

# CRS Report for Congress

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## Generalized System of Preferences

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# Generalized System of Preferences

## Summary

The Generalized System of Preferences (GSP) extends duty-free treatment to certain products that are imported from designated developing countries. The primary purpose of the program, which the United States and other industrial countries initiated in the 1970s, is to promote economic growth and development in these countries by stimulating their exports. The program was last reauthorized until December 31, 2006, by section 410 of the Trade Act of 2002 (P.L. 107-210)

U.S. companies and consumers who use products that benefit from duty-free treatment are strong supporters of legislation to reauthorize GSP. They argue that GSP reduces costs of production for companies that import components and parts under the program and lowers the prices that consumers pay. The program is also supported by observers who think that GSP is an effective, low-cost means of providing economic help to developing countries. They maintain that encouraging trade by private companies stimulates economic development more effectively than intergovernmental aid and other means of assistance.

There are several sources of opposition to GSP. Import-competing producers complain that preferential tariff treatment generates unfair competition. Others are concerned about the effects of GSP on the exporting countries. Some criticize the program for benefitting higher income developing countries disproportionately and providing too little assistance to the poorest countries. Some observers are concerned that tariff preferences may encourage inefficient trade and production patterns in the developing countries. Other critics maintain that U.S. officials have not vigorously enforced the country practice provisions, such as protection of intellectual property rights and observance of worker rights, which are required by the law. This report will be updated as events warrant.

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# Generalized System of Preferences

The Generalized System of Preferences (GSP) provides preferential tariff treatment to certain products that are imported from designated developing countries.<sup>1</sup> The primary purpose of the program, which the United States and other industrial countries initiated in the 1970s, is to promote economic growth in developing countries and countries in transition by stimulating their exports. The program was last reauthorized through December 31, 2006, by the 107<sup>th</sup> Congress in section 4101 of the Trade Act of 2002 (P.L. 107-210).

## Rationale for GSP

The United States and other industrial countries<sup>2</sup> established the Generalized System of Preferences in the early 1970s to promote economic development in developing countries through increased trade. The program extends preferential tariff treatment — low or zero duties for designated products exported from beneficiary countries — which provides a competitive advantage in the markets of industrial countries. It is a unilateral grant of tariff concessions; developing countries are not required to extend reciprocal tariff reductions. (They must, however, meet certain conditions.) The program is intended to give preferential tariff treatment to developing countries until their exporters are able to compete on world markets with normal, nonpreferential tariffs.

The preferential and unilateral nature of GSP is a departure from the principles that have guided post-World War II multilateral tariff reductions under the General Agreement on Tariffs and Trade (GATT). The GATT provides that trade must be conducted on a nondiscriminatory, or most-favored-nation (MFN), basis. Generally, members of the World Trade Organization (the organization that replaced the GATT Secretariat in 1995 and currently administers world trading rules) must extend any tariff concessions to all trading partners. Tariff reductions under the GATT have also been based on reciprocity: tariff concessions from each member country are reciprocated by concessions from others. Since 1971, however, a GATT waiver has allowed the industrial countries to extend preferential tariff treatment for developing countries.

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<sup>1</sup> This report was originally written by George Holliday, Specialist in International Trade and Finance.

<sup>2</sup> In addition to the United States, the European Union and 13 other countries — Australia, Belarus, Bulgaria, Canada, Czech Republic, Hungary, Japan, New Zealand, Norway, Poland, Slovak Republic, Switzerland, and the Russian Federation — currently have GSP programs.

## The U.S. GSP Program

Title V of the Trade Act of 1974 (P.L. 93-618), as amended,<sup>3</sup> authorizes the U.S. GSP program. It authorizes the President to provide duty-free treatment for any eligible product from any beneficiary developing country (BDC) and spells out criteria for designating eligible countries and products. Currently more than 4,600 products from over 140 BDCs are eligible for duty-free treatment under GSP and another 1,783 product categories eligible for duty-free treatment to least developed countries. In 2003, the United States imported \$21.9 billion under the program. Petroleum products, automobile parts, jewelry, and furniture were among the leading imports.

In designating beneficiary countries, the President is directed to take into account the level of economic development of the country, its commitment to a liberal trade policy, the extent to which it provides adequate protection of intellectual property rights, and its observance of internationally recognized workers rights.<sup>4</sup> The law prohibits (with certain exceptions) the President from extending GSP treatment to other industrial countries, Communist countries, countries that provide preferential treatment to the products of a developed country, and countries that nationalize or expropriate the property of U.S. citizens, or otherwise infringe on the property rights of U.S. citizens. The Trade Act also restricts the President's discretion in designating eligible products. It lists categories of import-sensitive products — certain textile and apparel products, watches, electronic articles, steel products, footwear, glass products, and other items — that are not eligible for GSP treatment. In addition, the Act establishes “competitive need limits,” which require the President to suspend GSP treatment when U.S. imports of a product from a single country reach a specified threshold value or when 50% of total U.S. imports of the product come from a single country.

The Trade Act authorizes the President to withdraw GSP treatment for any article or any country. The program is reviewed annually by a subcommittee of the Trade Policy Staff Committee (TPSC). It is chaired by the Office of the U.S. Trade Representative (USTR) and includes representatives from the Departments of Agriculture, Commerce, Interior, Labor, State, and Treasury. The subcommittee meets annually to decide which countries are eligible and to consider petitions to add or remove items from the list of eligible products. The subcommittee also resolves questions about country practices — trade policies, protection of intellectual property rights, observance of worker rights, and other matters — on which eligibility for GSP is conditioned. Although some critics maintain that U.S. officials have not vigorously enforced the country practice provisions, the subcommittee has

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<sup>3</sup> The GSP Program was reauthorized and amended by the Trade and Tariff Act of 1984 (P.L. 98-573). Seven subsequent laws have authorized GSP most recently through December 31, 2006.

<sup>4</sup> Workers rights are defined by law for the purposes of GSP to include: the right to association; the right to organize and bargain collectively; a prohibition on the use of any form of forced or compulsory labor; a minimum age for the employment of children; and acceptable conditions of work with respect to minimum wages, hours of work, and occupational safety and health.

occasionally denied benefits because of country practices. In 1994, for example, Maldives was suspended from the list of beneficiaries because it was not making sufficient progress in protecting basic labor rights. Some observers maintain that the threat of losing benefits sometimes persuades beneficiary countries to change objectionable policies or practices.

The subcommittee also makes recommendations about which products should be removed from the list because they have become sufficiently competitive or because they are import-sensitive. Since the law does not clearly define the terms “import-sensitive,” or “sufficiently competitive,” the subcommittee must make a judgement on a case-by-case basis for each product. Those who are affected by the subcommittee’s decisions often complain that the lack of clear definitions or criteria lead to subjective and inconsistent interpretations on product eligibility.<sup>5</sup>

The last major statutory change in the U.S. GSP program was enacted August 20, 1996 (P.L. 104-188). The 1996 law included several significant reforms of the program and an extension of its authority to May 31, 1997. (The program was extended retroactively because it had expired for over a year.) Among the most important changes were provisions to redistribute the benefits of GSP among beneficiary countries. It stipulated that, when the official statistics of the World Bank demonstrate that a beneficiary developing country has become a “high income” country, the President would terminate the country’s eligibility for GSP benefits. (World Bank statistics include countries with per capita incomes of over \$8600 in the “high income” category. Under the previous law, the per capita income threshold for graduation had been \$11,800.) Since the new income per capita threshold is considerably lower, countries will graduate from GSP sooner.

Another provision lowered the competitive need limit from \$114 million in 1994 to \$75 million in 1996 and increased it by \$5 million each year after 1996. The law provided specific authority for the President to designate additional articles from the least developed beneficiary countries as eligible for GSP. It also prohibited consideration of an article for GSP treatment for three years following formal consideration and denial of that article.

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<sup>5</sup> U.S. General Accounting Office. Assessment of the Generalized System of Preferences Program. November 1994, pp. 79-81. GAO/GGD-95-9. (Hereafter, cited as GAO.)

## Economic Effects of GSP

The GSP program affects trade flows and production patterns in both beneficiary developing countries and the industrialized countries. The effects on both groups of countries, however, are probably not large.

### Effects on Beneficiary Countries

Supporters of GSP maintain that it is an effective, low-cost means of providing economic help to developing countries. They argue that encouraging trade by private companies stimulates economic development more effectively than government-to-government aid or other means of assistance.

Empirical studies, based mostly on trade data from the late 1970s and mid-1980s, provide some support for the view that GSP stimulates development. Most suggest that GSP has modestly increased the exports of beneficiary countries. One study, for example, found that the eligible exports of beneficiary countries to the industrial countries increased by about 8% annually because of GSP.<sup>6</sup> The increase results mostly from creation of new trade opportunities, as relatively low-cost producers in the beneficiary countries take advantage of lower tariffs to displace higher cost producers in the markets of the industrialized countries.

The benefits of GSP to developing countries are limited by several features of the program. In 2003, for example, only about 11.5% of U.S. imports from beneficiary countries entered on preferential terms under GSP. Many products that were technically eligible for GSP treatment were excluded, most often because they exceeded the competitive need limit of a given product or because they did not meet the rules of origin requirements of the law.<sup>7</sup> Because the list of eligible products can change and because different countries make different products eligible for GSP, it is difficult for export industries in the developing countries to specialize to take advantage of the tariff preferences.

GSP tariff cuts can also result in efficiency and welfare losses for the world economy. Because GSP reduces tariffs in a discriminatory manner (that is, it favors some producers in developing countries over other producers), it can divert trade from more efficient producers in third countries to less efficient producers in beneficiary countries. Such costs are borne by relatively more efficient producers

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<sup>6</sup> Laird, Samuel and Andre Sapir. Tariff Preferences. In Finger, J. Michael and Andrzej Olechowski, eds. *The Uruguay Round: A Handbook on the Multilateral Trade Negotiations*. Washington, World Bank, 1987. Pp. 101-109. See also, Sapir, Andre and Lars Lundberg. *The U.S. Generalized System of Preferences and Its Impacts*. In Baldwin, Robert E., and Anne O. Krueger, eds. *The Structure and Evolution of Recent U.S. Trade Policy*. Chicago, The University of Chicago Press, 1984. p. 195-231.

<sup>7</sup> In 2002, of \$33.6 billion in imports that were eligible for GSP, \$17.7 billion actually entered duty free. Some other U.S. imports from developing countries entered duty free under other preferential tariff programs, such as the Caribbean Basin Initiative, the Andean Trade Preference Act, and the African Growth and Opportunity Act, or because the MFN tariff rate is zero.

who compete with those exporters that benefit from tariff preferences and by consumers in importing countries.

Trade diversion can harm not only producers in third countries but also the domestic economy of the beneficiary country. Tariff preferences could encourage exports of goods for which a country does not have a comparative advantage, thus distorting the domestic allocation of resources. By diverting resources away from potentially efficient producers, preferences could, over time, result in reduced exports and growth. Although the costs of trade diversion are real, the empirical evidence suggests that trade diversion from GSP is small.<sup>8</sup>

The lack of reciprocity in the GSP program may also result in long-term costs for the beneficiary countries. In multilateral trade negotiations, the requirement for reciprocal tariff reductions means that all signatories reduce their tariffs. By avoiding reciprocal tariff reductions under GSP, however, some developing countries have tended to keep in place protectionist, import-substitution trade policies that have impeded their long-term growth.

Because preferential tariffs under GSP can lead to inefficient production and trade patterns, most economists prefer multilateral, nondiscriminatory tariff cuts. When tariffs are reduced in a nondiscriminatory manner, countries tend to produce and export on the basis of their comparative advantage. That is, countries export products that they produce relatively efficiently and import products that others produce relatively efficiently. Multilateral tariff reductions such as those agreed to in the Uruguay Round of GATT, redistribute the benefits of trade liberalization in developing countries. Some exporters benefit because they face reduced tariffs in the industrial countries, while others are hurt because the margin of preference under GSP is reduced.

## **Effects on the U.S. Economy**

Several factors suggest that the overall effects of GSP on the U.S. economy are small. First, in 2003, only about 1.7% of total U.S. imports entered duty-free under GSP. Second, most products that would otherwise have been eligible for GSP did not come from GSP beneficiaries; they were imported from non-beneficiary countries at MFN (or normal trade relations) tariff rates. Third, many imports that entered duty-free under GSP would probably be competitive without preferential rates. Since, for many products, U.S. MFN rates are not much higher than the GSP rates, the effects of paying the higher rates would be small. Thus, the U.S. market for most products is unlikely to be adversely affected by imports under GSP.

Nevertheless, some domestic producers and consumers benefit significantly from GSP. For some companies that use parts, components, or materials that are imported under GSP, the reduced tariffs can mean lower costs. Consumers who buy products imported under GSP or products that are produced with GSP inputs may benefit from significantly lower prices. Those who benefit from GSP have provided a strong base of support for the program. Domestic producers who compete with

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<sup>8</sup> Laird and Sapir, p. 105.



imports that enter duty free under GSP, however, can bear significant adjustment costs. Adjustment costs include the costs to workers for retraining and finding new employment and the costs to firms for retooling to become more competitive or to shift capital to other uses. Such costs are ameliorated by the exclusion of import-sensitive products and by the competitive need limits of the program. Nevertheless, those who compete against GSP imports complain that preferential tariff treatment generates unfair competition.

## **The Diminishing Effects of GSP**

Two kinds of developments in the world trading system are reducing the effects of GSP on the U.S. economy and the economies of beneficiary developing countries. First, as multilateral trade agreements reduce tariffs worldwide, the margin between the GSP preferential rates and MFN rates becomes smaller. For example, U.S. tariff rates, which averaged 5.4% on industrial products before the Uruguay Round and 3.5% after the reductions competed. The General Accounting Office estimates that the value of tariff relief on GSP-eligible products was reduced by about 40% under the new reductions.<sup>9</sup>

Second, the growing number and size of other preferential tariff arrangements are also diminishing the value of tariff relief under GSP. The United States, for example, extends duty-free treatment to imports under the North American Free Trade Agreement, the U.S.-Israeli Free Trade Agreement, the Caribbean Basin Initiative, the Andean Initiative, and under the African Growth and Opportunity Act. The United States entered into a free trade agreements with Jordan and Chile and has completed negotiations on a free trade agreement with Central American countries, the Central American Free Trade Agreement (CAFTA). The United States has launched or soon will launch FTA negotiations with other developing countries, further diminishing the effects of the GSP program. The European Union is also expanding its preferential trading arrangements in Africa, Central and Eastern Europe, and elsewhere. As the number of preferential tariff agreements expands, the value of tariff preferences under GSP will decline. That is, beneficiaries of GSP are increasingly either participating in alternative preferential arrangements or competing with producers who enjoy preferential treatment under other arrangements.

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<sup>9</sup> GAO, p. 126.

**Table 1. U.S. Imports Under GSP — Leading Beneficiaries and Total, 2003**

(million dollars)

<b>Rank</b>	<b>Beneficiary Country</b>	<b>Total Imports from Country</b>	<b>GSP Duty-Free Imports from Country</b>
1	Angola	4,264	3,823
2	Thailand	15,181	2,694
3	India	13,053	2,644
4	Brazil	17,884	2,469
5	Indonesia	9,520	1,337
6	Philippines	10,061	891
7	Equatorial Guinea	904	741
8	Turkey	3,788	719
9	South Africa	4,638	670
10	Venezuela	17,144	619
	<b>Imports from Top 10 Beneficiaries</b>	<b>96,437</b>	<b>16,607</b>
	<b>Total Imports from all Beneficiaries.</b>	<b>183,068</b>	<b>21,089</b>

Source: USITC Database.