



# Five ways to make trade work for development



Five ways to make trade work for development

## Contents

|       |  |
|-------|--|
| P. 3  | Foreword   |
| P. 6  | Executive Summary                                  |
| P.11  | 1. A real Doha development round                   |
| P.16  | 2. An integrated deal for low income countries     |
| P. 21 | 3. Unlock Generic Medicine for the world's poor    |
| P. 27 | 4. Rebalance the aid budget towards aid for trade  |
| P. 35 | 5: Make sure 'Kyoto 2' delivers for poor countries |

Open Europe  
7 Tufton Street  
London SW1P 3QN

Tel: +44 (0) 207 197 2333  
Fax: +44 (0) 207 197 2307

Research by Neil O'Brien, Mats Persson and Hugo Robinson

[www.openeurope.org.uk](http://www.openeurope.org.uk)

# Five ways to make trade work for development

## Foreword - Andrew Mitchell MP

The global multilateral trade system is now confronted with perhaps its most serious challenge since the Second World War. The Doha round is suspended, dogged by continuing intransigence and rising protectionist sentiment among the major players. It is quite possible that the round will fail outright, for the first time since 1945.

This risks unravelling the fabric of multilateral trade. In its place we would see a tangled web of vastly inferior bilateral deals. The world's leading economies would compete in a fractious race to gain advantageous market access by signing bilaterals. Low income countries would become marginalised 'spokes' around the 'hubs' of the EU, US, and China, and would suffer trade diversion as a result.

This outcome would doubtless be viewed by future generations not only as a missed opportunity, but an historic failure.

It doesn't need to be this way.

This new pamphlet from Open Europe sets out five proposals to make trade work for development. These are big ideas. Some of them I agree with, others I don't. But all of them serve as a useful stimulus for discussion and reflection. They are presented in Open Europe's characteristically clear, concise and incisive style. With this pamphlet Open Europe has cemented its reputation as one of the most relevant and dynamic think tanks on the scene today.

So: how would Open Europe make trade work for development?

First, Open Europe argue - surely correctly - that we must get Doha back on the road. Although several other parties must take their share of the blame for the collapse of Doha, the EU has nonetheless emerged as one of the main stumbling blocks to progress in the round. The bottom line is that all parties need to move, and both the EU and the US must make more ambitious offers.

Secondly Open Europe propose, either as part of Doha, or on its own if needs be, an integrated package of measures to boost the trade of the world's poorest countries.

While a multilateral trade deal certainly will deliver benefits for these countries, they will be smaller than they might have been because of the erosion of the trade preferences which they are currently granted by different developed countries. Protectionists and unthinking anti-globalisation protestors have come together in an unholy alliance around this argument to try and stop a deal.

We need to address their argument. To outrun preference erosion Open Europe suggest that the Doha package should offer low income countries deeper and more effective preferences.

Open Europe argue that all low income countries should be offered the duty free access which the EU currently offers LDCs through its Everything But Arms scheme.

Equally importantly, they propose that this should be coupled with the liberal rules of origin which the US offers under the African Growth and Opportunity Act.

By targeting such a package at low income countries Open Europe argue that we could give these countries a big boost.

But liberalised trade in goods can only be one aspect of a pro-development strategy.

Public health is a major challenge for policy-makers, and must form a part of this vision. In 2005, 3.1 million people died of HIV - 570,000 of those were children. There are currently 40.3 million people in the world living with the disease - the highest level ever. Yet only 1.3 million of 6 million people in urgent need have access to anti-retrovirals, despite the Millennium Development Goals' objective of "universal access to [HIV/AIDS] treatment for all those who need it by 2010". And not enough is being done to help prevent new infections.

Open Europe argue that some of the problem lies in the excessive red tape currently hindering the provision of cheap 'generic' drugs. WTO members have agreed in principle several times that we should let the least developed countries bypass complex intellectual property rules. This pamphlet argues that the mechanisms which are supposed to allow this are not working and have not resulted in a single extra pill. Open Europe therefore suggest that we need to change the rules so we can start delivering on our promises.

Climate change is the major challenge of our time, and is now undeniably a development issue. Least Developed Countries will be the hardest hit, and the least able to shoulder the costs of such drastic environmental changes.

The existing Kyoto framework is supposed to channel investment into low-carbon projects in developing countries, through the Clean Development Mechanism and Joint Implementation projects. Substantial amounts of money - €20 billion - are flowing through the Kyoto system.

Open Europe argue that the scheme so far has failed to channel substantial investment to Least Developed Countries, the vast majority being soaked up by highly capitalised firms in China and Russia. Sub-Saharan Africa is expected to see just 4% of the money, and most of that is in the more developed countries.

Worse, says this pamphlet, nearly €5 billion will be wasted on projects that trap 'exotic gases' (which have few development benefits). The authors therefore argue that the post-Kyoto framework must learn from these failures and negotiators need to focus on signing a new agreement that delivers for the poor, rather than the powerful vested interests created under the present system.

As well as better market access, the poorest countries need help to take advantage of these opportunities. When it comes to assisting developing countries to open up their own trade, help to dismantle the practical obstacles to trade is at least as important as encouraging them to lower their tariffs and quotas. Cutting customs red tape, fighting corruption at the border, and enhancing trade infrastructure are important uses of our aid budget.

All of these ideas deserve serious consideration by Europe's policy-makers.

Recent years have seen some important victories for pro-development campaigners. Rich country governments have agreed to drop unpayable debts. They have agreed to increase aid budgets. But the promise of trade as a tool for development is still unfulfilled.

I believe we can use trade to make a real difference in the lives of what Paul Collier has termed the "bottom billion". We know what to do. Now we need to find the political will, the vision and the ambition to do it.



Andrew Mitchell MP is the Shadow Secretary of State for International Development

## Executive Summary of Proposals

### 1. A real Doha Development Round

*Current proposals on the table will not deliver the promise of the Doha round of world trade talks. In particular, the “small print” of the EU’s offer blocks a really successful outcome at Doha through its special conditions for so many ‘sensitive’ products. The EU’s refusal to make significant concessions on agricultural market access has been a major obstacle to reaching agreement, as well as being a key factor in the collapse of negotiations.*

- The UK should make a more generous Doha offer the condition of signing up to any future EU budget deal (due to be negotiated between 2009 and 2012). A radically improved offer on agricultural market access should be an essential condition. The EU should match the US offer of a 66% average tariff cut, with less than 1% sensitive products. The current offer, with 8% sensitive products, radically undermines the whole round.
- A World Bank report argued that the poverty alleviation potential of the Doha round was marginal when compared with the potential gains from full multilateral liberalisation. The authors suggest that the current Doha proposals would deliver just a tenth of the poverty alleviation effects of full liberalisation.<sup>1</sup>
- Failure to agree a substantial multilateral deal is already leading to an explosion in the number of discriminatory bilateral deals. These will not deliver anything like the benefits of multilateral liberalisation, and could actually be damaging for developing countries because of the “hub and spoke” effect. A WTO deal is essential and a tougher stance from reformist EU member states - particularly Britain - is essential to deliver it.

### 2. An integrated deal for low income countries

*A second key condition of success is an integrated package for the lowest income countries. While a multilateral deal will deliver benefits for these countries, they will be smaller than they might have been because of the “erosion” of the trade “preferences” which they are currently granted by different developed countries. To “outrun” this effect a Doha deal should look at how their preferences can be deepened in scope, widened in their coverage and made multilateral. Attempts to use preference erosion as an excuse for making limited offers must be resisted.*

- All developed countries and advanced developing countries should offer duty free and quota free access to all Least Developed Countries (LDCs) and, if politically possible - to other low income countries (OLICs).

---

<sup>1</sup> Hertel and Winters - “Estimating the Poverty Impacts of a prospective Doha Development Agenda”  
Thomas W Hertel and L. Alan Winters, The World Economy (August 2005)

- At the Hong Kong WTO ministerial, members came close to agreeing *largely* duty free access for LDCs. But they need to go further, and agree a package for low income countries with four main features:
  - 100% product coverage
  - Better, more liberal and harmonised rules of origin
  - Full market access granted by all developed countries
  - Full market access granted to all low income countries
  
- The EU has already promised complete duty free access for LDCs through its Everything But Arms (EBA) scheme. But a study by the European Commission found that countries reliant on this preference were still paying tariffs on 40% of their exports to the EU because of problems with Rules of Origin - the "small print" of such bilateral deals.
  
- The US introduced a waiver to its standard restrictive rules of origin for clothing and textile exports under the African Growth and Opportunity Act, allowing African Countries to use Asian textiles as inputs for clothing exports. The initiative has seen African textile exports to the US rise from US\$600 million to \$1,500 million, creating 10,000 new jobs in Lesotho alone in 2001. But the deal is time-limited and may be incompatible with WTO rules.
  
- These two elements - full coverage and liberal rules of origin - should be brought together with a third element: making such preferences multilateral. This would be a benefit in itself, as it would end the situation where LDCs face different rules and requirements for each developed country's preference scheme. If possible the deal should also grant LDCs tariff free access to advanced developing country markets, as well as to those of developed countries.
  
- Attempts to use preference erosion as an excuse for making limited Doha offers must be resisted. Overall, even a basic Doha deal should benefit LDCs. By including an integrated package for the poorest countries the benefits for LDCs can be enlarged further. It should also be remembered that the majority of people living below the international poverty line will soon be living in countries classified as "mid-income", so the wider deal remains important for them.

### 3. Unlock Generic Medicines for the world's poor

*Providing universal access to affordable medicine should be a major concern for every developed country government. Although attempts have been made to free up international trade in cheap 'generic' drugs, accessible to the world's poorest people, the regime for exports of generics remains overcomplicated and out of touch with medical reality, delivering no real benefits to people who need cheap medicines most.*

- When Intellectual Property became part of the WTO agreements through the TRIPS (Trade Related Aspects of Intellectual Property Rights) agreement, it was agreed that LDCs could be exempted. For medicines, developing countries could also issue "compulsory licences" - essentially allowing their manufacturers to make

cheap “generic” copies of patented drugs, while paying the patent holder only a small sum.

- The problem was that initially these compulsory licences could not be used to make drugs for export, and many poor countries do not have the capacity to manufacture their own pharmaceuticals. Reforms of the system in 2001 and 2003 have still not really succeeded in making it possible to export drugs under TRIPS because of complicated bureaucratic obstacles.
- *Medecins sans Frontieres* (MSF) report that they spent two years trying to order an AIDS drug from Canada - the first G8 country to implement the 2003 reform - without managing to deliver a single pill to patients.
- This problem will now become far more acute. Until 2005, India had not implemented TRIPS and was able to supply other countries with cheap generics. Now that India has implemented TRIPS, India will not make generic versions of drugs developed after this date. Anti-AIDS drugs have to be updated so often that this will be a real problem.
- The UK Government should provide technical assistance to developing countries, both to help them take advantage of the flexibilities in the TRIPS, while also campaigning for further reform of the system as part of the Doha Round.
- The Government should also support international groups and funds that work to provide developing countries with affordable drugs. Specifically, the Government should work with other countries and pharmaceutical producers to make the International Drug Purchase Facility “UNITAID” operational.

#### 4. Rebalance the aid budget towards aid for trade

*Making the changes described above in terms of market access opportunities for developing countries will not on its own be sufficient. The poorest countries need help to take advantage of these opportunities. When it comes to helping developing countries to open up their own trade, help to dismantle the practical obstacles to trade is at least as important as encouraging them to lower their tariffs and quotas. Cutting customs red tape, fighting corruption at the border, and enhancing trade infrastructure are some of the most effective uses of our aid budget.*

- The UK should aim to spend a larger proportion of its aid budget on aid for trade. The evidence suggests that aid for trade is one of the more effective forms of aid (even compared to other forms of aid for economic development).
- The Department for International Development (DFID) should set up an expert group with representatives of private-sector trade facilitation companies to work on trade facilitation issues and identify bottlenecks.
- The UK’s diplomatic support for trade promotion has been allowed to wither for decades. The Foreign and Commonwealth Office (FCO), in collaboration with the Department of Trade and Industry (DTI) and UK Trade and Investment (UKTI)

should build a joint business development unit and devote an increased proportion of their budgets to helping UK businesses trade with developing countries.

- The WTO's "Integrated Framework" should take on a stronger role in coordinating the delivery of trade-aid - rather than merely producing excellent studies which are not then acted upon.
- DFID should encourage and help developing countries to set up Export Processing Zones (EPZ), as a way of creating examples of success and making the case for trade reform in developing countries. Aid for EPZ formation should be part of a coordinated strategy involving changes to multilateral trade rules and other aid for trade and investments in infrastructure.

## 5. Make sure 'Kyoto 2' delivers for poor countries

*The existing Kyoto framework has established a framework for utilising the mechanisms of global trade to reward clean development in poor countries. This new flow of funds - worth up to €20 billion - could deliver a huge boost to low income countries. However, in practice these mechanisms are highly flawed. The poorest countries receive little of the money, there is wasteful profiteering from the capture of 'exotic' greenhouse gases and many of the projects are either of no environmental benefit - or even damaging. Any "Kyoto 2" agreement must learn from these mistakes and adopt wide-ranging reforms to the system. Developed countries should channel the funds going through the system towards those in the greatest need.*

- LDCs and Africa have been sidelined by the Kyoto credit process. Most of the investment in Clean Development Mechanism (CDM) projects has been absorbed by large developing countries, such as China and India. Sub-Saharan Africa is expected to account for a negligible proportion of overall investment (approx. 4%), most of which will be directed towards Nigeria and South Africa.<sup>2</sup>
- Loopholes have allowed profiteering at the expense of both poor countries and the environment. The Kyoto permit system awards funding on the basis of the quantity of CO2 equivalent reductions achieved, but often this is not related to the true cost of making those reductions. A particularly striking example, revealed in a study in *Nature*, relates to chemical factories producing the HFC-23 gas. These installations can reduce their emissions with a simple piece of equipment known as a scrubber, which generally costs a few million dollars. However, since HFC-23 is so potent (one tonne of the gas being equivalent to 11,700 tonnes of carbon dioxide), companies that install this equipment are eligible for tens of thousands of carbon credits for reducing just a few tonnes of the gas. This means that HFC-23 projects have received more credits than any other in the carbon markets so far. Total projects that should have cost no more than €100m may have wasted €4.6bn.<sup>3</sup> Such projects have sucked in as much money as all other types of projects in the system. Meanwhile, renewables are expected to generate just 25% of Kyoto project credits by 2012.

---

<sup>2</sup> Jørgen Fenhann, UNEP Risø Centre (01.02.07)

<sup>3</sup> FT (08.02.07)

- Developed countries should create a system of carbon trade preferences for LDCs. Low income countries' small share of the benefits could be resolved by introducing a quota-based preferential system, whereby developed country governments will only buy credits from middle-income countries like Russia if poorer regions have received substantial investment first.
- The system should be tightened up so that money goes to real environmental projects. Greater value should be assigned to Certified Emissions Reductions (CERs) generated by renewable project investments. This could also apply to the export and delivery of small scale renewable energy equipment, such as rooftop solar panels and small wind generators. A review of the 'fast-track' system for project approval should take place, making it easier and less bureaucratic to approve certain categories of renewable projects, such as wind farms and solar generation, which have zero carbon emissions and do not contribute to other forms of environmental degradation. The system needs to be tightened up and methodologies and standards for approval of CDM projects should be harmonised. A central database of baseline data should be set up and administered by the CDM Board. This would remove obstacles for project developers and create greater certainty and consistency in methodologies for setting up Kyoto projects.

## 1: A real Doha Development Round

*The UK should make a more generous Doha offer the condition of signing up to any future EU budget deal (due to be negotiated between 2009 and 2012). A radically improved offer on agricultural market access should be a central condition. The EU should match the US offer of a 66% average tariff cut, with less than 1% sensitive products. The current offer, with 8% sensitive products, radically undermines the whole round.*

### Current proposals on the table will not deliver the promise of Doha

- The potential gains from full multilateral liberalisation are potentially very large. However, the proposals currently on the table are far less ambitious, so many of the potential gains from trade liberalisation will not be realised.
- A World Bank report argued that the poverty alleviation potential of the Doha round was marginal when compared with the potential gains from full multilateral liberalisation. The authors suggest that the current Doha proposals would deliver just a tenth (11-12%) of the poverty alleviation effects of full liberalisation.<sup>4</sup>
- A summary of academic work comparing the effects of full trade liberalisation with the Doha proposals is listed in the table below:

| Estimates by  | Doha   | Full liberalisation   |
|---|--|---|
| Current World Bank model<br>Anderson et al. 2005/2006                           |  |   |
| Global income Gains from plausible Doha scenarios                               | \$96 billion (No exceptions for sensitive or special agricultural products)                                    | \$287 billion   |
| Change in real income under 8 alternative Doha scenarios                        | World GDP gain between 0.03 and 0.28%  | World GDP gain between 0.7 to 0.9   |
| Polaski, 2006   |  |   |
| Carnegie Endowment for International Peace                                      |  |   |
| Global income gains from full free trade compared with plausible Doha scenarios | \$59 billion (World GDP gain 0.146%)   | \$168 billion   |
| Hartel & Winters, 2005  |  |   |
| Reduction in poverty from 2015 levels   | 0.6% or 4 million people lifted from poverty (for \$1/day poverty line)<br><br>0.4% or 8.6 million people (for | 5.6% or 35 million people lifted from poverty (for \$1/day poverty line)<br><br>3.7% or 71.5 million people |

<sup>4</sup> Hertel and Winters - "Estimating the Poverty Impacts of a prospective Doha Development Agenda"  
Thomas W Hertel and L. Alan Winters, The World Economy (August 2005)

|   | \$2/day poverty line)                           | (for \$2/day poverty line)                      |
|---|---|---|
| Francois et al. 2005  | World gain of \$82 billion or 0.3% of World GDP | World gain of \$158 billion or 0.5 of World GDP |
| Bouët et al. 2006<br>International Food Policy and Research Institute |   |   |
| Estimated increase in world real income (using the MIRAGE model)      | \$54.7 - \$69 billion                           | About \$200 billion                             |

### Why Doha matters

- Despite progressive rounds of multilateral liberalisation, tariff barriers remain significant obstacles to global trade. Goods like agricultural produce and textiles which developing countries have an advantage in producing remain heavily protected in both Europe and the US due to powerful lobby group pressure.
- Average tariff rates, which are often cited as proof of openness, are misleading. They hide very high peaks in applied tariff rates in certain sectors and against certain countries. According to the WTO, the average EU applied tariff rate is 6.9%. However, for agricultural products this rises to 18.6%. Indeed, products enjoying high tariff protection are almost exclusively agricultural or processed food. These include flours and meat (427.9%); mushrooms (300.8%); frozen beef (276.9%); pineapple juices (209.8%) and live chickens (167.2%).<sup>5</sup>
- Because of the discrimination against the products developing countries tend to produce, poor countries are hit hardest. In the case of the EU, for example, the GTAP database shows that in 2002, rich countries with a GDP per capita over £15,000 a year face a tariff of just 1.6%. Countries with a GDP per capita of between £5,000 and £15,000 faced an average tariff of 2.9%. But poor countries with a GDP per capita of under £5,000 a year faced an EU tariff of 5% on average.

### How the “small print” blocks a pro-development outcome at Doha

- Agriculture has emerged as the major stumbling block to agreement at Doha. Despite its relatively small overall importance in the world economy, trade in farm goods remains the most significant issue for developing countries, and the area where the EU has been most resistant to making concessions.
- The issue of tariffs was one of the central reasons for the collapse of talks in June 2006. The EU refused to give ground on this point beyond a very limited offer, below the levels of reduction being pushed for by the US and the G20. The EU would move no further than a 39% average linear cut on its tariffs. Later in the

<sup>5</sup> WTO, *EU Trade Policy Review* (2007)

year the EU moved up its final offer to 46%. However, the EU wants to designate 8 percent of all the EU's tariffs "sensitive" and make them subject to a smaller cut.<sup>6</sup>

- The headline figures for average tariff cuts sound impressive. But for various reasons they translate into far smaller real gains. For example, take the EU offer:
  1. It proposes that 8% of all tariff lines are to be marked as sensitive - and therefore subject to tariff reductions of either 1/3 or 2/3 the normal level. So if the biggest reductions are supposed to be 60%, they could be taken down to a 20% cut by being designated as "sensitive".
  2. On top of this, the tariff cut applies to the rate at which the tariff is "bound" at the WTO, and not at the rate that is really applied. The EU has less of this "water" in its tariff scheme than other blocs, but still a quarter of its agricultural tariffs are "bound" at a level higher than the applied rate, meaning the impact of a deal on the real rate is reduced.
  3. Trade preferences themselves reduce the overall impact of cuts in the rate through a gearing effect. If the preferential rate is, say, 50% of the headline rate which is being cut, then if a headline tariff of 40% is being cut in half to 20%, the preferential rate will be cut from 20% to 10% - a smaller amount in absolute terms. Roughly two thirds of the EU's imports come from countries which are supposed to be able to access some kind of preferential rate.
  4. So despite big headline figures for cuts, World Bank research suggests the EU offer would mean a cut of just under 1% in the applied tariff.
  5. And then there is still a lot of "tariff overkill". If the round succeeds in reducing a tariff of 100% to 80%, there may still be no new trade created if a tariff of, say, 20% is a big enough barrier to make foreign products uncompetitive in the EU market.
- As the Commission for Africa has noted, "if only two percent of agricultural tariff lines are designated as sensitive... three quarters of global welfare gains will be lost." The US<sup>7</sup>, Canada<sup>8</sup> and the Cairns Group<sup>9</sup> also separately analysed the EU's proposal, in the weeks after 28 October 2006, finding that designating 8% of goods as "sensitive" would effectively block all exports of interest to developing countries in the EU market.
- A study by the United States Trade Representative (USTR) found that the use of so many sensitive products would radically undermine the effect of the round: "The proposed tariff on chicken leg quarters into the EU is 53%. Under the EU proposal, if, as seems likely, the EU selects this product as one of the 142 sensitive product

---

<sup>6</sup> More recently, EU Trade Commissioner Peter Mandelson has increased the EU's offer to a 54% average cut. However, it is unclear a) whether this changes the EU's offer on sensitive products and b) whether such a reduction is in fact acceptable to EU member states. France strongly criticised the 54% cut, claiming that Mandelson had exceeded his negotiating mandate.

<sup>7</sup> USTR, Implications of EU Agriculture market Access Position, USTR website

<sup>8</sup> Canadian Department of Foreign Affairs and International Trade *EC Proposal of October 28, 2005. Sensitive products: Preliminary Analyses of an Obscure Proposal* DFAIT website

<sup>9</sup> Cairns Group, *Comments on EC Proposal*, Australian Mission, Geneva.

tariff lines it has requested, it could reduce the tariff by as little as 15% (to 45%). The size of the additional access to the EU market works out to only 0.02 kg per capita. That is not even one chicken nugget per person per year.”<sup>10</sup>

### How to get a pro-development Doha deal

- It is clear that revised positions from the major players, especially the EU regarding its tariff rates, will be necessary to get the Doha round back on track. A WTO deal is essential and a tougher stance from reformist EU member states - particularly Britain - is necessary to deliver it.
- The UK should make a more generous Doha offer the condition of signing up to any future EU budget deal (due to be negotiated between 2009 and 2012). A radically improved offer on agricultural market access should be an essential condition. The EU should match the US offer of a 66% average tariff cut, with less than 1% sensitive products. The current offer, with 8% sensitive products, radically undermines the whole round.
- The EU and others should also move further on subsidies. Despite talk about what the EU is “offering” on subsidies, the truth is that the EU is not making a new proposal at all - it is merely offering to bind in the reform of the CAP which was agreed in 2003. As well as decoupling subsidies the EU should reduce the overall amount of spending. Mandelson’s spokesman has already made clear that under the EU’s current offer, “Nothing he is proposing as part of the EU’s offer in world trade talks will reduce overall levels of EU farm spending by one cent.” The UK needs to make the EU go beyond the 2003 agreement, and make further cuts.
- Ultimately, the CAP should stop being an EU-funded spending policy and become instead a spending cap. Member states should fund farm subsidies out of their own national budgets up to a certain limit, and the spending ceiling should be lowered year on year.

#### A reminder: the case for multilateral liberalisation

Following the collapse of the Doha negotiations, the future of multilateralism has been put in jeopardy. Since talks broke down, the EU has taken a decisive step to support bilateral and regional agreements with its new “Competitiveness Agenda”, under which it plans to agree new Free Trade Agreements with India, South Korea and the Association of Southeast Asian Nations (ASEAN).

All but one WTO member (Mongolia) are now involved in some sort of bilateral arrangement. But such agreements are doomed to be far less effective and less equitable than a multilateral deal for several reasons:

- **Multilateral tariff reductions reduce distortions and increase economic efficiency - they are ‘real’ free trade.** The fundamental goal of trade liberalisation is to remove economic distortions and increase overall

<sup>10</sup> USTR, Implications of EU Agriculture market Access Position, USTR website

economic efficiency by ensuring that prices reflect real costs globally. Preferential bilateral trade deals create trade diversion by making goods from countries which are treated preferentially relatively cheaper, regardless of their underlying cost of production. Economic distortions mean less efficiency, and therefore more cost for consumers.

- **Numerous bilateral deals create a tangled 'spaghetti bowl' effect, the complexity of which in itself inhibits trade.** Instead of guaranteed access, exports under bilateral free trade agreements are limited by rules of origin and complicated bureaucracy.
- **'Hub and spoke' bilateralism harms developing countries - a multilateral deal prevents this.** 'Hub and spoke' bilateralism occurs when smaller economies (the spokes) are drawn into bilateral trade deals with larger economies (the hubs) - but do not have agreements between each other. For example the EU and US have trade agreements with many other countries, while small countries may only have one deal, with the US or EU. This scenario benefits the hub countries, which have a cost advantage because they can import goods from wherever they like, while the spokes suffer from trade diversion, buying goods from the hub country rather than those of cheaper producers elsewhere. In this situation the hub countries will tend to gain inward investment at the expense of the spokes.
- **Developing countries are at a disadvantage in bilateral negotiations.** In contrast to multilateral negotiations, bilateral Free Trade Agreements (FTAs) are more vulnerable to deal-making - in practice, this means poorer countries with less economic weight and more limited negotiating resources are at a disadvantage relative to their more powerful negotiating partners. As a leader in the *Economist* noted, "Bilateral deals are complex and tend to be bad for poor countries. In multilateral deals, poor countries can piggyback on powerful countries' negotiating clout; in bilateral deals they're on their own."<sup>11</sup> Small countries often simply do not have the administrative capacity to negotiate and run hundreds of free trade agreements, and would benefit from doing a single deal through the WTO.

---

<sup>11</sup> *Economist* (29.07.06)

## 2: An integrated deal for low income countries

*A second key condition of success is an integrated package for the lowest income countries. While a multilateral deal will deliver benefits for these countries, they will be smaller than they might have been because of the "erosion" of the "preferences" which they are currently granted by different developed countries. To "outrun" this effect a Doha deal should look at how their preferences can be deepened in their scope, widened in their coverage and made multilateral. Attempts to use preference erosion as an excuse for making limited offers must be resisted.*

### Trade preferences - why the current system can be improved

- **Preferences remain only a partial remedy to the underlying problem of discrimination against developing countries' exports.** Even where developing countries are granted trade preferences, it is not necessarily the case that they will face lower tariffs than developed countries overall. As noted in the previous section, over the last couple of decades developed countries have lowered tariffs on the industrial goods that are important to their economies, but kept high tariffs on food and textiles to protect farmers and traditional industries. Those are exactly the sorts of goods that developing countries (which have low labour costs but little capital) might export in order to get their feet on the ladder of development. Trade preferences usually just take the edge off this intrinsically unfair situation. Even with the preferences, the EU still has higher trade barriers against poor countries than rich ones.
- **Limited coverage excludes many of the world's poor from feeling the full benefits.** For example, in the case of the EU, 50 small countries on the UN Least Developed Country (LDC) list are granted tariff-free access under Everything But Arms, which is being phased in by 2009. But this list does not cover some of the world's poorest countries, and excludes large poor countries where (obviously) many of the poorest people in the world live. Countries excluded from EBA preferences include very low income African countries like Kenya, Cameroon, Ghana, Côte d'Ivoire, Congo and Nigeria. These countries have to fall back on "second best" preferences such as Cotonou, Generalised System of Preferences (GSP), or even the full Most Favoured Nation (MFN) rate. There are also very large nations with very low income (as defined by the OECD as having a GDP per head of under \$825 in 2004), such as India and Pakistan, who have to rely on GSP.
- **Complex rules of origin requirements undermine benefits of preferences.** Rules of origin (ROO) requirements mean that while in theory a country might be allowed to export its products to the EU duty free, this preferential access is only available to goods which do not contain parts, materials or ingredients from other countries. The argument for such rules is that they are intended to stop third countries exploiting the preferential access granted to developing countries by using these states as intermediaries for their own exports. However, it can also mean that developing countries may be deprived of the potential opportunities of processing inputs from other developing countries, which they may not be able to produce domestically.

- As the DTI has noted: “The problem of deflection should only arise where the recipient’s tariff is lower than that of the donor (EU). Where this is not the case, the ROO is presumably performing some other function... Given that most EU industrial tariffs are very low, and very often lower than those of preference recipients, it would seem that prevention of pure trade deflection is not the primary function of most EU ROOs in the industrial sector”.
- Part of the problem in this respect is the sheer bureaucratic burden of compliance with ROO. Based on indirect evidence, several studies provide estimates of the administrative compliance costs of preferential schemes to be between 1 and 5 percent of the value of exports.<sup>12</sup> These costs can make it more attractive to fall back on the MFN rate - particularly if the margin of preference is small.
- **“Cumulation rules” do not apply for the very poorest preference recipients.** Cumulation of origin allows a country exporting to another country under a preferential scheme to use parts, materials or ingredients from a third country in the manufacture of a product, but to receive the same treatment for the final product as if they were originating in that country. Although there is full cumulation of origin within the Cotonou agreement, and some within the GSP, there is no cumulation within the EBA scheme. When the EBA initiative was agreed in 2001, the EU chose to tighten Rules of Origin at the same time as it gave the new, more generous, preferences: effectively giving with one hand and taking away with the other.
- Limits on cumulation are becoming an increasingly significant problem as the globalisation of chains of production make it increasingly likely that many products will have value added in more than one country.
- **Overall, data shows that preferences are not working as well as they could.** A report by UNCTAD in 2003 noted that “In theory, market access preferences

|        | Product coverage ratio | Utilisation ratio |
|--------|------------------------|-------------------|
| Quad   | 64.3                   | 68.5              |
| Canada | 12.1                   | 70.2              |
| EU     | 99.4                   | 46.9              |
| Japan  | 69.9                   | 57.4              |
| US     | 44.1                   | 95.8              |

provide LDC exporters with a competitive advantage. In practice, LDCs are often unable to realise this advantage. This has been illustrated by the low degree of utilisation of market access schemes in favour of those countries.” As the table (left) shows, the EU’s preferences have produced the least favourable utilisation ratio amongst the “quad” of industrialised trade blocs. The rate of utilisation of US preferential schemes is over double that of the EU regime.

- The UNCTAD report continues, “In the European Union...the GSP scheme grants LDC exporters a wide preferential coverage. However, an examination of the utilisation of these preferences by LDCs provides a different perspective. Imports from LDCs actually receiving tariff preferences (\$1.8 billion in 2001) account for less than 50

<sup>12</sup> Anson et. Al. “Rules of Origin in North-South Preferential Trading Arrangements with an Application to NAFTA”, CEPR Discussion Paper 4166, 2003, and Herin, J. “Rules of Origin and Differences between Tariff Levels in EFTA and in the EC,” EFTA Occasional Paper No. 13, 1986

per cent of total dutiable imports from LDCs...Thus, although the potential preferential coverage of LDC exports to the European Union has been close to 100 per cent, more than half of total LDC exports to the European single market were actually facing MFN duties rather than enjoying preferential treatment in 2001.”<sup>13</sup>

- A study published by the European Commission found that in 2004 nearly 40% of imports from LDCs that were not part of the ACP attracted tariffs.<sup>14</sup>
- Collier (2006) compares the effects of EBA, the US African Growth and Opportunity Act (AGOA) and the agreement in principle of developed countries at the Hong Kong WTO meeting to allow Duty Free and Quota Free (DFQF) access to all LDCs. He notes that: “All these schemes fail because, for different reasons, the details of the schemes limit their effectiveness. The most successful of the three is AGOA. A recent study shows that it has increased Africa’s apparel exports by 50%. The weakness of AGOA is partly that it only applies to the US market, but mainly that its time horizon is too short: a mere three years. Evidently, this is insufficient for investment. For example, apparel firms in Madagascar are profitable but dare not risk expansion. EBA has had no discernable effect on African exports. Its rules of origin are far more restrictive than those of AGOA and it applies only to the LDCs which are precisely the countries least in a position to diversify their exports. EBA’s good features are its much longer time frame, and its coverage of the EU market which is probably the critical market for Africa. The Hong Kong offer had a number of weaknesses. However, its key strength was that it applied across the OECD.”

### EU trade preferences: a summary

The WTO’s predecessor, the GATT, aimed to replace the complicated web of bilateral trade deals which had existed in the inter-war period with multilateral liberalisation. The tool intended to achieve this end was the principle of unconditional Most Favoured Nation (MFN) treatment, based on the requirement that if a WTO member offers a low tariff to another member, it must be extended to all other members, regardless of whether they grant an equivalently low tariff in return. However, this has in practice been circumvented by subsequent agreements which allow members to set up free trade agreements (FTAs) that go beyond MFN requirements, subject to certain conditions.

The EU has been very active in pursuing FTAs which bypass the MFN principle. The Union’s current system of trade preferences has evolved into a complicated hierarchy of different preferential agreements with different countries, many of which overlap. Below is a basic summary:

|                                      |  |
|--------------------------------------|--|
| WTO<br>MFN (Most Favoured<br>Nation) | The least favourable regime. The MFN regime is applied to other developed countries. |
|--------------------------------------|--|

<sup>13</sup> UNCTAD, Recent initiatives in favour of least developed countries in the area of preferential market access: preliminary impact assessment (August 2003)

<sup>14</sup> *Preferential Trade In The EU - Making Trade Policy Work for Development*, Report from DG Trade of the European Commission to the European Parliament (May 2006), p. 16.

|   |   |
|---|---|
| GSP (Generalised System of Preferences) | A limited trade preference: for all developing and mid-income countries, granting reductions on the MFN rate. This includes large developing countries, such as India and Indonesia.  |
| GSP+                                    | A better-than-GSP regime for developing countries which meet various political and social criteria (however, it may be WTO-illegal as it is limited to smaller countries).  |
| ACP/<br>Cotonou<br>Agreement            | The second best market access - but tariffs remain on 900 products. Aimed at former colonies. Was ruled illegal at the WTO and is due to be replaced after 2007.<br><br>In total there are 79 African Caribbean Pacific (ACP) countries but 38 are also LDCs, and so can also qualify for EBA treatment (see below). South Africa has a reciprocal FTA with the EU. Cuba is an ACP member but receives GSP treatment. |
| EBA (Everything But Arms)               | The best access - no tariffs on any products from 2009 on. Applies to the world's 50 Least Developed Countries (LDCs), including states such as Burkina Faso, Afghanistan and Somalia.  |

### An integrated trade framework for developing countries

- The current trade preference systems can be improved on. A better deal for preference-receiving countries is also important to stop preference erosion being used as an excuse for making limited offers in the Doha round.
- Even critics of globalisation such as Joseph Stiglitz and Andrew Charlton conclude that the overall gains of reduction in MFN tariffs will be "positive and significant for most industries in most countries...preference erosion is not a consideration that should impede multilateral liberalisation" - though they note that preference erosion will affect a small number of producers in a serious way.<sup>15</sup>
- That said, preference erosion (and terms of trade effects) will reduce the benefits of the Doha round for preference-receiving countries. To "outrun" this effect a Doha deal should look at how their preferences can be deepened in their scope, widened in their coverage and made multilateral.
- All developed countries and advanced developing countries should offer duty free and quota free access to all Least Developed Countries (LDCs) and, if politically possible - to other low income countries (OLICs).
- At the Hong Kong WTO ministerial members came close to agreeing *largely* duty free access for LDCs. But they need to go further in four respects:
  - 100% product coverage
  - Better, more liberal and harmonised rules of origin
  - Full market access granted by all developed countries
  - Full market access granted to all low income countries

<sup>15</sup> J Stiglitz and A Charlton, *Fair Trade for All* (2005) pg. 177

### Deeper preferences - extend EBA-style arrangements to all ACP countries

- The UK should seek to make sure that generous and deep preferences, with liberal rules of origin are granted by all developed countries (and ideally also *harmonised*) through multilateral WTO agreements. The EU should offer duty free and quota free access to all LDC and ACP countries and - if politically possible - all other low income countries.

### Address the small print: liberalise rules of origin

- The EU should allow poor countries to work together and use each others' goods as inputs - a boost in south-south trade could have a substantial positive effect. For example, when the US introduced a waiver to its standard restrictive rules of origin for clothing and textile exports under the African Growth and Opportunity Act (AGOA), allowing African Countries to use Asian textiles as inputs for clothing exports. The initiative has seen African textile exports to the US rise from \$600 million to \$1,500 million, creating 10,000 new jobs in Lesotho alone in 2001. In contrast, while the same duty free access is enjoyed under the EU's EBA, the rules of origin applied under the EBA have seen Lesotho's exports of clothing to the EU virtually cease.
- Rules of origin should be dramatically liberalised and the value added requirement reduced. At the same time the range of different ways to qualify should be maintained rather than reduced to value added only. The list of explicitly non-qualifying activities should be deleted.
- Countries granted such preferences should be allowed full cumulation of origin with *all* other low income countries, as defined by the OECD. If this is unacceptable at the WTO then they should be allowed to use inputs from all developing countries. This will enable large developing countries to act as a 'locomotive' for the development of smaller low income countries - as has happened under AGOA to some extent.

### **3. Unlock Generic Medicine for the world's poor**

*Compulsory licences - allowing the production of cheap drugs - need to be unlocked for the world's poor. Particularly, the red tape involved in the provision of these licences must be reduced and the mechanism made more automatic and responsive to health needs. Utilisation of other 'safeguard' mechanisms in the Trade-Related Aspects of Intellectual Property Rights (TRIPS) should be explored as well. The Government should actively engage in and support international groups and funds that work to provide developing countries with affordable drugs. Specifically, the Government should support the work of IDPF/UNITAID.*

- The Millennium Development Goal aims at achieving “universal access to [HIV/AIDS] treatment for all those who need it by 2010”. The task looks challenging - but is not impossible. In 2005, global efforts to improve access to drugs for the world's poor had almost doubled the number of people on anti-retrovirals (ARVs) in low and middle-income countries, from 720,000 to 1.3 million. HIV/AIDS is an enormous health challenge to developing countries. And it does not stand alone. Tuberculosis, Malaria and Hepatitis C remain endemic in the developing world and access to vital medicine is scarce. But as the increased number of people on ARVs show, well-directed efforts can bring life-saving treatment to those who need it the most.
- Providing universal access to affordable medicine should be a major concern for every developed country government. In these efforts, unlocking the flexibilities in the WTO's Trade-Related Aspects of Intellectual Property Rights (TRIPS) must be made a priority. Indeed, there is scope to work within the current framework of the TRIPS/Doha Declaration.

#### **Public health in the developing world: the statistics**

- There are currently 40.3 million people in the world living with HIV - the highest level ever. In 2005, 3.1 million died of the disease - 570,000 of those were children.
- Out of 6 million people in urgent need of ARV drugs only 1.3 million received them in 2005.
- There are nine million new cases of Tuberculosis each year, 95% of which are in developing countries.
- Malaria - although preventable - kills a child under the age of five in Africa every 30 seconds.
- Almost half of the people living in the developing world who are on ARV treatment rely on generic versions of more expensive patented drugs.

#### **Framing the debate: strong vs. weak IP rights in pharmaceuticals**

On one side of the spectrum are those who see strong Intellectual Property (IP) rights for pharmaceuticals as necessary to promote innovation and growth. There are others

however who argue that relaxing IP protection is essential to provide low and middle income countries with affordable “generic” drugs.

- **Strong IP rights:** Strict IP protection is a condition for investment in Research and Development (R&D). It allows the innovator company to retrieve the costs of identifying, processing and marketing a drug composition.<sup>16</sup> Removing this incentive could provide the market with less efficient and fewer drugs, which would hurt low-income countries as well. Pharmaceuticals are expensive to invent, but cheap to copy. It has been estimated that the cost of developing a new drug is \$802 million<sup>17</sup>, while copying the same drug amounts to only \$1 million.<sup>18</sup> Investment in R&D and technology transfers will in the long run benefit developing countries as well.
- **Weak IP rights:** Allowing for large scale production of copied and therefore cheaper medicine, will lower the prices and provide life-saving treatment that otherwise would have been unavailable for millions of poor people. Countries with no pharmaceutical industry and no R&D gain little from paying for innovation elsewhere, and given that they could not afford to pay the patent price anyway, their “free ride” is not reducing the incentive to innovate. Generic medicines can also provide effective pharmaceutical treatment which would have been impossible under a strict IP scheme. For example, it could facilitate better treatment of HIV/AIDS by making available fixed dose combinations, in which three different drugs (with different patent holders) are combined in one pill. Also, newer and improved drugs are, and will be, covered by strict patents under TRIPS. For example, all the vital “second line” HIV/AIDS drugs are currently under patents. The most effective drugs will therefore be out of reach for millions of people.

Both sides of the IP debate make valid points. Access to affordable medicine for the world’s poor may require some compromises in international IP rights. But this must be done in a manner that as much as possible takes into consideration the need to preserve innovation incentives. The balance of these arguments led WTO members to conclude that there should be exemptions from TRIPS. But this decision in principle is yet to be translated into a practical and workable solution.

### **Background: the Compulsory License and the evolution of the TRIPS**

- The TRIPS Agreement was agreed in 1994 at the end of the WTO Uruguay Round. The Agreement provides minimum standards for the protection of intellectual property, such as setting out the time period a patent shall last (normally 20 years). Developed countries were given one year to implement the Agreement, whereas transitional periods were granted to developing countries. In 2001, LDCs were given an extension of the transition period to 2016.

---

<sup>16</sup> Sell, Susan K. & Prakash Aseem, “Using Ideas Strategically: The Contest Between Business and NGO Networks in Intellectual Property Rights”, *International Studies Quarterly*, 2004, 48, 143-175

<sup>17</sup> Joseph A. DiMasi et al., *The Price of Innovation: New Estimates of Drug Development Costs*, 22 J. HEALTH ECON. 151, 166 (2003).

<sup>18</sup> F.M. Scherer, *The Pharmaceutical Industry and World Intellectual Property Standards*, 53 VAND. L. REV. 2245, 2247

- In the aftermath of the TRIPS, developing country governments, NGOs and others asserted that the Agreement had serious negative public-health consequences for developing countries. The efforts to harmonise global IP rules had led to artificially high prices for vital drugs also in the very poorest countries - something many considered unacceptable.<sup>19</sup>
- The original TRIPS allowed for some flexibilities or “safeguards”. Under Article 31, for example, governments may issue a *compulsory licence* to a generics manufacturer who can then reproduce the invention without the patent holder’s consent.
- But these safeguards were of little use to developing countries. Most importantly, under Article 31 a compulsory licence was not to be used to export generic drugs. This meant that countries with no production capability could not take advantage of the provision. Because of this, the “Doha Declaration on TRIPS and Public Health” was adopted in 2001.
- The Declaration reaffirmed the right of developing countries to take advantage of exports of generic drugs manufactured in countries with production capabilities under the compulsory licence.
- It also instructed the Council for TRIPS “to find an expeditious solution” to the problem associated with exporting generics manufactured under the compulsory licence.

#### What is a compulsory licence?

A compulsory licence is an involuntary contract between the patent holder and a generics manufacturer. The licence is authorised by a government and the patent holders’ consent is not necessary. There are several conditions under which a government is allowed to issue a compulsory licence - in case of a health emergency for example. Under the TRIPS Agreement, the patent holder must still be paid “adequate remuneration” (no exact cost or percentage is specified). It is important to separate compulsory licences issued for generic medicine to be used on the domestic market and those issued for export purposes. The domestic ones have been used for a long time, and some middle-income countries, such as Indonesia and South Africa, are currently using these to supply their home markets with generic drugs. It is the compulsory licence issued for exportation of generic medicine that is the issue. This is what the Paragraph 6 Decision was supposed to make workable and what we are concerned with here.

### The regime for exports of generics remains overcomplicated and out of touch with medical reality

- In 2003, the WTO adopted a decision to address the shortcomings of the compulsory licence, in the so called Paragraph 6 Decision (also known as the August 30<sup>th</sup> Decision). However, this has not been effective.
- **Exports of generics remain highly restricted in practice.** The Paragraph 6 Decision provided a temporary “waiver” enabling countries with generic manufacturing capacity to produce and export generic versions of patented drugs to developing countries which lack production capacity. But this amendment has

<sup>19</sup> *Medecins sans Frontieres*, “Neither Expeditious, nor a Solution: The WTO August 30<sup>th</sup> Decision is Unworkable”, August 2006.

not made any real change.<sup>20</sup> A recent TRIPS Council report noted that no qualifying member has notified the WTO of an intention to use the system.<sup>21</sup>

- *Medecins sans Frontieres* (MSF) report that they spent two years trying to order a triple-fixed dose combination ARV from Canada - the first G8 country to implement the decision - without managing to deliver a single pill to patients in the developing world. This led MSF to conclude that despite the explicit instruction in the Doha Declaration, the Paragraph 6 Decision is "neither expeditious, nor a solution".
- MSF points out that the Paragraph 6 Amendment is not based on medical reality. Addressing ever-changing health needs and sudden emergencies requires flexibility and rapidity of response. Currently, compulsory licence is issued on a drug-by-drug, case-by-case basis and subject to a longwinded process.
- **The Decision offers limited incentives for generic manufacturers to produce under a compulsory licence.** A company must engage in a long negotiation-process for a voluntary licence; take a series of anti-diversion measures; apply for two licences - one in its home country and one in the country of export. The latter in particular can be costly. This resource-consuming process must be undertaken *each time* a company files for a compulsory licence. One should also keep in mind that production of cheap generics has low margins of profit to start with.
- **Complexity is the main barrier - particularly for LDCs.** Governments - particularly LDCs - lack the resources to deal with all the legal and administrative complexities involved. Notifying the use to the WTO and filing for the licence with a generic manufacturer is a complicated procedure. In addition, domestic applications of Paragraph 6 vary and are often onerous.

## Unlocking access to generics - policy proposals

*"The use of compulsory licensing has been recognised as one of the most important tools for addressing the issue of medicines, particularly with the introduction of the pharmaceutical product patents in major generic manufacturing countries. At this point, affordable access to patented HIV/AIDS drugs in developing and least-developing countries is likely to become increasingly dependent on compulsory licensing."*

- Stop AIDS Campaign

## Make compulsory licence grants for generics automatic

- The process needs to be made automatic. The focus should be on making the mechanism correspond to the reality of changing health needs and provide more incentives for generic manufacturers to invest in export production. This could include relaxing the need to file for generics on a country-by-country, drug-by-drug

<sup>20</sup> *Ibid.*

<sup>21</sup> *Stop AIDS Campaign*, "Background Paper: Access to Essential Medicines for HIV", July 2006

basis and dropping the requirement to specify the precise quantities that eventually will be exported.

#### Allow compulsory licensing to work on a regional, rather than national basis

- There may be advantages to granting one country a licence to manufacture generics for its domestic market *and* for neighbouring markets with similar health needs. Regional coordination among poor countries should be encouraged in order to increase market size within which prices are integrated and make full use of compulsory licence and parallel imports. The WTO could *possibly* allow for this under GATT Article 24. One country that has signed up to a Regional Trade Agreement (RTA) could then export a drug under a compulsory licence to another member of the same RTA. For example, Ghana could use its Economic Community of West-African States (ECOWAS) membership to serve the region with generic ARVs - notably Nigeria, which has a high HIV infection rate.

#### Other measures to improve the availability of medicine

##### Make full use of flexibilities for trade in patented goods

- Under the TRIPS Agreement, countries can also make use of so called *parallel imports*. In essence, parallel imports “are goods produced genuinely under protection of a trademark, patent, or copyright, placed into circulation in one market, and then imported into a second market without the authorisation of the local owner of the intellectual property right.”<sup>22</sup> Unlike drugs manufactured under compulsory licence, therefore, parallel imports are not generics.
- Parallel imports are based on the “exhaustion principle”. This involves the patent holder’s exclusive right to control the sale, use and marketing of the medicine once it consents to sell the product to a given market. The principle is about when this right ends.<sup>23</sup> Each nation can establish its own “exhaustion” policy covering parallel imports.
- Developing countries could use this flexibility to adopt a generous exhaustion principle allowing the country to scan the world market for the cheapest drug available. The Doha Declaration reaffirmed this flexibility.
- As with the Compulsory License, there also seems to be scope for working on a regional basis to promote effective and well-functioning parallel imports.
- At present, however, low-income countries do not take advantage of the flexibilities entailed in the parallel import provision.<sup>24</sup> Although it is not clear

---

<sup>22</sup> Keith E. Maskus “Parallel Imports in Pharmaceuticals: Implications for Prices and Competition in Developing Countries”. Final Report to World Intellectual Property Organization, April 2001.

<sup>23</sup> Under “national” exhaustion, exclusive rights end upon first sale within a country but IP rights owners may exclude parallel imports from other countries. Under “international” exhaustion, rights are exhausted upon first sale anywhere and parallel imports cannot be excluded. A third possibility is regional exhaustion, under which rights end upon original sale within a group of countries, thereby allowing parallel trade among them, but are not ended by first sale outside the region.

<sup>24</sup> *Stop AIDS Campaign*, “Background Paper: Access to Essential Medicines for HIV”, July 2006.

exactly why, many observers point to scarce government resources among poor countries to scan world markets and limited knowledge of the provision itself. In addition, fears of reprisal, such as in the case of Pfizer v. Philippines, have been identified as a deterrent.

### **Voluntary licensing**

- An innovator company may voluntarily licence a patent to a company in an LDC or a middle-income country for the purpose of production. This type of licence has been used so far only to a limited extent, but has potential. One obvious problem is that a voluntary licence is of limited use to many of the poorer countries that lack manufacturing capacity and whose markets are too small in the first place for a generic drug manufacturing industry to pay off. Licenses also need to be issued for HIV/AIDS ARVs to a larger extent.

### **Establish public-private partnerships between pharma companies and developing countries' governments**

- In addition, several people point to the need to ease the tense relationship that now exists between large companies eager to protect IP and governments, NGOs and other non-profit organisations. This could be done by greater dialogue and by establishing various public-private partnerships (PPPs) in which IP-related matters and groundwork for deal making between various actors can be worked out.

### **The Global Fund and UNITAID**

- Promoting universal access to affordable drugs can also take place through funds and facilities. One example is the Global Fund to Fight AIDS, Tuberculosis and Malaria which was established in 2002. The Fund is a partnership of governments, non-profit organisations, and the private sector, working together to address the most urgent needs pertaining to AIDS, tuberculosis and malaria.
- Another facility in the making is the International Drug Purchase Facility (IDPF/UNITAID). Part of what UNITAID seeks to do is about bargaining with pharmaceutical companies for large and long term contracts to drive down prices. Another, innovative aspect of UNITAID is an attempt to boost the use of generic drugs by removing bureaucratic obstacles. "UNITAID will boost the marketing of generic drugs by accelerating their WHO pre-qualification and facilitating their distribution in developing countries." Making such facility operational should be made a priority.

## 4. Rebalance the aid budget towards aid for trade

*Making the changes described above to terms of market access opportunities for developing countries will not on its own be sufficient. The poorest countries need help to take advantage of these opportunities. When it comes to helping developing countries to open up their own trade, help to dismantle the practical obstacles to trade is at least as important as encouraging them to lower their tariffs and quotas. Cutting customs red tape, fighting corruption at the border, and enhancing trade infrastructure are some of the most effective uses of our aid budget.*

- The evidence suggests that aid for *trade* is one of the more effective forms of aid (even compared to other forms of aid for economic development). A larger proportion of aid budgets should be targeted at aid for trade and trade facilitation projects. The OECD's measure implies that only around 3% of the total aid budget of developed countries is currently spent on narrowly defined trade policy. Even if other economic development measures are included, the total is still only around a quarter of the total aid budget. EU countries should immediately direct more of their aid budgets towards aid for trade.

### How effective is aid for trade facilitation?

- According to a study by the World Bank Development Research Group, the gains from aid for trade facilitation are very large.<sup>25</sup> They note that: "Trade-aid is a very efficient type of aid that brings back to the world much more than it takes. In the case of the annual aid of \$28.7 billion, the net gains - after subtracting the cost of the investment - amount to \$18.4 billion. Even though most of these gains go to the developing countries, the developed countries are able to recoup a portion of their costs through cheaper imports from and exports to the developing countries."
- A study by Wilson et al (2004) attempted to measure the effectiveness of different kinds of aid for trade. They looked at the potential benefits of reforms (see table below) which would increase the efficiency of each of the variables half of the way towards the global average efficiency for each measure. They find that for Sub-Saharan Africa, such improvements would boost exports significantly.

| Measure                | Increase in exports |
|------------------------|---------------------|
| Port efficiency        | 1.1                 |
| Customs environment    | 0.6                 |
| Regulatory environment | 2.8                 |
| Services/E-commerce    | 4.8                 |

Source: Wilson et al (2004)

- They also compare the potential gains from trade facilitation to the gains from a hypothetical scenario of total tariff abolition. Their results suggest that a 15.6% improvement in port efficiency or a 10.2% improvement in customs environment by

---

<sup>25</sup> Ivanic et al, November 2006

the importer would be equivalent to complete tariff elimination. An improvement in the efficiency of service sector infrastructure (credit mechanisms etc.) by 6.6% or a regulatory environment improvement of 17.0% would also be equivalent in effect to an abolition of tariffs.

"It takes 28 days to deliver an order placed in Maputo, Mozambique's capital, about 600km from Johannesburg, because of inspections and paperwork. As a consequence we are selling less than 10 percent of South African goods. They have been replaced by goods from Europe and South America."

- Whitey Basson, CEO of Shoprite Checkers, Africa's largest retailer

### Existing aid for trade mechanisms

- The Integrated Facility (IF) was established in 1997 by a consortium of multilateral institutions: the WTO, IMF, ITC, UNCTAD, UNDP and the World Bank. It aims to help LDCs create a trade strategy and identify what assistance they need to achieve it. It also encourages such countries to build a trade strategy into their wider Poverty Reduction Strategy Papers (PRSP).
- The main output of the IF has been a series of Diagnostic Trade Integration Studies (DTIS) - effectively action plans for trade development. The main criticism of the IF has been that it fails to follow up or coordinate its expensive technical studies with the financial support needed to achieve their recommendations. There is a small IF trust fund, which pays for the DTIS and provides very small sums of money for capacity building. After a review, it was agreed in mid-2006 that IF would be scaled up and would have a stronger independent secretariat.
- The Trade Integration Mechanism (TIM) and the Joint Integrated Trade Assistance Programme (JITAP) are aimed more at helping countries meet the adjustment costs of multilateral trade liberalisation and strengthen the ability of poorer nations to take part in WTO processes.
- The UK is currently involved in the Africa Infrastructure Consortium<sup>26</sup> - an initiative of the G8. Members include the African Union, the New Partnership for Africa's Development (NEPAD), the African Development Bank, the Economic Community of West African States (ECOWAS), the World Bank and the EU. This has a particular focus on donor coordination and mobilising resources for national and cross-border regional infrastructure projects. DFID has pledged \$20 million over 3 years to help with the work of the Consortium.<sup>27</sup>
- These efforts are welcome and set good examples. But as the House of Commons International Development Committee concludes, the UK and the EU "undoubtedly, could do more."<sup>28</sup> Not enough mechanisms are in place geared specifically at improving trade facilitation. In particular, there needs to be a

<sup>26</sup> <http://www2.dfid.gov.uk/news/files/infra-consorti-africa.asp>

<sup>27</sup> Select Committee on International Development, Fourth Report 2005-2006, 17 July 2006

<sup>28</sup> *ibid.*

stronger emphasis on coordinating the delivery of trade-aid - rather than merely producing excellent studies which are then not acted upon.

### Why is increasing south-south trade so crucial for development?

The combination of social unrest, limited competition, multiple checkpoints, red tape and corruption has been identified as one of the greatest impediment to south-south trade. This is critical, because increased intra-developing country trade has large potential to work for development. Trade opening between economies of similar size may give poorer countries confidence to liberalise certain sectors without the fear of being swamped with imports from companies in more developed countries. Over time, poorer countries signing bilateral deals may build up trade capacity and gain confidence in negotiating trade agreements, both bilateral and multilateral. It could also encourage export diversification.

For example, through increased trading with southern partners, Costa Rica managed to boost demand for high-salary jobs in the capital-intensive sector and managed to significantly diversify its exporting goods.

Promoting south-south trade is also a way to offset the dangers of hub and spoke bilateralism. This is a scenario whereby smaller economies (the spokes) are drawn into agreements with the larger ones (the hubs) but without agreements between each other. These arrangements are far more beneficial to the hubs, who can import goods from wherever they like, and export goods to countries which may be locked into receiving these imports, rather than those of cheaper producers elsewhere.

South-south trade has grown at twice the rate of the global average in the past decade, and makes up 40% of all trade for developing countries. Yet it is between developing countries that trade barriers are highest. For instance, exporters of manufactures in Latin America face tariffs in the rest of Latin America that are seven times as high as the average rate applied to exporters in industrialised countries. The greatest developmental gains to be accrued from trade are being stifled as a result of high levels of protection between developing countries.

According to the World Bank, elimination of tariffs on manufactured goods between developing countries will lead to welfare gains of \$30bn per year, and doing the same for agricultural goods will add a further \$30bn per year.<sup>[1]</sup> In fact, south-south liberalisation could yield even greater gains for developing countries than increased market access to developed countries.<sup>[2]</sup> A large part of this is due to the fact that south-south trade barriers are relatively high. However, as argued above, improved trade facilitation - even on its own - can have an even bigger impact than lowering tariffs and quotas, especially where south-south trade is concerned.

The Commission for Africa states that "Recent ECA estimates indicate that welfare gains from regional integration in sub-Saharan Africa alone, could be in the order of \$1.2 billion, reinforcing the view that Africa's own liberalisation offers major gains."

<sup>[1]</sup> World Bank (2002)

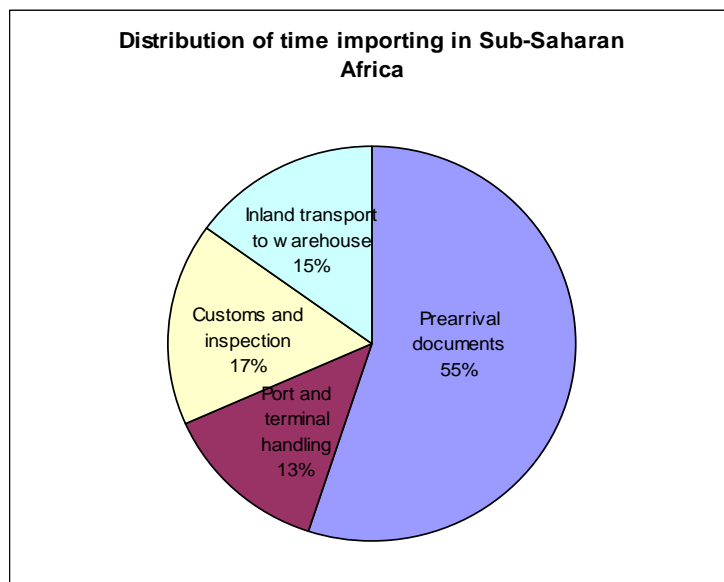
<sup>[2]</sup> Joseph Francois , Hans van Meijl , Frank van Tongeren, Trade Liberalization and Developing Countries Under the Doha Round (2003)

## Trade facilitation - policy proposals

A larger proportion of aid budgets should be spent on aid for trade. The narrowly defined trade facilitation projects should focus on:

### Reducing red tape

- Trade facilitation is not only about the physical, or hard, infrastructure. In fact, it has been estimated that just a quarter of delays are due to poor road or port infrastructure. The rest is due to “soft” infrastructure, such as heavy bureaucracy, overcomplicated customs procedures, tax procedures, clearances and cargo inspections. Such problems begin long before the cargo reaches the port, and are magnified for landlocked African countries.
- A World Bank paper by Djankov, Freund, and Pham from January 2006 found that: “On average, each additional day that a product is delayed prior to being shipped reduces trade by at least 1 percent. Put differently, each day is equivalent to a country distancing itself from its trade partners by 85 km on average.”



Source: World Bank 2006

- Putting this in context, they note that “It takes 116 days to move an export container from the factory in Bangui (Central African Republic) to the nearest port and fulfil all the customs, administrative, and port requirements to load the cargo onto a ship. It takes 71 days to do so from Ouagadougou (Burkina Faso), 87 days from N’djamena (Chad), 93 from Almaty (Kazakhstan), and 105 from Baghdad. In contrast, it takes only 5 days from Copenhagen, [and] 6 from Berlin”.

- The same problem comes back when a company wishes to import, or an individual wants to start up a business. The World Bank's 'Doing Business' 2007 database reveals that in Rwanda, for example, a new business must fill out 14 documents to be able to export, and 20 documents to be able to import. In Guinea-Bissau, starting a business involves 17 different procedures, takes 233 days and costs more than 261% of income per capita. This compares with 2 procedures, 3 days and 0.9% of income per capita to start a business in Canada.<sup>29</sup>
- By giving assistance and exchanging best practice with developing country governments, high-income countries can help to streamline bureaucratic procedures and identify areas of improvement. Aid should then be given to clearly targeted projects to improve export, import and start-up procedures. Emphasis should be on measurable results. Also, DFID should set up an expert group with representatives of private-sector trade facilitation companies to work on trade facilitation issues and identify bottlenecks.

### Cleaning up Customs Procedures

- Several studies have shown that the costs of delays and unnecessary red tape at the border of certain southern countries can be the equivalent of a 5 to 15 percent tariff.<sup>30</sup> But experiences indicate that drastic improvements in custom practices are realistic and can have tremendous potential to increase trade flow.
- According to a recent World Bank study, Peru managed to shorten its customs release time from 15-30 days to 2-48 hours through custom staff training and through the introduction of a code of conduct. In Costa Rica, electronic declaration and the switch towards a single window warehouse clearing reduced customs clearing time from an average of 6 days to 12 minutes.<sup>31</sup> This was a significant factor behind Costa Rica's dramatic rise in exports, which went from \$2.9 billion to \$6.1 billion in less than ten years, with a continuing annual average growth of these exports close to 9.4 per cent.<sup>32</sup>

### Improving Infrastructure

- According to the Commission for Africa, it costs more to ship a ton of maize from Zambia to neighbouring Tanzania than it costs to send the same ton of maize from Tanzania to Europe or the United States. Poor roads in Uganda add the equivalent of an 80 per cent tax to every dollar's worth of clothing exported to a market.<sup>33</sup> In landlocked countries transport costs may be equivalent to three-quarters of the value of exports.<sup>34</sup>

<sup>29</sup> [http://www.doingbusiness.org/documents/Doing\\_Business\\_2007\\_Country\\_pages.pdf](http://www.doingbusiness.org/documents/Doing_Business_2007_Country_pages.pdf)

<sup>30</sup> Office of the United States Trade Representative, Doha Development Agenda Policy Brief - October 2005

<sup>31</sup> Lamy, Pascal, Indian Council for Research on International Economic Relations, April 2006

<sup>32</sup> UNCTAD, 2004

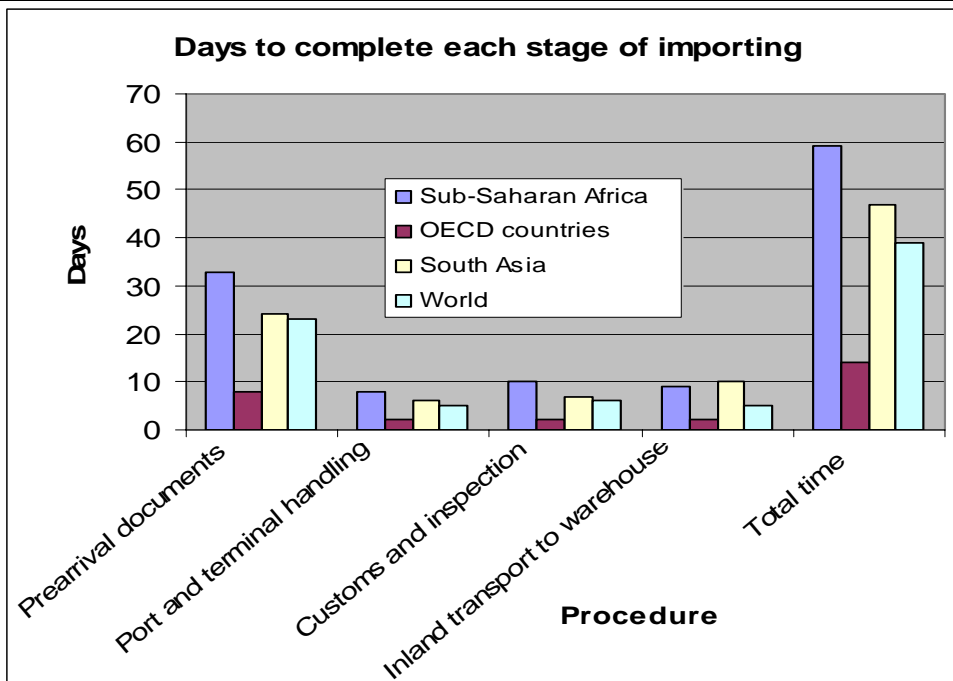
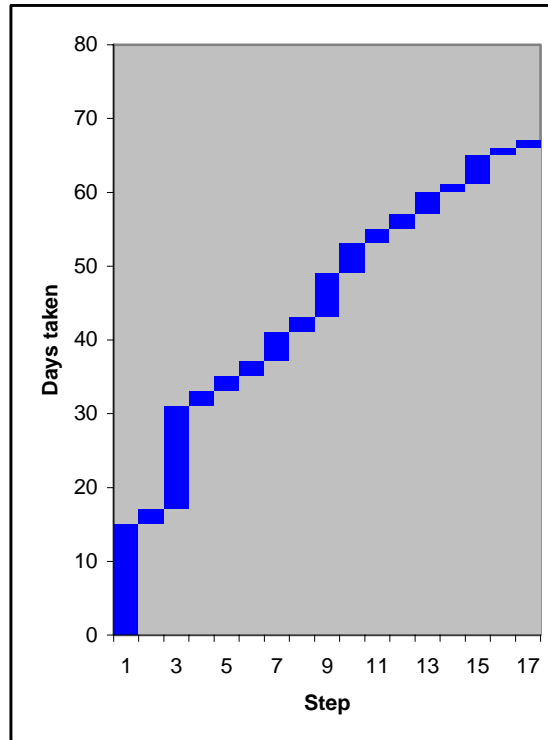
<sup>33</sup> Commission for Africa, 2005

<sup>34</sup> Ibid.

### How long does it take to export from Burundi?

#### Steps of the process:

- 1 Secure letter of credit
- 2 Obtain and load containers
- 3 Assemble and process export documents
- 4 Pre-shipment inspection and clearance
- 5 Prepare transit clearance
- 6 Inland transportation to port of departure
- 7 Arrange transport; waiting for pickup and loading on local carriage
- 8 Wait at border crossing
- 9 Transportation from border to port
- 10 Terminal handling activities
- 11 Pay of export duties, taxes or tariffs
- 12 Waiting for loading container on vessel
- 13 Customs inspection and clearance
- 14 Technical control, health, quarantine
- 15 Pass customs inspection and clearance
- 16 Pass technical control, health, quarantine
- 17 Pass terminal clearance



Source: World Bank 2006

## Aid for trade facilitation - what works?

The World Bank's Doing Business in 2006 notes that in 2004, 25 countries reformed their customs or trade transport procedures. Egypt was at the top of the chart - it managed to reduce the number of approvals required to export from 26 to only 5. Rwanda was also a great reformer, dropping the requirement for pre-shipment inspection altogether and introducing an electronic system for customs declaration. Several other countries, including Guatemala and Peru, reduced the time limit for a cargo to go through the customs. Fiji and Hungary introduced electronic filing of customs documents which has meant that almost 90% of shipments in the two countries now go through without stopping. Several countries, such as Pakistan and Yemen, reformed their license practises. Pakistan has started to grant a two-year license to the trader, rather than giving out licenses on a cargo-by-cargo basis, which was the case under the previous, cumbersome system.

Despite the fact that more than half of the reforms in 2004 took place in poor countries, it still takes on average 3 times as many days, nearly twice as many documents and 6 times as many signatures to import in a poor country compared to a high-income one. In Africa, it takes 45 days on average to export and 59 to import.

The World Bank report lists the 3 most effective reforms in 2004:

### *Make document filing electronic*

Singapore introduced a system, TradeNet, which linked the various government agencies responsible for customs clearance. The trader could therefore send in a single form which TradeNet forwarded to the relevant agency, cutting the time for cargo clearance from 4 days to 30 minutes in less than two years. As a result, the number of shipments processed tripled. Mauritius followed Singapore's example, and from Mauritius the technology was exported to Ghana, where it reduced the clearing time in most instances from two weeks to less than a day.

### *Use risk assessment policy for inspections*

Another problem identified by the World Bank report is that too large a share of imported cargo containers are opened and inspected when clearing customs. In Africa and South Asia 70% of the cargos are opened. One way to deal with this is to introduce a software program that calculates the probability that the shipment would need inspection. Such a system allowed Mexico to limit the inspections to only 10% of the shipments.

### *Go regional with reform of customs and transport*

To address the disadvantaged position of landlocked countries, there is a case to be made for encouraging regional integration, including harmonisation of customs forms. Botswana, Namibia, Lesotho and South Africa have done precisely this and cut down on paperwork and costs. A desirable next step, according to the World Bank, would be to remove border checks and introduce harmonised transport rules.

Thus, it is important to identify the relatively simple reforms that actually do work. If the World Bank's study is accurate, even poor countries could make swift progress in custom procedures and trade transport. This seems to reinforce the importance of giving aid to countries that actually engage in specific and cost-efficient reform programmes.

## Combating Corruption

- More initiatives such as the Africa Infrastructure Consortium are needed. Particular focus should, again, be placed on measurable, narrowly defined infrastructure projects. High-income governments should also back private investments in these types of projects. The World Bank has suggested that an additional \$10 billion to \$20 billion need to be invested in the infrastructure of developing countries in order for trade to be properly facilitated.<sup>35</sup>
- A businessman in Ghana says: "It costs \$1,000 to ship a 20-foot container to the United Kingdom. You need \$2,300 to transport the same container just next door to Liberia. By road, our drivers can be stopped five times in Ghana, six times in Togo, six times in Benin and easily 20 times within Nigeria alone. Sometimes for good reason, to protect against highway robberies, but some officials can be abusive."<sup>36</sup>
- Every regulation and hold up is potentially an excuse for a bribe for an official. One of the major challenges will be to attempt to change this culture. Reducing red tape could also reduce corruption.

## Encourage Export Processing Zones

- Several developing countries have formed Export Processing Zones (EPZ) - areas in which goods can enter, undergo processing, and be re-exported without facing tariffs. Such zones often offer better infrastructure than the rest of the country and can attract higher quality investment. There are a wide variety of EPZ - from free port arrangements to city-wide zones or even whole regions. Some schemes do not set up bounded "zones" as such but allow individual factories or companies to apply for the special status such as the Export Oriented Units in India, or single-company zones in the Dominican Republic. Some allow all goods to enter duty free, while others only allow capital goods and production inputs to gain duty free status.
- As well as classic duty free goods processing arrangements, the International Labour Organisation has expanded the definition to include other industries (like tourism or e-commerce) and the provision of other incentives apart from duty free status, including: relaxed foreign exchange controls, more liberal regulatory codes, reduced taxation and liberal planning laws. In the case of call centre zones it may also involve lifting a telecoms monopoly and other obstacles to market-priced telecoms.
- Hand in hand with aid for trade facilitation (such as infrastructure investment) aid to help set up EPZs could have a big effect. For one, it can lead to spill-over effects in areas of trade facilitation, through demonstrating the benefits of liberalisation and the reduction of red tape in developing countries. The cases of China's "Special Economic Zones" and coastal zones, and India's telecoms clusters are both powerful examples of how EPZs have mobilised support for further reforms in developing countries.

---

<sup>35</sup> World Bank, Estache, 2004

<sup>36</sup> Africa Renewal, Vol.20 #3, October 2006

## 5: Make sure 'Kyoto 2' delivers for poor countries

*The existing Kyoto framework has established a system for utilising the mechanisms of global trade to reward clean development in poor countries. This new flow of funds - worth up to €20 billion - could deliver a huge boost to low income countries. However, in practice these mechanisms are highly flawed. The poorest countries receive little of the money, there is wasteful profiteering from the capture of 'exotic' greenhouse gases and many of the projects are either of no environmental benefit - or even damaging. Any "Kyoto 2" agreement must learn from these mistakes and adopt wide-ranging reforms to the system. Developed countries should channel the funds going through the system towards those in the greatest need.*

### Why is climate change a development issue?

- Global warming is likely to affect the world's poorest people most. Nazmul Chowdbury from NGO Practical Action argues, "Forget about making poverty history. Climate change will make poverty permanent."<sup>37</sup> Those who have limited access to food, water and healthcare now are the most likely to suffer from disruption to rainfall and weather patterns in the future.
- The mechanisms of global trade can be mobilized as a key tool in combating climate change, whilst simultaneously creating incentives for increased investment in vital infrastructure in developing countries; this is the other aspect of climate change as a development issue. However, whilst these ideas have been integrated in the existing Kyoto framework, the current mechanisms in place are highly flawed. Some believe they may even be doing more harm than good.

### How is Kyoto-based trading supposed to help developing countries?

- The Kyoto protocol requires developed countries that have ratified the text to reduce their greenhouse gas emissions by an average of 5% on 1990 levels by 2012. The target for the EU is 8%.
- Commitments towards meeting Kyoto reductions not achieved through domestic emissions abatement in the developed (or 'Annex 1' countries) will be taken up by importing Clean Development Mechanism and Joint Implementation (CDM/ JI) permits from projects in developing and middle income countries ('non-Annex 1' states). "Certified Emissions Reductions" (CERs) are awarded for projects in non-annex 1 countries according to the amount of greenhouse gas emissions they avoid as a result of the project. The CERs are then sold to governments and companies in Annex 1 countries, and count towards their required Kyoto emissions reductions. In the case of the EU, demand for CERs is expected to be largely created by the bloc's Emissions Trading Scheme (ETS), which requires EU businesses to buy in credits if they emit above a predetermined amount of greenhouse gas. Such installations can either import CERs, or buy internal EU permits certifying emissions abatement (EUAs) from other EU companies.

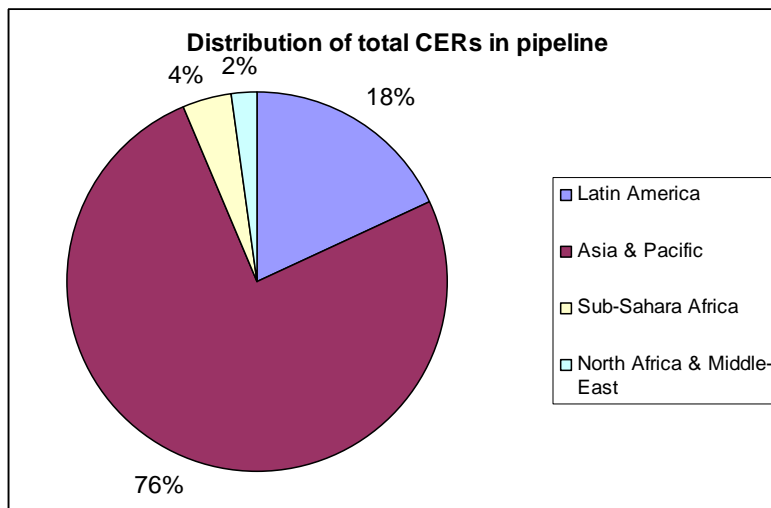
---

<sup>37</sup> <http://www.christian-aid.org.uk/indepth/605caweek/caw06final.pdf>

- The central idea behind Kyoto permits is that they should (in theory) help emerging economies develop in a less pollution intensive way, channelling investment from the developed world towards pro-development, sustainable projects. The mechanism is also designed to allow the economics of emissions reductions to be played out on a global level, encouraging the process of emissions cuts to take place wherever costs are lowest.

### Why the Kyoto protocol is not delivering on clean development

- **LDCs and Africa have been sidelined by the process.** Most of the investment in CDM projects has been absorbed by large developing countries, such as China and India. Sub-Saharan Africa is expected to account for a negligible proportion of overall investment (approx. 4%), most of which will be directed towards Nigeria and South Africa.<sup>38</sup> This situation is to a large extent created by design flaws in the CDM rules, as the World Bank notes: “in Uganda or Zambia, just around 10% of the country’s population has access to the grid for electricity. Yet, a clean, grid-connected electricity project in such a country has to demonstrate under CDM rules that it displaces ‘carbon-intensive’ electricity on its grid; the fact that it derives mainly power from clean hydro sources is seen as a reason for it not to receive credits for proposed new clean energy sources. This unintended consequence unnecessarily punishes the poorest people in poor countries, who can least afford to use expensive diesel, kerosene or fuel-wood for their basic needs... No approved methodology exists as yet through which countries with such obvious energy needs such as these can be rewarded for clean development.”<sup>39</sup>



- **Kyoto projects do not reward absolute cuts in emissions.** CDM/ JI projects give credit for emissions that are avoided (ie. reduced below the level that would have otherwise occurred), not necessarily for absolute emission reductions. These projects do not generally translate as concrete investments in renewable energy - in fact, only one quarter of credits generated from the CDM before 2012 are

<sup>38</sup> Jørgen Fenhann, UNEP Risø Centre (01.02.07)

<sup>39</sup> World Bank, *State and trends of the carbon market 2007*

expected to be from renewables, and only 2% of credits so far issued originate from such schemes.

- **Many Kyoto projects would have gone ahead anyway - meaning carbon markets are diluted for no environmental gain.** Lack of “additionality” is a major criticism levelled by environmental NGOs against Kyoto projects. Additionality refers to the principle whereby a project should be entitled to CDM status on the condition that it would not otherwise take place without the funding provided by carbon trading. The Jindal metal plant in India is an example of a programme claiming carbon credits for technology that would have been installed anyway. Axel Michaelowa, an advisor to the CDM board, claims that around one third of the 50 projects he surveyed in India were not “additional”, and therefore should not have been eligible for carbon credits. Another example is the Xiaogushan dam in China. The project was awarded \$30m worth of credits, even though construction of the dam had been long underway, was nearing completion and had already been given loans by the Asian Development Bank. Patrick McCully, Executive Director of environmental NGO International Rivers Network argues:

*“...the UN panel that governs the scheme is being deceived by developers and consultants into giving away many millions of credits to schemes that would very probably have been built anyway, and so do not avoid any carbon emissions. Worse, these credits will then be ‘cashed in’ by their European and Japanese government and corporate buyers, allowing them to avoid their commitments to reduce their own emissions.”<sup>40</sup>*

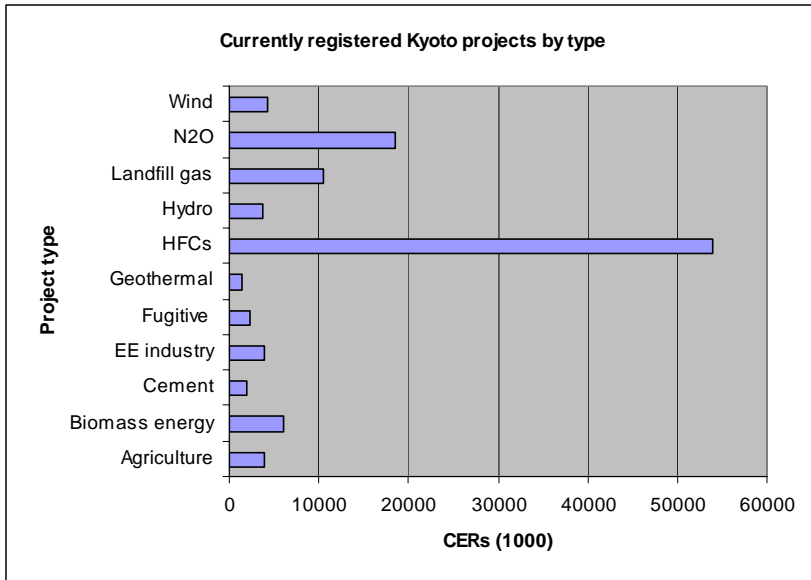
- **Kyoto projects may damage the environment in other ways.** There are examples of CDM projects which, whilst complying with criteria on emissions, contribute to other forms of non-sustainable environmental degradation, such as soil and water pollution.<sup>41</sup>
- **Loopholes create massive distortions in carbon markets.** The Kyoto permit system awards funding on the basis of the quantity of CO<sub>2</sub> equivalent reductions achieved, but often this is not related to the true cost of making those reductions. A particularly striking example, revealed in a study in *Nature*, relates to chemical factories producing the HFC-23 gas. These installations can reduce their emissions with a simple piece of equipment known as a scrubber, which generally costs a few million dollars. However, since HFC-23 is so potent (one tonne of the gas being equivalent to 11,700 tonnes of carbon dioxide) companies that install this equipment are eligible for tens of thousands of carbon credits for reducing just a few tonnes of the gas. This means that HFC-23 projects have received more credits than any other in the carbon markets so far. Total projects that should have cost no more than €100m may have wasted €4.6bn.<sup>42</sup>

---

<sup>40</sup> Letter to *FT* (13.02.07)

<sup>41</sup> Channel 4 news bulletin (07.02.07); reported by *Point Carbon* (06.02.07)

<sup>42</sup> *FT* (08.02.07)



- Furthermore, the author of the study, Michael Wara, suggests that this loophole creates perverse incentives to produce even more of this gas, and there is evidence to suggest this has already happened: "HFC 23 emitters can earn almost twice as much from the CDM credits as they can from selling refrigerant gases - by any measure a major distortion of the market."<sup>43</sup> The development gains of such large scale 'end of pipe' capture of gases are very limited, delivering no real benefits in terms of improvements in energy supply, job creation or infrastructure. As the graph above shows, HFC capture projects are currently the largest single source of registered CERs.<sup>44</sup>
- The necessary money could have been provided by other funders (such as development banks or aid funds) in the first place, and the wasted money invested far more efficiently on real emission reduction projects. To make matters worse, the unnecessarily large numbers of extra credits awarded for HFC-23 projects will further dilute European carbon markets.
- Wara gives his overall assessment of the scheme:

*"...the CDM has primarily proffered an exchange of CO2 reductions in the developed world for reductions of various non-CO2 gases in the developing world. Furthermore, because the price paid for reductions has become tied to the major developed world cap and trade market, the European Union Emissions Trading Scheme ("ETS"), a CO2 only market, the price paid is between 10 and 100 times greater than the cost of most of these reductions...The CDM is neither functioning well as a market for emissions reductions nor is it a successful subsidy. As a result, it is creating skewed but powerful political institutions and interest groups whose interests are not aligned with the ultimate goals of either the UNFCCC or the Kyoto Protocol...The CDM fails as a market because it has animated accounting tricks that allow participants to manufacture CERs at little or no cost. It fails as a*

<sup>43</sup> "Is the global carbon market working?" by Michael Wara, *Nature* (vol 445, p 595) 8 February 2007

<sup>44</sup> Jørgen Fenhann, UNEP Risø Centre (01.02.07)

*subsidy because the developed world has had to purchase these emissions reductions at an extremely high premium that bears no relation to their cost. The CDM, even as it is supplying CERs to developed world parties to the Kyoto Protocol at prices that are less than they would otherwise have to pay, is an excessive subsidy that represents a massive waste of developed world resources.*"<sup>45</sup>

## Policy Proposals - making 'Kyoto 2' deliver for poor countries

- **Create a system of carbon trade preferences for LDCs.** Sub-Saharan Africa currently receives negligible investment from Kyoto projects. This could be resolved by introducing a quota-based preferential system, whereby projects will only be approved in other regions after a given number have been set up in priority regions. Similarly middle-income countries such as Brazil and Russia should only become eligible after poorer regions have received substantial investment first.
- **Caps limiting emissions growth in large developing countries such as India and China should be introduced.** This will encourage CDM investment to be channelled towards poorer countries and real emissions reductions.
- **Adopt the 'Gold Standard' for CER imports.** The Gold Standard is a currently recognised standard for classifying premium-quality Kyoto projects according to factors such as sustainability and community development. At present these only comprise a tiny proportion of the total, however. National governments in Annex I countries buying CERs should give preference to such projects.
- **'Delink' different gases to make investment levels reflect actual costs.** HCF 23 capture projects are important in combating climate change, but have proven a heavily distorting factor in existing CDM markets, creating perverse incentives to maximise production of the gas. Emissions reductions for such highly potent greenhouse gases could be funded through development funds instead of the Kyoto mechanisms. The sums involved are relatively small.
- **Alternatively, they could operate in their own 'delinked' trading system.** As Wara argues: "One possibility that might resolve the inefficiencies that currently exist in the CDM would be to recognise that although the six GHGs regulated by the Kyoto Protocol should also be regulated by any future climate regime, any future treaty or treaties should address each gas separately, at least so far as subsidised abatement is concerned. Instead of one agreement incorporating a conversion factor for each GHG, a future climate regime might be composed of multiple agreements, each aimed at combating particular types of GHG emission. This de-linking would be based upon the economic costs and complexity of emission reduction...it would be possible to make sharp reductions in GHG emissions of non-CO<sub>2</sub> gases by paying a relatively small number of current emitters to abate at a much lower cost than is currently the case. This would allow relatively uncontroversial, low-cost early action on certain classes of emissions. Second, separate regimes for each gas would allow for the creation of a more sensible trading program involving CO<sub>2</sub> only, derived principally from energy systems but

---

<sup>45</sup> Michael Wara, Measuring the Clean Development Mechanism's development and potential (July 2006)

including other large emitters. Such a program has a good chance of substantially accomplishing most of the original goals of CDM.”

- **Greater value should be assigned to CERs generated by renewable project investments.** This could form the basis for a system of graded value of CERs according to the category of the project type, based on environmental sustainability, development potential and levels of absolute emissions reductions. Definitions of these terms will need to be harmonised and clear. Under this regime, wind farms would thus generate more CERs than ‘end-of-pipe’ projects.
- **The ‘fast-track’ system for project approval should be reviewed for certain categories of renewable projects,** such as wind farms and solar generation, which have zero carbon emissions and do not contribute to other forms of environmental degradation. This should also include credits issued for the export and delivery of small scale renewable energy equipment, such as windmills and rooftop solar panels - running in parallel with the existing project-based system. These have key advantages over large project-based schemes, being carbon neutral, and will create direct benefits at a grass-roots community level. It is also likely to open up more potential for CER generation in LDCs, particularly in Africa. This should be managed in conjunction with NGOs and aid agencies, who can ensure effective delivery.
- **Tighten up and harmonise methodologies and standards for CDM projects.** Perhaps most importantly, it is essential to reach a tighter definition of “additionality”. Disagreement on this point led to relatively vague wording in the Marrakesh Accords, with the harmful effects described above. A standardised methodology for calculating baselines will also be necessary. The baseline is the presumed counterfactual for what would have happened in the absence of the CDM project, meaning that calculating the baseline is an essential part of working out whether or not a project is additional, together with the number of CERs an approved project will generate.
- **Create a centralised official database for baseline data.** As Michaelowa points out, project developers face serious obstacles in getting reliable data for their baseline calculations, which is necessary to calculate the marginal emissions reductions of a given project. A centralised database administered by the CDM Board would remove these obstacles and create greater certainty and consistency in methodologies for calculating the baseline. This ties in with the need for greater resources and funding for the CDM Board, in order to speed up project approval times and increase the administrative capacity of the body.