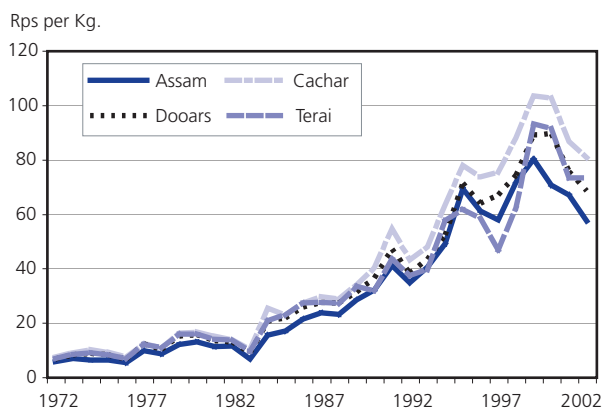
Several effects should arise from the introduction of legal protection for the name "Darjeeling". There should be an improvement in price following the introduction of protection (timing effect). The price should rise relative to other closely related products (price premium effect). This premium effect could be accentuated if producers use the protected name as a marketing or promotion tool to draw attention to the product. And we should expect to see an improvement in the quality of the product (quality effect). These three elements

Chart IB3.1
Nominal and deflated price of Darjeeling tea, 1972-2002



Source: International Tea Committee (various issues) Annual Bulletin of Statistics and IMF International Financial Statistics.

Chart IB3.2
Price differential between Darjeeling and other teas, 1972-2002



Source: International Tea Committee (various issues) Annual Bulletin of Statistics.

should allow us to distinguish the effect of legal protection from other factors which could shift demand and supply and change prices.

The Indian Tea Board conducts weekly auctions of various grades of tea. The data used are the annual average prices and the quantities sold at auction in Calcutta from 1972 to 2002 of various tea leaves: Darjeeling, Assam, Cachar, Doaars and Terai. The nominal price of Darjeeling tea has shown a pronounced rise since about 1984 (Chart IB3.1). However, the deflated price of Darjeeling only rose until 1998 and fell afterwards.³⁶ The period under consideration also witnessed an increase in the price difference between Darjeeling and other teas sold at auction in Calcutta (Chart IB3.2). Regressing these price differences on a time trend reveals that the increases were statistically significant. But is the legal protection of the name "Darjeeling" part of the reason?

To test the impact of GIs, the demand for Darjeeling tea was estimated during the period 1972-2002. The results obtained suggest that GI protection has increased the price of Darjeeling tea in total by less than 1 per cent in real terms over the 1986-2002 period (See Box IB3.2 for more details). This result is suggestive of only a very modest price premium effect of GI protection, although there is some indication of improvement in quality in Darjeeling tea production which can be gleaned from the decline in the proportion of Darjeeling tea dust relative to Darjeeling tea leaf (Chart IB3.3). Tea brewed with whole-leaf tea is considered the best tasting while tea bags made from fannings and dust are usually considered inferior. Beginning in

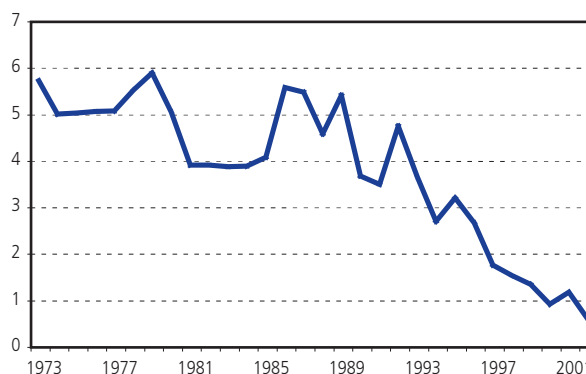
the mid-80s, there is a decline in the share of Darjeeling tea dust to Darjeeling tea leaf in total sales. This is consistent with tea estates in the Darjeeling region improving the quality of their tea farming and thus producing more tea leaves for sale in the market and losing less of their production to tea fanning and dust.

According to this study, GI protection seems hardly to have improved Darjeeling tea prices. One explanation for this could be a gap between the legal protection that has been given to Darjeeling tea in India and the quality of enforcement. Pettigrew (2000) estimates that 40,000 tons of tea is sold every year as Darjeeling tea in the world market, whereas production of Darjeeling tea in the area has not exceeded 10,000 tons in any year since 1976.

³⁶ The nominal price is deflated by the Indian wholesale price index.

So far, the empirical literature on GIs is extremely limited. A number of studies have examined the contribution made by regional origin to prices but there have been few studies made on the effect of introducing legal protection for GIs and none which has sought to measure the impact of different levels of GI protection. The case study of Darjeeling has been an initial attempt to close the gap on the first of these points. Further improvements in the methodology and more empirical studies on other products are needed to obtain a better understanding of the value of GIs to consumers and producers alike.

Chart IB3.3
Proportion of dust Darjeeling to leaf Darjeeling tea sold, 1973-2002
 (Percentage)



Source: International Tea Committee (various issues) Annual Bulletin of Statistics.

Box IB3.2: The case of Darjeeling tea

An inverse demand equation for Darjeeling tea was estimated with its deflated price as the dependent variable. The explanatory variables are a dummy for geographical indication, quantity demanded, the deflated price of a substitute tea and growth in GDP in five major export markets (United States, United Kingdom, Germany, Japan and the Netherlands). The dummy takes on a value of 1 beginning in 1986, when protection was introduced. The use of growth in foreign GDP as an explanatory variable reflects the fact that most of Darjeeling production is exported.

Since price and quantity are both endogenous variables, estimating the equation by ordinary least squares (OLS) will yield inconsistent estimates of the regression coefficients. The demand equation has therefore been estimated by instrumental variables (IV). The technique involves identifying and using a set of exogenous variables (instruments) which are correlated with the explanatory variables but not the error term in the demand equation. In this case, the additional variables used are climactic variables that affect supply but not demand. IV estimation is similar (but not identical) to a two-stage estimation process which first involves regressing all the endogenous variables on the instruments and then substituting the fitted values for the endogenous variables in the second stage of the estimation (Davidson and MacKinnon, 1993).

The instruments include: a) all the exogenous variables of the demand equation – constant, dummy variable, the price of Assam tea leaf (substitute), GDP growth in key export markets; and b) exogenous variables which affect supply but not demand – average annual rainfall, average temperature and the supply of Assam (a substitute). All variables, except the GI dummy, are in natural logarithms. The results of the IV regression are shown below. The first column of the table lists the explanatory variables. The second column shows the estimated value of the coefficients. The third column reports the t-statistics (a measure of the statistical significance of the estimates), and the last column indicates the probability that the estimated coefficient is zero.

Instrumental Variable Regression: Deflated Price of Darjeeling Tea, 1972-2002

Parameter	Coefficient	T-Statistics	Probability
Constant	4.106	3.789	[.000]
Geographical Indication	0.086	1.923	[.054]
Quantity Demanded	-0.288	-2.572	[.010]
Price of Assam Leaf	0.591	7.431	[.000]
Export Market GDP	2.611	2.436	[.015]

$R^2 = 0.87$

Note that all the variables have the correct signs. The constant, quantity demanded and the price of the substitute are significant at the 1 per cent level. The growth in GDP in export markets is significant at the 5 per cent level, while the dummy for GIs is significant at the 10 per cent level. The R^2 (which measures the explanatory power of the regression) suggests that a large part of the variability in price is explained by the set of variables. The coefficient on the GI dummy represents the price premium of protection, which amounts to about 1.08 rupees per kg. in 1995 prices. But this represents less than 1 per cent of the price of Darjeeling during the 1986-2002 period, suggesting that GI protection hardly added a price premium.

Data sources: The prices and quantities of Darjeeling and other teas are from various editions of the Annual Bulletin of Statistics published by the International Tea Committee. The Indian Wholesale Price Index used to deflate nominal prices and the GDP data of the United States, Japan, Germany, the United Kingdom and the Netherlands are from the IMF's International Financial Statistics CD-ROM. Rainfall data of Northeast India, where West Bengal is located, is from the Indian Institute of Tropical Meteorology. Average temperature observed in the Gauhati weather station is from the NASA Goddard Institute for Space Studies.

(e) Conclusions

The TRIPS Agreement is the first multilateral agreement defining the term "geographical indication" as such. WTO Members follow a variety of practices in implementing their TRIPS obligations to provide the legal means for interested parties to prevent the use of GIs in a manner which misleads the public as well as to prevent acts of unfair competition. These legal means can be broadly categorized into horizontal laws focusing on business practices, trademark law and special means of protection.

In international trade, it may happen that producers, recognized at home as having rights in a GI, export their products to markets where the same sign is in use by other parties. There are a number of guiding principles in national and international law which are used to resolve such situations.

Stronger protection is available under TRIPS to prevent use of a GI identifying wines for wines (respectively spirits for spirits) not originating in the indicated place. Besides the debate on whether this level of protection should be extended to GIs for products other than wines and spirits, there are negotiations under way concerning the establishment of a multilateral system of notification and registration of GIs for wines and spirits. These negotiations have proven difficult, in particular in regard to any legal implications of registrations on such a register.

Taking a step back from the complex legal issues raised in WTO discussions, a number of economic concepts offer useful insights into the purpose and effects of GIs in markets for differentiated products. In markets characterized by asymmetrical information between producers and consumers, GIs can act as one instrument to make a product recognizable to consumers who previously experienced and appreciated specific properties of that product. Distinctive signs, such as GIs, allow for repeat purchases through which, in the case of experience goods, maintenance of the peculiar mix of product characteristics is rewarded. The mark-up obtained enables producers of those products to incur the higher production costs necessary to maintain those qualities compared to other varieties. As a pre-condition, free-riding by third parties must be prevented in order to protect the information capital embodied in the sign – hence the need for protection of such signs at the national level and, when it comes to international trade, at the international level. In consequence, markets of differentiated goods will, in general, be characterized by a larger product variety and higher product quality on average, to the benefit of consumers.

With the exception of wines, few econometric studies have been undertaken on the contribution made by regional origin to price. Hardly any study has been carried out to examine specifically whether a price premium is obtained when GI legislation is introduced and none that analyses the differential impact of different levels of GI protection. Our study of Darjeeling tea suggests that the GI protection given to this term did not have a noticeable effect on price. These results may suggest that protection is not enough and that it must be coupled with strict enforcement and significant investments in promotion of the product if consumers are to attach value to the indication. There is a need for further empirical research in this direction covering a larger group of products.