ACP–EU trade liberalization

Equal partners?

The Economic Partnership Agreements between the European Union and 77 African, Caribbean and Pacific (ACP) countries will not cause markets in the South to be swamped with European imports, as opponents suggest. But they will result in dramatic reductions in government revenues.

By **Evert-jan Quak**

With the failure of the World Trade Organization (WTO) summits in Cancún (2003) and Hong Kong (2005), the Doha round of trade negotiations – known as the 'development round' – appear to have reached an impasse. All eyes are now on bilateral trade talks, particularly those between the European Union and the African, Caribbean, Pacific (ACP) countries. At present, the 77 ACP countries – most of them former colonies of EU member states – have much easier access to European markets than non-ACP countries like Ecuador or Bangladesh.

This system of preferential access, as it is known, was established in the 2000 Cotonou Agreement, but contravenes the WTO's non-discrimination rules. At the ministerial meeting in Doha, Qatar, in 2001 Europe was granted a waiver, but this is due to expire in 2008. New 'WTO-proof' agreements must therefore be agreed as a matter of urgency. The current negotiations should result in Economic Partnership Agreement (EPAs), which amount to free trade agreements, with additional arrangements regarding development aid.

For the ACP countries, the EPAs will bring to an end the benefits of over three decades of preferential access to European markets. But that will not be the end of the matter. Under the Cotonou Agreement the ACP countries were also allowed to retain trade restrictions on imports from Europe. The European Commissioner for Trade, Peter Mandelson, is now sticking to the principle of reciprocity in the EPA negotiations, and is asking the ACP countries to open their markets to European imports. 'We are opening our markets to you, and you must do the same for us' is Mandelson's message. In other words, the EPAs will mean that ACP countries can no longer use import tariffs to protect their markets from European goods and services.

Proponents and critics of the EPAs have drawn on academic studies in support of their arguments. Opponents are particularly critical of the economic damage that could occur if Europe were able to sell its products *en masse* on fragile ACP markets once trade restrictions are lifted. This could mean that small producers in developing countries could be forced out of their own market by competition from large European producers.

Supporters of the EPAs take a more positive view. They see free trade between the EU and ACP countries as a way of boosting regional integration in the South. The EPAs will force the countries in the six negotiating groups to work closely together. When neighbouring countries reach harmonious agreements and open their borders to each others' goods and services, this eventually leads to more mutual trade and economic growth. The free internal market in the EU is a good example.

Trade creation or diversion?

Where do academics stand in the debate on the EPAs, and on the key point of dispute: reciprocity? Before examining this question, it is important to distinguish between the economic principles of *trade creation* and *trade diversion*. In essence, an economy benefits most if it is able to purchase products from the most efficient producers, wherever they happen to be, as they are able to market products of the same quality more cheaply.

In a free trade area – in which there are no trade barriers between countries (or regions, like the European Union) – it is assumed that countries will specialize in those goods and services that they can produce most efficiently. This will eventually lead to substantial increases in trade, employment and economic growth. Besides *trade creation* of this type, it is also possible that free trade agreements actually exclude the most efficient producers if they are located in countries that are not party to the agreement. Such *trade diversion* means that goods and services are replaced by less efficiently produced imports. As a result, consumers in the free trade area will have to pay more than necessary for goods and services. But such fears may be unfounded, according to researchers Massimiliano Calí and Dirk Willem te Velde of the Overseas Development Institute (ODI). Based on a comparison of a number of studies of ACP countries, they conclude that 'For virtually all African countries, EPAs would lead to more trade creation than trade diversion. The welfare effects are positive for almost all countries (except

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for some countries including Tanzania and Swaziland) and in most cases significant'.

Not swamped

What does this imply for ACP countries? Are critics of the EPAs correct in saying that their markets will be swamped with imports from Europe? Many economists agree that this fear has been exaggerated, as the current negotiations assume 'asymmetrical reciprocity'. While Europe will fully open its markets to ACP countries, the six negotiating groups need not open their borders 100%, but only around 80%. The new regime with a 20% waiver means that the ACP countries will no longer be able to adequately protect their agricultural sectors, and thus the livelihoods of millions of smallholder farmers.

In the EPA negotiations, the various ACP groups will have to decide which products they wish to protect with tariffs in the future. These products will need to be chosen carefully, based on assessments of the likely economic impacts. Since each group is free to choose which products to protect, West Africa, for example, may decide to protect an entirely different list of products than Southern Africa. To assist in this choice, researchers at the Institute of Development Studies (Sussex, UK) have developed a methodology and set of databases that can be used by governments and civil society in each ACP state to examine the impacts on the economy of retaining or abolishing protection of certain products.

It is assumed that the ACP groups will opt to liberalize trade in those products on which the duties levied on EU imports are already low. The ACP countries will also be given at least 12 years to effect the transition. ODI researchers Christopher Stevens and Jane Kennan have concluded that 'Reducing a tariff that is currently set at only 25 or 30% over a period stretching out to 2020 or 2028 cannot be described as a "shock".' In other words, many import tariffs are already low in the ACP countries, so gradually reducing them over a period of at least 12 years would not lead to a massive increase in imports from the European Union.

Lower government revenues

While opening the markets between the European Union and the ACP countries may well have positive impacts on trade and consumer prices, this is not enough to draw any conclusions about the impacts of free trade on overall welfare in developing countries. For many ACP countries, however, the complete

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abolition or drastic reduction of duty on imports from Europe would have major implications for state finances, as this duty is an important source of government revenue. If the government has less to spend, this might have significant impacts in many areas, such as employment.

Indeed, research by Susanna Wolf of the Centre for Development Research (ZEF) in Bonn, Germany, has shown that a free trade agreement between the EU and West Africa would have a negative impact on welfare, despite the growth in trade with Europe. Besides the decline in government spending due to the loss of revenue from duty on imports, both employment and gross domestic product (GDP) would fall dramatically.

Three-quarters of ACP countries would face a decline of 40% or more in their tax revenues on imports if trade with the European Union were to be liberalized. Of those countries, more than a third would see a decline of over 60%. This loss of tax revenues, which would impact on government spending, would have to be compensated for during the EPA implementation period (12-20 years). The question is: how?

Wolf presents two possibilities. The EU could make up the shortfall by increasing its development aid budget in order to limit the damage. Alternatively, ACP governments could increase VAT on imported goods, thus raising prices and reducing the demand for products subject to the higher tax rate. However, many governments in developing countries have found it difficult to set up an effective VAT system; levying tariffs on imports is much cheaper and easier.

The limits of liberalization

Most economists support the removal of as many protection measures as possible, since fewer trade barriers ensure better prices and healthy competition in the long term. The question is, however: where is the limit beyond which further liberalization would cease to be beneficial and in fact damage the economy?

It is unlikely that there will be a massive increase in imports as a result of the EPAs, as opponents of free trade argue. In the short term, however, ACP countries would be unable to compensate for a small increase by increasing their own exports to Europe. Imports from Europe would grow more rapidly than exports from ACP countries to Europe. As a result, ACP countries' income from exports would rise more slowly than their expenditures on imports.

Wolf has also shown that in the short term signing an EPA would reduce income from tariffs on imported products more rapidly than the crucial investments needed to establish a healthy export sector to provide products for which there is demand in Europe. As a result, the balance of trade (the difference between imports and exports) would deteriorate, at least in the short term.

The case of chicken offers a good example. In the 1990s chicken farming appeared to offer interesting prospects for West African farmers, from Senegal to Cameroon. However, Europeans eat mainly chicken breasts, leaving wings and legs that were exported at very low prices. West African governments could have protected their farmers by raising the duty on imported chicken, but under pressure from free trade agreements, most of them did not, so the tariffs were too low to protect their market from the cheap imports. This resulted in the loss of tens of thousands of jobs, as well as markets for local cereal growers who provided feed for the chickens.

If it is agreed during the current EPA negotiations that the duty on imported chicken will be reduced to zero, this would mean the end for chicken farming in West Africa. Many economists maintain that this situation would be only temporary, however. In the long term, the transformation of the economy would mean that the ACP countries would produce more efficiently in sectors where they excel. But this assumes that there would be enough money to retrain producers (chicken farmers in this case) or to provide start-up grants to allow them to switch to other activities.

Regional integration

One important question currently being debated is whether the EPAs will boost the process of regional integration in the South, particularly in Africa. Supporters of the EPAs, and the European Union itself, have long argued that the regional agreements and the removal of trade barriers between the countries in a group should promote increased trade, eventually resulting in more economic growth.

Researcher Caroline Freund reaches a different conclusion, however. See maintains that free trade agreements based on reciprocity work out best for countries at the same level of development. In other words: North–North or South–South agreements. She says that the North derives much more benefit from free trade agreements with the South than vice versa.

The six ACP groups hope to work more closely together to harmonize their markets, but this will depend on whether they can present a common list of products they wish to continue protecting after the agreements are signed. At present there appears to be little overlap between the products that individual countries within a group wish to exclude from liberalization. The European Union may therefore decide to enter into agreements with individual countries, thus undermining the desired harmony within the negotiating groups.

Whether the EPAs will really promote economic development in the ACP countries, will depend on the outcomes of the negotiations on the six EPAs. The negotiations are still in full swing, and the precise contents of the agreements will probably remain unclear up to the last moment. No one even knows whether the deadline of 1 January 2008 will be met. ■

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