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Generalized System of Preferences and Graduation: Is there a Parallel with Infant Industries?

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Abstract

The generalized system of preferences (GSP) is an accepted part of trade and development policy. Their rational and expected outcome are strikingly similar to those associated with the promotion of infant industries through the imposition of tariffs. One common thread in both GSP and infant industry arguments is that the benefits offered should only be temporary – until the affected industries become internationally competitive. For GSPs the temporary nature of the protection is institutionalized in the idea of graduation. In the case of infant industries, it is observed that they never grow up – they do not become internationally competitive – and they often can successfully lobby to retain their protection. This is not the case with GSP graduation, but there is no reason to be optimistic that firms receiving GSP benefits will have become internationally competitive. Thus, they may face similar adjustment costs to those that are deemed unacceptable in the case of firms protected under the auspices of infant industry policy. This asymmetry suggests a further examination of GSP schemes, and graduation in particular, is warranted.

Keywords: graduation, GSP, infant industry, internationally competitive, tariffs

Introduction

Bounties are in various instances proposed as one species of encouragement.

It is a familiar objection to them, that they are difficult to be managed and liable to frauds. But neither that difficulty nor this danger seems sufficiently great to countervail the advantages of which they are productive, when rightly applied. And it is presumed to have been shewn, that they are in some cases, particularly in the infancy of new enterprises indispensable.

Alexander Hamilton, 1791

Nearly every industrial tariff was first imposed as an infant-industry tariff under the promise that in a few years, when the industry had grown sufficiently to face foreign competition, it would be removed. But, in fact, this moment never arrives. The interested parties are never willing to have the duty removed. Thus temporary infant-industry duties are transformed into permanent duties to preserve the industries they protect.

Gottfried von Haberler, 1936, p. 281

... it is necessary to go further and introduce a system of preferences.

The case for preferential treatment for exports of developing countries is that it would help the industries of developing countries to overcome the difficulties that they encounter in export markets because of their high initial costs. It is a temporary measure which, by opening up larger markets to the industries of developing countries, would enable them to lower their costs and thus compete on world markets without the need for continuing preference.

The case is thus a logical extension of the infant industry argument.

Raúl Prebisch, 1964, p. 222

To the Congress of the United States:

I am writing concerning the Generalized System of Preferences (GSP) and Hong Kong, the Republic of Korea, Singapore, and Taiwan. The GSP program is authorized by the Trade Act of 1974, as amended ("the Act").

I am hereby providing notice of my intent to remove Hong Kong, the Republic of Korea, Singapore, and Taiwan from their status as beneficiaries of the GSP program as of January 2, 1989, under Section 504(a)(1) of the Act (19 U.S.C. 2464(a)(1)). All four have achieved an impressive level of economic development and competitiveness, which can be sustained without the preferences provided by the program. Graduating these

economies may also enable other less developed countries to benefit more fully from the GSP program.

Ronald Reagan
The White House, January 29, 1988

By the middle of the 20th century the long process of stripping away the intellectual legitimacy of protectionist trade theories that started with Adam Smith's criticism of mercantilism was largely complete with protectionists exposed as no more than advocates of vested interests (Kerr, 2007a). Protectionists could no longer cloak themselves in the guise of acting, and advocating, in the name of society's best interest. They are nothing if not persistent and crave the legitimacy that comes from being associated with the *general good* (Kerr and Perdakis, 2014). Some protectionist theories have had their credibility impinged with relatively little effort but other theories have persisted immersed in the thrust and parry of economic debate and the inconclusiveness of empirical evidence. One such persistent focus of contrasting views is *Infant Industry* theory.

The persistence of *Infant Industry* theory when many other protectionism theories have been vanquished likely lies in its compelling narrative. Startup enterprises are often inefficient as they initially entail a considerable degree of learning by doing to acquire and hone skill, to prevent mistakes, to organize supply chains and gain sufficient market to realize a degree of scale economies. The *infant* period for enterprises is one of considerable risk – and if degree of risk is too great, the investment in the enterprise will not take place. One of the factors that increases risk is competition. In particular, if there are mature foreign competitors that have acquired full economies of scale, potential domestic newcomers with considerable promise may be deterred from attempting to enter the market, or if they do, fail. The *Infant Industry* theory suggests putting in place temporary trade barriers so that new domestic entrants do not have to face the full force of mature foreign competitors. Behind the protective barrier, and the higher prices it brings, the new domestic entrant can have time to undertake its learning process and have access to sufficient market to acquire economies of scale. Once those tasks have been completed, the firm(s) will have achieved a degree of maturity and the industry will no longer be an *infant*. At that point, so the theory goes, the trade barriers can be removed. It is a compelling logic, one that can sway domestic politicians that wish to see a modern (industrial) sector develop and who have the power to put in place trade barriers.

The problem is real, it is difficult to compete with mature foreign competitors. The rest of the narrative surrounding *Infant Industry* theory, however, often appears to be a *non-sequitur*. While the trade barrier allows a new firm (or firms) to become established

they do not progress to become internationally competitive as the theory predicts. They remain high cost relative to their potential international competitors. There are a number of explanations for this failure that have been articulated by Baldwin (1969), Bartlett (1997), Slaughter (2004) and Krueger (1993). As is the norm with policy interventions, the economic benefits arising from the trade barriers also become capitalized into the cost structure of those in the industry making it difficult to abandon policies (Kerr, 2007b).

As the cost reductions from learning by doing are less than those that have been achieved by potential foreign competitors, the size of the domestic market does not allow full economies of scale to be achieved (Slaughter, 2004) or the benefits of protection have been capitalized into firm costs, firms given protection to foster their development do not become internationally competitive. If the trade barriers are removed the firms will not survive in competition with unfettered imports. While some firms may respond and successfully adapt to foreign competition, many would not, and it is not possible for policy makers to know which result will be manifest prior to the trade barriers being removed. Thus, policy makers have a dilemma – do they remove the trade barriers and allow the domestic industry to flounder or do they extend the period of protection. The evidence seems to suggest that they tend to extend protection by making the trade barriers more permanent (Krueger, 1997). This leaves the domestic economy with an inefficient industry – and an industry that cannot be considered modern, which was likely a motivation for providing the protection in the first place. Clearly, it would have been better not to have provided trade protection in the first place and an alternative means found to encourage domestic industrial development. Given an *Infant Industry* strategy had been followed, it is unlikely that the industry will ever *grow up*. The inefficiencies and distortions caused by the *Infant Industry* strategy will continue characterize the industry. Are there parallels and lessons that can be applied to other trade policies?

The Generalized System of Preferences

Although some of what are considered developing countries today took part in the negotiations in Havana to establish the International Trade Organization (ITO), the idea that countries could be classified into developed and developing for the purposes of trade policy had not yet evolved. Of course, most of today's developing countries were colonies. The ITO negotiations, and the parallel General Agreement on Tariffs and Trade (GATT) negotiations, were aimed at removing trade issues as a source of international conflict (Kerr, 2010).¹ One of the issues arising from the experiences of the Great Depression was the capricious and selective use of trade barriers. To prevent

the selective use of trade barriers to punish particular foreign competitors, the GATT negotiators devised the *principle of non-discrimination* whereby tariffs on *like goods* would be the same for all trading partners – or at least for all countries that signed on to the GATT. Issues arising from different degrees of economic development – although that term was not yet in common use – were to be dealt with by the World Bank.

In the years following many colonies gained independence and a number of countries classified as being in the *Third World* came into being. These new countries aspired to rapid industrialization and many decided to follow *Infant Industry* policies or the broader development strategy of *Import Substitution* (Gerber, 2007). The influential economist, Raúl Prebisch, from the UN's Economic Commission for Latin America and the Caribbean, was a major proponent of this strategy.² His view was in direct contrast to that of the GATT that saw the road to economic prosperity arising from the reduction or removal of trade barriers. The GATT vision is summed up succinctly in its pre-amble:

Recognizing that their relations in the field of trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, developing the full use of the resources of the world and expanding the production and exchange of goods.

Being desirous of contributing to these objectives by entering into reciprocal and mutually advantageous arrangements directed to the substantial reduction of tariffs and other barriers to trade and to the elimination of discriminatory treatment in international commerce (GATT, 1947).

The centrepiece of the GATT's principle of non-discrimination was the granting of Most Favoured Nation (MFN) tariff rates among members. While it was agreed that every country could establish its own tariff rates and negotiate its own tariff concessions, once the lowest rate negotiated with another (most favoured) member was agreed, that rate was extended to all other members. It was seen as an incentive for new members to enter into the GATT to escape the capricious and unpredictable use of tariffs by GATT member trading partners against non-members. It had also been agreed that the MFN rates were *bound* meaning they could not be raised, even in future negotiations. The developed country members of the GATT initially stood firm on there being no derogations from the MFN commitments.³ Frustrated by developed country intransigence, and fostered by Prebisch, developing countries sought a forum to discuss the issues through the creation of a new institution, the United Nations Conference on Trade and Development (UNCTAD). Given this forum to bring forward their concerns regarding trade and development, they did so and were able to engage with developed countries. The long process to garner the recognition of GSP concessions through

UNCTAD and the GATT is described in detail in Breda dos Santos et al. (2005) and Cole (2003).

The only dent in the GATT MFN tariff system came when developing countries were able to have Article XVIII modified in 1955. The purpose of Article XVIII was to “enable developing countries to pursue *inward looking* growth policies based on protection and promotion of infant industries” (Howse and Trebilcock, 1999, p. 373). In the notes to Article XVIII it explicitly states:

The reference to the establishment of particular industries shall apply not only to the establishment of a new industry, but also to the establishment of a new branch of production in an existing industry and to the substantial transformation of an existing industry, and to the substantial expansion of an existing industry supplying a relatively small proportion of the domestic demand (GATT Article XVIII, notes).

Prebisch and his fellow travelers also thought that economic development, and in particular industrialization, were not only plagued by *infant industry* constraints but also by their exports being constrained by the trade barriers of developed countries. According to Prebisch (1964, p. 222):

In order to be efficient, those industries must have access to wider markets; otherwise they may not be able to break out of the vicious circle of low output and high costs. Such markets must be sought in the developed countries as well as in other developing countries. But if infant industries need protection in the domestic market because of high costs, they obviously need even more protection in foreign markets, whether developed or developing, in the form of preferential treatment. It is for this reason that the following two suggestions have been made: (a) developing countries should give preference to imports from other developing countries in their own markets; (b) developed countries should give preference to imports from developing countries in their own markets.

This was a clear challenge to the GATT Principle of Non-Discrimination and MFN tariffs. The principle of Special and Differential Treatment was accepted into the GATT in 1964 in Part VI. Breda dos Santos et al. (2005, p 462): state:

Part IV of GATT institutionalized the notion that developing countries were entitled to “special and differential treatment” in the GATT system. It implied that deviations from GATT’s principles that could enact most favourable terms for developing countries ... would be accepted under certain circumstances. It also entailed a new perception of developing countries concerning the means through which they could achieve development. One of the most direct means was the developed countries’ non-reciprocity of concessions for developing counterparts.

Developed countries resisting the granting of such preferential access to their markets were worn down by persistent argument and a few GATT members like Australia and the European Community deciding to offer preferential access to their markets prior to any official movement at the GATT.

Finally, in 1971, a waiver spanning ten years was agreed at the GATT that enabled the establishment of generalized, non-discriminatory and non-reciprocal preferences to apply to developing countries. There was to be no general model for GSP programs, rather each developed country established its own. Eight years later, the Enabling Clause, in effect, made the 1971 waiver permanent. Each country offering a GSP scheme is allowed to decide which countries shall benefit from their scheme and which goods are eligible for tariff concessions. They can also determine when countries or products *graduate* from GSP schemes (Breda dos Santos et al., 2005). In effect, graduation cancels any preferential access received by the developing country or its individual products.

The following countries have established GSP schemes in 2021: Armenia, Australia, Belarus, Canada, the EU, Iceland, Japan, Kazakhstan, New Zealand, Norway, the Russian Federation, Switzerland, Turkey, the UK and the US. The schemes, some countries have more than one, allow better than MFN tariff access for subsets of developing countries and subsets of their products. In that way they are the mirror of infant industry protection allowing firms receiving GSP benefits not to have to compete in international markets (i.e. to be competitive facing MFN tariffs).

Existing GSP schemes have come in for heavy criticism.⁴ One oft made criticism is that the goods upon which preferential market access is offered are not those developing countries see as being where their comparative advantage lies. Instead, products that the developed country see as a competitive threat are excluded. Another criticism is that the schemes require the developing countries to fulfil a range of non-trade requirement that may be onerous – International Labour Organization (ILO) conventions and commitments contained in Multilateral Environmental Agreements (MEA) The EU, for example, requires recipients to sign onto the Biosafety Protocol pertaining to the use of GMOs, which simply reflects the EU's view of biotechnology and inhibits the use of the technology in countries that would benefit (Kerr, 2019). The EU has also experimented with using these types of preferences and a means of providing humanitarian aid but encountered both domestic protectionism and other countries complaining about potential erosion of the advantages provided by their preferential access (Khorana et al., 2012). The insecurity surrounding the potential for *graduation* is also a subject of criticism. This risk may inhibit investment. Further, if investments have been made, withdrawal of GSP concession can leave developing

countries with reduced market access leading to excess capacity (Herz and Wagner, 2010).

Graduation

Graduation is similar to removal of tariffs put in place to protect *infant industries*. In the case of GSP preferential market access, the products of countries that were deemed unable to compete on MFN terms are faced with having to do so. As the evidence from *infant industries* suggests, firms do not appear to grow up and there is no reason to believe that they will have in the GSP case. There is certainly fierce resistance from developing country firms, and their countries, when withdrawal of GSP concessions appears immanent. In the case of the EU, some countries that have graduate were subsequently de-graduated as exports fell sufficiently to again be under the EU thresholds – indicating they were not yet fit to graduate (Ailert, 2010). It has also been found that obtaining GSP status does not lead to long run increases in export performance, suggesting that even with preferred access firms were still not able to improve sufficiently to become internationally competitive (Nguyen 2008).

The main difference between the removal of tariffs put in place to protect *infant industry* firms and graduation out of GSP tariff rates is that the former is within the political jurisdiction of the firms being protected while graduation out of GSP is under the control of the country providing the improved market access. As domestic firms are able to effectively lobby for the retention of *infant industry* protectionist measures, the negative impacts of the failure to grow up can be forestalled, often indefinitely. In the case of graduation, it is more difficult to ensure continued preferred market access.

Countries offering GSP preferences often use a combination of domestic pleading and automatic (or semi-automatic) triggers for the initiation of graduation. While, triggering mechanisms offer transparency, they increase the difficulty of lobbying.

According to Cassing and Hillman, 1991, p. 41) in the US GSP graduation arises from one of two processes:

Domestic import-competing industries can lobby to have competitive imports from designated countries removed from the list of products eligible for duty-free access under the GSP. Developing countries consequently find themselves graduated in certain goods following petitions by domestic import-competing producers ...

The second procedure for graduation is based on predetermine rules, albeit with discretionary components. These rules relate to (1) competitive need, as expressed in a country's competitiveness in a product in the U.S. market, (2) a country's overall level of development, and (3) the economic interests of the U.S.

The final criteria is very broad. GSP has been withdrawn, for example, for refusal to honor international copyright conventions (Cassing and Hillman, 1991). Further:

The *competitiveness need* criterion is product and country specific. A country loses GSP access for a good, if its annual exports to the U.S. of that good exceeds half of U.S. imports. However, if a country has been found *sufficiently competitive* graduation occurs at 25 percent of U.S. imports (Cassing and Hillman, 1991, p. 42).

Given both the ability of domestic firms in the United States to petition for removal of GSP on individual products and the automatic triggers, or quasi-automatic triggers, firms in countries that have obtained GSP status have little control over the graduation process. Effective lobbying against the requests of import competing rivals and the triggers is difficult.

The EU has three arrangements that provide GSP access. The three EU GSP schemes are: (1) Standard Generalized System of Preferences (EUGSP); Generalized System of Preferences – Plus (EUGSP+) and; (3) Everything But Arms (EUEBA). The EU's GSP schemes have differing thresholds for graduation. For EUGSP there is both an income threshold and product thresholds. Countries are only eligible if they are not classified as high or upper-middle income countries by the World Bank. If a country graduates into the upper-middle income classification then it no longer qualifies for EUGSP and tariffs increase to MFN levels.

Even if a country has not graduated to the upper-middle income classification, for individual products:

When the average value of imports from a GSP beneficiary country (divided by the total value of all GSP imports for that Section) over 3 years exceeds the general threshold of 57%.

For vegetable products, animal or vegetable oils, fats and waxes and mineral products graduation applies when the percentage share referred to exceeds 17.5%.

For textiles graduation applies when the percentage share referred to exceeds 47.2% (European Commission, n.d.)

then the GSP tariff concessions on those products are withdrawn.

In the case of EUGSP+ the same graduation criteria apply as for EUGSP. In terms of the EUEBA scheme, graduation is implicit rather than explicit. Retaining GSP status is, however dependent on a country maintaining its least developed country (LDC) classification determined by the UN Committee for Development Policy, a subsidiary body of the United Nations Economic and Social Council. The Secretary General of the United Nations nominates its twenty-four members.

The UN Committee for Development Policy has devised the criteria for a country to be eligible to be classified as an LDC. A country's status is reviewed every three years. The threshold has three components: (1) Gross National Income Per Capita (GNI) – current level less than US\$1025; (2) a Human Asset Index (HAI) – current level 60 or below and; (3) an Economic Vulnerability Index (EVI) – current level 36 or above. The HAI indicators include: the under five mortality rate, the percent of population undernourished; the maternal mortality ratio; the gross secondary school enrolment ratio and; the adult literacy rate. The EVI includes: population; remoteness; merchandise export concentration; share of agriculture, forestry and fishing in GDP; share of population in low elevated coastal zones; instability of exports of goods and services; victims of natural disasters and; instability of agricultural production. Both the HAI and EVI are clearly complex measures with both what is measured and the weighting given in calculating the measure having large degrees of arbitrariness in their makeup. Thus, for EUEBA, the EU has removed its direct involvement in the determination of graduation making it impossible for countries worried about graduation to directly lobby the EU for its retention.

The GSP systems of other countries vary. Canada's GSP scheme, for example, has no formal graduation provisions but the Canadian government has removed countries from the list of those it grants GSP access. All have one thing in common, however, the countries that are receiving GSP benefits have no role in the graduation process and have no direct lobbying conduit to decision makers in the governments that may be considering having their country graduate. They will face graduation whether or not they have reached the stage where they are internationally competitive. This stands in stark contrast to firms that benefit from infant industry tariffs which experience suggests are able to lobby effectively against the removal of their protective tariffs.

Conclusions

Both *infant industry* protection schemes and the preferred market access provided by GSP programs are justified on the basis that they will foster economic development. The objective of both is for the firms receiving their benefit to become internationally competitive over the long run. In the case of firms receiving protection from infant industry tariffs, the evidence suggests that the objective is seldom achieved – the firms do not grow up and lobby hard for their protection to continue. They have not *grown up*. Their lobbying is often effective and the protective infant industry tariffs remain.

It has been generally accepted, however, that firms in developing countries require *special and differential* treatment to become internationally competitive.⁵ One manifestation of *special and differential* treatment is the GSP system recognized by the

WTO under which developed countries can offer better than MFN tariffs to the products of developing countries. The design and implementation of GSP schemes is under the control of the country offering GSP tariffs. The rationale for GSP schemes is the same as for infant industry tariffs including the idea that they will be temporary. The concept of graduation is an explicit recognition that the granting of GSP benefits should be temporary.

GSP schemes have been much studied, and much criticized. Criticisms relate to their degree of coverage, the products exempted, the degree of uptake, the inhibiting effects of the potential for withdrawal of preferential rates due to graduation, politicization, efficacy, contribution to development, erosion of benefits, conditionality and the negative impacts of graduation. There has been little examination, however, of whether firms have reached the stage when they are ready to graduate – that they have become internationally competitive. There are no *tests* to determine the fitness for graduation. Graduation triggers are simply *arbitrary lines in the sand* (e.g. 50 percent of a country's imports of a particular product, level of GDP per capita) that have nothing to do with the actual performance of firms or the complaints of import competing industries. Of course, there is no such *test* in the case of infant industries. In the case of infant industries, however, it does not matter because they do not have to graduate (or *grow up*). They are able to lobby effectively for continued protection. In the case when GSP recipients face graduation, they must lobby in the country that has granted the preferential access. Automatic triggers and protectionist lobbies in the granting countries reduce the efficacy of such offshore lobbying.

While *infant industry* protection has been largely debunked and governments are reluctant to put in place tariffs justified on the grounds of *infant industry* arguments, *infant industry* protections initiated in the past remain in place – because of the perceived adjustment costs that would be associated with their removal. GSP schemes put in place as part of *special and differential* treatment, while subject to criticism, are still in vogue. Graduation is accepted and expected. It seems likely, however, that the adjustment costs associated with graduation could be just as high as those expected in the case firms protected by infant industry tariffs. This asymmetry suggests that the initiation of new GSP schemes need closer scrutiny, such as that received in the case of *infant industry* proposals, or that graduation no longer be institutionalized in GSP schemes. Removing graduation, as with retention of infant industry tariffs, carries an ongoing cost to society. It is not clear why such asymmetry is justified. It suggests a more thorough examination of the generalized system of preferences is warranted.

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Endnotes

¹ In the post-Second World War period, the victors – principally the US, as the new hegemon, and the very experienced UK – felt that the Great Depression and the Second World War had shown them that international institutions were needed to eliminate, or at least dampen down, the sources of international conflict. To that end they fostered the creation of four major institutions to reduce international conflicts: (1) the United Nations – for political conflicts; (2) the ITO – for trade conflicts; the International Monetary Fund – for strategic use of currency devaluations and; (4) the International Bank for Reconstruction and Development (IBRD) or World Bank – for differences in economic prosperity.

² See Prebisch (1962) *The Economic Development of Latin America*, *Economic Bulletin for Latin America*, 7 (1).

³ There was an exception in the original GATT agreement that allowed members of a preferential trade agreement to charge lower than MFN tariffs among the preferential agreement's members.

⁴ See for example Herz and Wagner (2010).

⁵ *Special and differential* treatment has been the subject of criticism. See, for example, Kerr (2005).