The real costs and benefits of Economic Partnership Agreements

Complied by Christina Weller and Tzvetelina Arsova, Christian Aid; Sophie Powell, Traidcraft and Mari Griffith, Tearfund, April 2007

Introduction

Economic Partnership Agreements (EPAs) are presently being negotiated between the EU and six regional groupings of African, Caribbean and Pacific (ACP) countries set to replace from 1 January 2008 the non-reciprocal trade preferences EU has granted the ACP for years under the Lome conventions. The broader legal framework of the Cotonou Agreement - agreed by the EU and the ACP, and governing the principles under which EPAs are being negotiated – clearly envisages these, above all else, as developmental tools and remains open on the legal and substantive form the trade deals will take in order to achieve this objective.

Negotiating EPAs have proven to be a difficult process full of disagreements and controversy. In the absence of adequate evidence, the Commission peddles free trade agreements on the basis of a number of myths about the extent of the benefits and the limited costs. Based on these myths and optimistic assumptions about improvements to its own aid delivery and effectiveness, the EC also maintains that its "aid for trade" provisions will be more than adequate to offset costs to the ACP, and ensure their traders can take advantage of any new opportunities arising from EPAs.

This paper contests this view. It brings together what is already known about EPAs in order to assess the potential costs and benefits of these agreements.

Without solid evidence on the real costs and benefits of EPAs being expected to press ahead with negotiations is a *'nonsense yet a fact'* as stated by the Senegalese Minister of Trade.[1]

How can we know what an EPA will look like?

The short answer is that we don't - EPAs are still under negotiation and there are still many possibilities for their final form, including no EPA at all. However, analysis of the negotiation process show that it is heavily driven by the EC and forthcoming agreements will be an EU-led deal.

The EC's mandate, internal strategic documents, and their proposals going into to EPAs provide a clear picture of an EU-designed EPA:

- The EU and ACP would have to liberalise 90 per cent of their trade, with the EU liberalisation making up the larger part of this target, over a period of around 10 years, and not much more.[2] However, given the already considerable level of EU market opening to ACP it will be the ACP that in reality will be undertaking the more significant tariff reductions.

[1] Mamadou Diop, Minister of Trade for Senegal, speech delivered at high level conference on EU-ACP trade relations: "The Development Challenges of EPAs", Brussels, 12 October 2006, hosted by South Centre, report posted at: http://www.southcentre.org/Events/2006Oct_EPA_conference.htm

[2] EC's non paper on Article XXIV plus EC's reactions to ESA proposal

- The ACP would have to liberalise key services sectors, whilst the EC is unlikely to liberalise significantly in areas of interest to the ACP.[3]
- The ACP would have to sign-up to far-reaching deals on investment, government procurement, intellectual property rights, competition and trade facilitation.[4]
- There would be no separate adjustment fund or mechanism attached to EPAs.[5]

On the basis of this highly likely EPA scenario, it is possible to work out what the balance-sheet would look like for ACP countries evaluating an EPA proposal.

Unfulfilled promises and illusory benefits

'There may be costs associated with an EPA. But we should not forget about the benefits'[6]

One of the highly advertised by the EC benefits of EPAs is that they will help ACP to integrate into global markets and increase their trade. The EU's position is that Cotonou preferences failed to increase ACP trade, as they did not provide the stimulus to reform and diversify their trade. By their thinking providing the same kind of market access, whilst forcing the ACP to liberalise, will achieve this.

Will EPAs increase ACP trade?

ACP have pointed out for the EC several reasons why this is not likely to happen:

1 <u>There are important supply-side factors affecting ACP countries' ability to take up the opportunities for increased trade and compete with foreign traders and investors in their own markets.</u>

These are things such as infrastructure, human resources and institutional capacity and EU assistance, as explained below, will not be adequate to address these. Forcing the pace of liberalisation before these constraints are addressed, does not simply prevent gains, but causes damage to ACP economies and trade prospects. Two decades of trade liberalisation has cost Africa US$272 billion, roughly what it has received in aid. Had they not been forced to liberalise as the price of aid, loans and debt relief African countries would have had enough extra income to wipe out their debts and have sufficient left over to pay for every child to be vaccinated and go to school.[7]

2 <u>Besides tariffs and quotas, there are other non-tariff import barriers to ACP exports to EU markets.</u>

These take the form of strict rules of origin (ROO) and compliance requirements with constantly changing production standards such as sanitary and phytosanitary

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[3] EC "requests" to ACP countries under WTO, EC stated aims on services in internal docs, EU disputes on migration, banking, power, transport sectors – among themselves, EC "offers" under WTO
[4] EC internal documents on RTAs and investment, EC involvement in WIPO and WTO
[5] The 10th EDF spending is already decided; besides historically, the delivery of European development assistance has not been timely and efficient.
[6] Leaked letter from Stefano Manservisi (head of EC's Development Directorate) and Karl Falkenburg, (EC's deputy head of Trade) to Fijian trade minister Kaliopate Tavole.
[7] "The economics of failure: The real cost of 'free' trade for poor countries", Christian Aid, June 2005

measures (SPS). SPS measures, covering food safety and animal and plant health standards, affects the ACP countries' ability to export these products to the EU, whose standards are significantly higher than the minimum standards set by the WTO. Compliance with SPS measures can cost exporters between 2-10% of their turnover. The initial costs of establishing a national food safety control council are around €2 million per country and €5 million for similar regional facilities, totalling €180 million for the ACP region.[8] This is a tiny amount in terms of the newly announced 10th EDF package of €24 billion[9], yet it is critical to the ACP future agricultural exports to the EU. Unless there is serious effort to strengthen the capacity of developing countries to meet the food safety standards of the developed world, the opportunities presented by trade liberalisation may prove illusory.

It is likely that EPA will not address any of these issues. For example, the EC could improve its rules of origin, to allow ACP clothing and textile traders to export to the EU under special conditions available to them, even when their products contain cloth or other inputs from outside the region, providing one stage of processing has taken place within their borders. A similar provision in the US arrangements with African exporters (the AGOA scheme) saw African textile exports to the US rise from $600 million to US $1,500 million between 2000 and 2005. This created 10,000 new jobs in Lesotho and a similar number in Swaziland. In contrast, the equivalent EU scheme has seen Lesotho's exports of clothing to the EU virtually cease. The review of the EU's rules of origin is ongoing but proposals so far are not promising.[10]

3 <u>The main beneficiaries of new tariff and quota arrangements will not be the ACP regions.</u>

Since trade negotiations are based on "trade offs" of benefits and interests of the parties, who stands to gain most is important. The EC constantly point out the gains ACP exporters will make, and emphasize their own lack of commercial interests in ACP markets. However, without improvements to SPS and ROOs conditions, the ACP are in fact gaining little real new market access to EU markets. For example, Namibia could earn $2-6 million extra from increased exports in seedless grapes, in a sector that employs 3,500 full time and 700 part time workers. Unfortunately, in a context where by excluding sugar and bananas the scope for further tariff liberalisation on current trade affects only 0.46% of current imports, the scope for improving access under EPAs is so limited that the EC is holding all outstanding potential concessions back for inclusion in an EPA.[11]

4 <u>The market access that ACP already have and for which they have to make trade offs in order to maintain under EPAs is also of rapidly diminishing value.</u>

A concrete example of this process of "preference erosion" can be seen in the beef sector. In recent years Brazil and Argentina have been exporting around 600,000 tonnes of beef duty paid to the EU market. Should these tariffs be reduced either multilaterally through the WTO agreement or bilaterally via the EU-Mercosur

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[8] "Food Safety" Executive Brief by CTA (ACP-EU Technical Centre for Agricultural and Rural Development) http://agritrade.cta.int/en/topics/food_safety/executive_brief
[9] Including the €2 billion loan package made available by the EIB, which is potentially relevant for providing low cost loans for food safety related investments in ACP countries.
[10] "Creating development friendly Rules of Origin in the EU: The EU Commission argues that radical changes to the origin rules will both simplify processes and make them more development friendly. Will they?", ODI Briefing paper, November 2006
[11] See EC memo to Article 133 Committee "Economic Partnership Agreements: Key Political Issues and Background" Brussels 25 October 2006.

agreement, EU market prices would fall considerably to the detriment of ACP beef exporters, who would receive much lower prices for their beef exports. This could well push ACP beef exports out of the EU market - a trend already evident as a result of the price depressing effects of CAP reform.[12]

CAP reform also affects the value of preferences, the shift from price support for products to income support for producers, is leading to a decline in EU market prices for a range of ACP agricultural exports. This has seen beef prices offered ACP suppliers fall by 20% and sugar prices now set to fall 36% over four years. This has a direct impact on ACP earnings from agricultural exports and can even lead to some ACP exporters leaving the EU market (e.g. Swazi exports of low quality beef cuts are no longer profitable, while St Kitts is set to stop sugar exports to the EU). In rice, a 50% reduction in the EU's intervention price since 2003 effectively closed off any interest EBA countries might have had for developing countries to produce rice for the EU market.

5 <u>The big change under EPAs is the market access that the ACP will have to offer to EU in order to hit WTO targets.</u>

Studies on the trade effects of EPAs on African economies show that significant trade creation will occur for EU goods, and that Africa's trade with other non-EU partners and even their own intra-regional trade are likely to shrink.[13] Even in a region such as SADC, where the effects of EPAs will be modest compared to the rest of the four African regions in terms of creating or diverting trade flows, the net trade effect of EPAs will be trade expansion, with all the expansion attributed to increased market share for the EU. For example Tanzania will provide significant scope for market expansion for the EU worth of US$88.6 million and 30% of EU's gain will be coming from diverted trade from other countries that arguably are possibly more efficient.[14]

Will EPA support regional integration and boost regional trade?

African countries for example have long considered regional integration an important development strategy. It is both a means to overcome the limitations of small markets and an opportunity to pool resources for infrastructure and major production projects. According to the EC trade liberalisation under EPA will boost regional trade and integration among countries. Evidence points in quite the opposite direction of regional trade shrinking to the benefit of ACP-EU trade. Regional tariff liberalisation has been going on in ACP regions for several years but it is likely that the elimination of tariffs between EU and ACP countries will lead to EU exports becoming more competitive in local markets and pushing out exports from other ACP countries. Impact assessments shows that a reciprocal EPA would diminish intra-regional trade in all four African regions. The effects will be to the detriment of ACP countries' trade balance and their producers but to the benefit of EU exporters.[15]

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[12] Average beef quota utilisation in the period from 2001-2004 was 39.6% the lowest level since the period of the 1980-82 drought in Southern Africa.
[13] "Economic and Welfare Impacts of the EU-Africa Economic Partnership Agreements", ATPC briefing No 6, UNECA and other studies referenced in this paper.
[14] Ibid, p.78
[15] UNECA Regional Integration Study 2006 referenced in Perez (2006) – "Are Economic Partnership Agreements a first-best optimum for the African Caribbean and Pacific Countries?"

- Countries in the East and Southern Africa (ESA) region stand to lose US$ 242 million from decreased intra-regional trade while EU will earn more than US$ 1.1 billion through the increase in their exports to ESA countries.[16]

- In West African (ECOWAS) trade diversion will amount to US$ 365m, of which US$ 35.6 millions will be forgone exports from ECOWAS countries to the rest of the region. Ghana faces the greatest loses in exports of approximately US$23m followed by Nigeria US$4.5m and Burkina Faso US$2.9. EU countries will gain in total more than US$ 1.9 billion of increased exports to ECOWAS.[17]

On country scale the impacts will be significant for most countries. For example imports from the EU to Burkina Faso would increase by about US$ 40m (or 8% of current export levels) while Burkina Faso's exports to other West African countries could experience an overall decline of more than US$ 2 million (or 6% of the country's current exports to the region).

The contraction of intra-regional trade will be 'more pronounced in the sectors that are seen as the bases of industrialization, namely, low- and medium-technology industries; heavy industries; and clothing and textiles…sub-Saharan Africa industrial sectors stand to contract significantly'.[18] Such impacts will curtail opportunities for diversification and moving up the value chain.

- In the case of Rwanda – far from diversifying its production or markets – this LDC will become further entrenched in its dependence upon EU markets and agricultural commodities, its potential to industrialise undermined. Moreover, other countries in the region will also suffer as a result of increased EU imports of industrial goods into Rwanda. Kenya, for example, is attempting to diversify and has been developing light industries producing small electrical equipment as well as car spare parts, but 'this diversification strategy could be hampered by the EPAs reform'.[19]

- Similarly in Ethiopia, African countries' exports to Ethiopia will be displaced by EU exports to Ethiopia under an EPA. Displacement of regional trade in value added goods will undermine the ESA diversification strategy and its efforts to promote ESA member states to move up the value chain. In contrast the EU stands to gain significantly in terms of expanded trade into Ethiopia. For Ethiopia itself, instead of leading the country to deepen regional integration and diversify its output, the EPA will cement a dependency on trading with Europe, as well as the traditional agricultural specialisation of the country.[20]

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[16] Main beneficiaries in Europe would be the United Kingdom with 22% of the additional exports for a sum of 244.7 million dollars from the supplementary exports. Followed by France, Germany, Italy and Belgium these countries could gain more than 72% of the increase in exports to ESA.
[17] Largest gainer would be France with 26% of the additional exports (at just under US$ 500m of increased exports) followed by the UK (17%) and together with Germany, Italy and Belgium they will reap-up more than 80% of the increased exports to ECOWAS.
[18] "Economic and Welfare Impacts of the EU-Africa Economic Partnership Agreements", ATPC briefing No 6, UNECA, page 55-6
[19] "Assessing the Consequences of the Economic Partnership Agreement on the Rwandan economy", ATPC work in progress No 13, UNECA
[20] "Assessing the Consequences of the Economic Partnership Agreement on the Ethiopian economy", ATPC work in progress No 43, UNECA, October 2006

It is only when countries liberalise to one another *without* liberalising to the EU that their regional markets will be built. Eventual liberalisation towards the EU would have to be at the level of no more than 60% of trade; otherwise intra-regional trade – and especially intra-regional trade in the kinds of products that countries would like to diversify into - would be undermined rather than enhanced.[21] Yet the European Commission has made it abundantly clear that it will consider no less than 80% liberalisation on the part of ACP countries.

Real and hidden costs

The Commission has generally downplayed the costs involved in the implementation of EPAs preferring to focus on the supposed benefits. Certainly there are problems in accurately forecasting what those costs will be, as the negotiations are not yet concluded and the final structure of the EPAs is still undecided. However, research to date suggests various costs, some of which substantial, will arise from the implementation of EPAs.

Revenue loss

For governments whose revenue is heavily dependent on import tariffs, the reduction of tariffs on up to 90% of imports from the EU (as the WTO's "substantially all trade" is generally interpreted) represents a substantial loss of public revenue. Customs revenues in Sub-Saharan Africa for example tend to be high, amounting to 27% of public revenues in 1995.[22]

Given that the EU is still the biggest trading partner for most African countries the reliance of these countries on public revenue generated through taxing European imports is very high, therefore the dismantlement of import tariffs under EPAs will result into significant revenue shortfalls for African governments. UNECA study on the revenue implication of EPAs on the four African regions warns that 'revenue forgone is likely to have negative impacts on other government programmes' and that 'if no appropriate measures are put in place to forestall the macroeconomic imbalances that are likely to result form the falling revenues (EPAs) will have the possibility of undermining development objectives of the African countries'.[23]

The hardest hit in terms of revenue loss will inevitably be the larger economies of the regions whose volume of trade with the EU is bigger – such as Kenya, Nigeria, Ghana and Angola – or those countries whose markets have been more protected than others – mainly countries in the Central African region. The revenue loss figures for larger, non-LDC countries are not something that can easily be ignored:

- Nigeria - US$ 427 million
- Ghana - US$ 193 million
- Cameroon – US$ 149 million
- Kenya – US$ 107 million
- Angola – US$ 103 million

Even when countries stand to lose "insignificant" amounts of tax revenue – such as Zambia (US$ 15.8 million), Burundi (US$ 7.6 million), Mozambique (US$ 7.6 million),

[21] UNECA Regional Integration Study 2006 referenced in Perez (2006) – "Are Economic Partnership Agreements a first-best optimum for the African Caribbean and Pacific Countries?"
[22] Romain Perez. Are the Economic Partnership Agreements a First-best Optimum for the African Caribbean Pacific Countries? In The Journal of World Trade 40 (6):999-1019, 2006
[23] "Economic and Welfare Impacts of the EU-Africa Economic Partnership Agreements", ATPC briefing No 6, UNECA, p.63-82

Malawi (US$ 7 million) – this will in any case affect adversely their national budgets and may lead to cuts in public spending in order to keep those budgets in balance.

- Zambia's potential deficit of US$15.8 million in government revenue derive from trade taxes is enough to cover the country's annual spending on HIV/AIDS or to secure the livelihoods of the 8.8 million Zambians, who live on less that US$2 a day.

- Malawi's tax revenue loss of US$ 7 million may not seem extortionate at first glance but it is almost enough to cover the annual US$ 7.3 million budget allocation for pro-poor expenditure on agriculture that funds life-sustaining food security initiatives, agricultural extension and technical services to over 10 million Malawian farmers.[24]

- In Mozambique, the relatively slight reduction (of US$7.6 million) in tariff revenue when coupled with the potential increase in tariff free imports from the EU will inevitably worsen both the current account and the state deficit of the country[25], where national budget is already heavily dependent on external aid (with DFID alone contributing US$ 60,000 of direct budgetary support[26]). To tackle this situation government will have to deepen its tax policy reform further, even though it has been undertaking economic reforms at an accelerated pace for a post-conflict country.

- US$ 7.6 million might not be a dramatic loss figure but for Burundi – a country with a population of 7.2 million - this translates into an extra dollar per head that the government can use on education or basic healthcare.

The revenue implications of EPA are understandably gaining some serious concerns among African countries, especially as these will be hard felt at the mid-point period of governments struggling to achieve the ever-so-elusive Millennium Development Goals (MDGs).

The major challenge will be how to make up for lost revenue through shifting to other forms of taxation. Such shifts will not come at zero cost and there will be significant adjustments costs associated with reforming the tax policy and administration systems. Besides, 10 years provides little time to restructure government revenue collection away from trade based taxes, which will be an essential requirement if major fiscal imbalances or savage cuts in public spending are to be avoided under EPAs.

Adjustment costs

Research by the Commonwealth Secretariat estimates that the overall costs for a minimum level of restructuring adjustment support required by ACP countries is €9.2 billion (at 2005 prices) over 10 years. There is the additional requirement that this support is frontloaded with 60% of the total needed in the first five years, which raises the issue of the timeliness of distribution of this aid.[27] The study identifies four main

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[24] Malawi government, budget figures for 2003/4 www.finance.**malawi**.gov.mw/ppejun04.pdf

[25] Carlos Nuno Castel-Branco, Michael Davenport, Leonardo Iacovone, José Sulemane, 'National Assessment Study of an Economic Partnership Agreement (EPA) between Mozambique and the European Union (EU)', August 2004

[26] In 2005 - see DFID website: http://www.dfid.gov.uk/countries/africa/mozambique.asp

[27] C. Milner 'An assessment of the overall implementation and adjustment costs for the ACP countries of Economic Partnership Agreements with the EU', in Grynberg, R. and A. Clarke (2006) The

areas where ACP countries will need support with adjustment costs. These include costs incurred by fiscal reform, made necessary by loss of government revenue due to removal of tariffs; trade facilitation and export diversification costs; production and employment adjustment programmes; and skills development and productivity enhancement support programmes. Among those, the easies to quantify are the costs associated with revenue loss.

Costs of addressing supply side constraints
Assuming that liberalisation will have two substantial effects on the economies of the ACP countries: the contraction of production in non-competitive sectors and the simultaneous expansion of sectors which hold a comparative advantage, it is important to take into account supply side constraints which may hinder either of these effects, thus working against the stated benefits of trade liberalisation. These constraints may include lack of transport infrastructure, limited access to telecommunications, barriers to entry to markets because of lack of economies of scale, and investment.

A European Analysis Research Paper examining possible supply side constraints concludes that 'liberalisation is not a magic trick to promote development and that it can only work if many other issues are addressed successfully at the same time'[28].

Who will cover these costs?

'There's no new money. Don't hold your breath. There'll be creative accounting but there'll be no new money', Glenys Kinnock, MEP

The EC says that aid to cover the costs of implementing and adjusting to EPAs will come from the 10th EDF. €22.7 billion has been pledged for the 10th EDF. However, before consideration of any EPA related needs, it was estimated that €21.3 billion was need to fund the costs of the existing aid portfolio and maintain EU contributions at 0.38 % GNI. So, if the EDF is to provide new funds for EPAs, it's clearly going to be diverted from other areas such as health and education.[29]

Putting aside problems with the *amount* of aid available, there are massive process problems with the EDF, not least the time it takes to commit and disburse EDF resources. Even if there was more money in the EDF or it was felt justified to divert EDF money away from social spending, the time delay in delivery of aid poses major problems for 'time sensitive' EPA related adjustment costs. For example, EC assessments of time frame required for full deployment of existing 9th EDF resources in Botswana, Lesotho and Swaziland show that it will take between 9 and 17.5 years to disburse existing EDF funds and between 7 and 14.66 years to even sign contracts for the implementation of specific project activities.[30]

On the 16th October the EC announce new policy in this regard, reiterating a commitment to provide €2 billion annually in aid for trade support to developing countries. Half of this is to be new money drawn from EU member states expanding

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European Development Fund and Economic Partnership Agreements, Commonwealth Secretariat Economic Affairs Division
[28] "Putting Liberalisation On The Right Track – The Case of Supply Side Constraints in the EU-ESA Negotiations For An Economic Partnership Agreement", S. Liebig, A.Niemann, E.von Uexkull, F.Vogt, European Analysis Research Paper Series, Number 1, January 2005
[29] Oxfam International (2006) Unequal Partners: How EU-ACP Economic Partnership Agreements (EPAs) could harm the development prospects of many of the world's poorest countries
[30] Section 6 performance Appraisal, Mid Term Review Conclusions, CEC

ODA budgets. Half of it will be drawn from the EDF. It is the part to be drawn from EU member states expanding aid budgets which could potentially contribute to EPA related adjustment initiatives. However the EU is still elaborating how precisely it is to live up to these commitments. It is planned that in 2007 a strategy on the delivery of previously pledged “aid for trade” support will be prepared. For the moment however all ACP countries have is a “definite maybe” on future aid support. The best endeavour nature of these commitments compared to the binding nature of the tariff commitments entered into through an EPA is a matter of major concern to ACP countries and one which could still torpedo the EPA negations.

It remains to be seen whether in the course of 2007 the EU will make binding commitments for the provision of EPA related adjustment support commensurate with the challenges faced. The provision of the necessary funding is possible within existing EU commitments to expanding aid allocations, it simply needs to be formalised in a binding contractual commitment as an integral part of any EPA agreements.

Revenue lost through lowering of tariffs can be replaced by other means of taxation

Experience shows that restructuring government revenue away from trade taxes is a difficult, complex and lengthy process.

- For example – the EC funded a fiscal restructuring programme in Swaziland with the aim of diversifying the tax revenue base and reducing heavy dependence on customs receipts from SACU. In first 4 yrs of implementation: dependence on SACU receipts increased and the creation of a single revenue authority and introduction of a VAT system was running more than 2 years behind schedule).[31]

Recent empirical evidence suggests that low income countries have struggled to recover trade tax revenue lost as a result of trade liberalisation. Only recover 30% has been recovered, nor is there much evidence that the presence of a value-added tax has in itself made it easier to cope with the revenue effects of trade liberalization.[32] So even if the money could be found for restructuring tax systems, which the Commonwealth Secretariat estimates at 3billion or so, it probably wouldn’t even work.

Are EPAs the most effective way to increase ACP trade?

A 2006 study in the Journal of World Trade looks at various models for a new trade agreement and finds that most ACP countries would be better served in terms of overall welfare effects by switching to the Generalized System of Preferences and the Everything But Arms initiative, rather than adopting EPAs. This is shown to be the case even if there is only partial reciprocity in an EPA agreement. Least developed ACP countries would be able to trade with the EU using the existing EBA agreements, whilst the non-LDCs would face European tariffs but would not have to eliminate their own tariffs. Due to the general openness of the European market, this increase in tariffs would be less costly than an EPA.

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[31] Joint Annual Report 2004, Swaziland-European Community, section 4.3
[32] “Tax revenue and or Trade Liberalisation?” , IMF Working Paper 05/112, Baunsgaard and Keen, IMf, 2005