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TRADE LIBERALISATION AND THE DIFFICULT SHIFT TOWARDS RECIPROCITY IN THE EPAS

SYNOPSIS

This Analytical Note is part of a series of Fact Sheets designed to overview and assess the development implications of the Economic Partnership Agreements (EPAs), which the EU is currently negotiating with 76 countries in Africa, the Caribbean and Pacific (ACP). The purpose of these Fact Sheets is to examine the existing material on EPAs and to provide an analysis of their potential impact on ACP countries. The Fact Sheets seek to increase the understanding of the substantive issues at stake in the negotiations, thereby enabling policy-makers, lobbyists and campaigners to make informed decisions about how to engage with EPAs.
This Fact Sheet focuses on the implications of tariff liberalisation under the EPAs, particularly on government revenue, industrial development, and food security.

March 2007
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BACKGROUND

1. The Economic Partnership Agreements (EPAs) currently being negotiated between the European Union (EU) and the African, Caribbean and Pacific (ACP) countries would require ACP governments to liberalise 'substantially all' their trade with the EU. EPAs are, in fact, a turning point in the EU-ACP relationship in that they would entail a shift from unilateral (non-reciprocal) preferences to a reciprocal Free Trade Agreement (FTA) between some of the most developed and some of the poorest countries in the world.

2. While the exact level of liberalisation and the length of the implementation period are still being discussed, this is likely to entail the total elimination of tariffs on about 80% of ACP imports from the EU over a 12-year transition period. The exercise would be unprecedented for ACP countries, all the more so since tariff elimination would cover all goods: both agricultural and fish products, as well as manufactured or processed goods.

3. The EC has argued that this trade liberalisation will benefit ACP countries through increased competition and productivity, reduced prices for consumers, greater investment and economic growth. In contrast, several ACP governments, academics, and civil society are highly sceptical that far-reaching trade liberalisation by ACP countries will result in positive outcomes and have warned against a result that could put at risk the prospects of industrial development and food security in ACP countries.

4. For ACP countries, trade liberalisation raises the following questions of strategic importance:
   (a) What does trade liberalisation entail, and what are the avenues through which it impacts on countries?
   (b) Will an EPA lead to benefits for consumers in ACP countries?
   (c) What impact will an EPA have on domestic producers and what will be its consequences on manufacturing activities and employment?
   (d) What will be the impact of liberalisation on government revenue?
   (e) How will the liberalisation of agricultural and fisheries products impact on food security in poor ACP countries?

I. HOW DOES TRADE LIBERALISATION AFFECT DEVELOPING COUNTRIES?

5. Trade liberalisation entails the elimination of 'cross-border policy barriers' between countries, such as tariffs, quotas and other restrictions on trade. Broadly

speaking, trade liberalisation can impact on a country's development prospects through various channels, including:

6. *Economic Growth:* The theory that supports trade liberalisation posits that the lowering of tariffs gives countries increased access to a wider market, which results in increased economies of scale and competition, thereby encouraging businesses to produce goods more efficiently and cheaply. A larger market also allows better access to cheaper imports and to technology in the form of productive hardware and the transfer of knowledge, practices, information and ideas. However, in practice trade liberalisation has often failed to enhance economic growth and has led to significant de-industrialisation. The linkage between trade liberalisation and growth is a controversial issue that has been keenly contested in the literature on trade (see Box 3.1 Trade Liberalisation and Economic Growth: The Debate)

7. *Households and Markets:* Trade liberalisation impacts on households by affecting price changes on the goods that they consume or on the goods and services that they sell, including the sale of labour for a wage. These price changes occur due to the lowering of trade taxes. If trade liberalisation leads to a reduction in the price of goods or factors where households are net buyers, this will result in an increase in income. For example, if due to the drop in tariffs imports become cheaper then consumers will benefit. However, if the household is a net seller of a commodity that becomes cheaper after liberalisation, income will decrease. The impact of changes in tariffs on poverty is a controversial issue. The impact on the poor differs between sectors and countries; in many cases trade liberalisation has resulted in decreases in consumer prices, but has not led to an expansion of exports and employment.

8. *Policy Space:* Since trade liberalisation entails the elimination of certain policy measures, such as tariffs, they imply that governments must refrain from having recourse to measures which might have been useful in the future. Policy instruments, such as tariffs, subsidies, state trading enterprises, export taxes, investment measures, government procurement, etc., belong to an array of instruments used in the implementation of development strategies. By permanently forbidding access to such instruments, free trade agreements curtail the policy space that governments have to formulate and effectively implement policies to promote trade and development.

9. *Government Revenue and Spending*: Government revenue is generated through a variety of taxes including income tax, consumption tax and trade tax (primarily in the form of tariffs on imports)[1]. As trade liberalisation requires countries to lower their tariffs on imports, this affects the amount of tax that governments are able to raise through trade duties and can result in a loss of government revenue. If the government is unable to mitigate the loss of tariff

[1] Foreign aid is also part of a governments' budget. Some studies disaggregate government revenue based on income generated through taxes and income from foreign aid.

revenue through other means, then this can lead to a cut in government spending.

10. *Food security.* According to the FAO, a situation where (a) per caput food availability is decreasing because of falling domestic production or (b) where it is increasing only because per caput food imports are growing more rapidly may be unsustainable in the longer term without a concomitant rise in export earnings. It has been well documented that, because of the implementation of the WTO Agreement on Agriculture, developing country imports have increased faster than their exports. Moreover, developing country exports continue to be concentrated in products of low value added and subject to large price volatility, which undermines their capacity to generate export earnings. Therefore, it is important for developing countries to increase domestic production and productivity in their agricultural sector, to be able to feed their own population and generate a more stable string of export earnings to complement their food availability needs through imports.

Box 1: Trade Liberalisation and Economic Growth: The Debate.

The prescription repeatedly given to developing countries to encourage economic growth is to liberalise trade. Does the empirical evidence support this position? Cross-country regressions have been frequently used to test whether liberalisation has increased growth. These regressions compare over time the levels of GDP growth in different countries to various measures of trade liberalisation. In a widely cited study, Sachs and Warner (1995) argue that there is a positive correlation between 'open markets' and economic growth. Similarly, Dollar and Kraay (2001) find that the higher the level of a country's exports, the higher its GDP. However, both of these studies have been challenged because of their weak foundations:

- Their measurements of trade liberalisation are unable to isolate changes in tariff policy from other factors of an 'open economy', such as exchange rate policy.
- They fail to establish the precise direction of causality – that is, what their results might be showing is that as countries got richer they began to liberalise their economies, rather than showing that countries which liberalised tended to grew.
- Their results fail to account for 'omitted variables' which may be driving economic growth in countries that successfully liberalised, such as strong domestic institutions and policies designed to promote human capital accumulation, etc.

Moreover, economic history demonstrates that virtually all of today's developed countries, including the Asian Newly Industrialised Countries, have used a mix of selective border protection measures, such as tariffs, in order to promote their industrial capacity.

This does not make the argument for protectionism. There is no evidence that higher tariffs are a priori good for economic growth. However, the range of outcomes associated with past experiences of trade liberalisation suggests that its links to growth are more complex that is often argued.

Source: UNDP (2005) Human Development Report, New York: UNDP; J. Sachs and A. Warner (1995); D. Dollar and A. Kraay (2001a,b); South Centre / OXFAM (2005) Why developing countries need tariffs? By Prof. Ha -Joon Chang.

II. CONSUMER WELFARE EFFECTS OF TRADE LIBERALISATION UNDER THE EPAS: WHAT MODELS SAY

11. Because of the far-reaching implications that trade liberalisation could have for poor countries, some studies have attempted to simulate the consumer welfare effects of EPAs on ACP countries and regions, thereby providing an estimate of the potential magnitude and the possible determinants of gains and losses. These studies concentrate on quantifiable effects, such as direct trade effects and direct government revenues. The direct trade effects consist of two aspects:

(a) Trade Creation which is welfare improving: it represents the increase in welfare enjoyed by consumers (through lower prices and thus higher numbers of consumers accessing the good) following the elimination of tariffs on imported goods; and,

(b) Trade Diversion which is welfare reducing: it occurs when the elimination of tariffs leads to a switch in imports from relatively efficient, low-cost producer in a third party country (i.e. not an ACP country or the EU) in favour of less efficient producers from the EU, which become cheaper only due to the preferential treatment they enjoy.

12. Table 3.1 below summarises a number of key studies which use Computable General Equilibrium models (CGE) and Partial Equilibrium Models (PE) to estimate the potential effects of an EPA[2]. However, the results of such simulations need to be interpreted with caution, as there are a number of limitations to the approach taken in these studies. The modelling gives a good indication of the likely short-term impacts of trade liberalisation and helps governments identify the likely 'winners' and 'losers', but it is limited in several ways:

13. *The modelling framework is essentially static in nature* (i.e. it estimates a one-off effect of a more efficient allocation of resources) and does not effectively incorporate the implications of trade liberalisation on growth and productivity;

14. *The models are heavily dependent on assumptions about the way that production and consumption will respond to liberalisation*, the degree of substitutability of imports, and the nature of competition in markets. For example, all models assume that tariff cuts will automatically translate into a proportionate reduction of prices, while it is likely that some of the cuts will be appropriated by EU producers (see below – Would Consumers Really Benefit from an EPA?).

[2] CGE models simulate the whole world and are more suitable for estimating trade creation and diversion but use a high level of sectoral aggregation and hence lack detail on sectors and many ACP regions. PE models only look at the impact of tariff cuts on trade. They address the welfare effects by comparing trade creation and diversion effects, ignoring the impact of the potential displacement of local producers, or a more efficient reallocation of resources in the economy.

15. *The models lack important details in their scenarios* (such as the prevalence of non-tariff barriers) and tend not to include an option whereby ACP countries are able to exclude part of their trade with the EU from reductions. Moreover, these studies are general and do not inform decision-makers about how specific sectors would be impacted by liberalisation.

16. These caveats, many of which are acknowledged by the modellers themselves, measurably constrain the reliability of these models as a mechanism for assessing the likely impact of trade liberalisation on overall welfare.

17. The range of studies tends to show that for virtually all African countries, EPAs would lead to more trade creation than trade diversion. Welfare effects are mixed. However, tariff revenue losses following EPAs are likely to put government resources under strain.

Table 1: Economic effects of EPAs on ACP regions

Region and source	Trade creation (TC)/ Trade diversion (TD)	Fiscal effects: tariff revenues	Welfare effects	Major gainers and losers
All Sub-Saharan Africa[a]			Negative (EPA with no regional integration) Positive (removal of intra-SSA trade barriers) Positive (unrestricted market access for SSA in the EU)	
West Africa[b]	TC larger than TD	Loss	Positive	Nigeria and Ghana (gainers); Cape Verde and Gabon (losers)
Central Africa [a]	TC larger than TD	Loss	Positive	Cameroon, Gabon and DRC (gainers)
EAC[c]	TC smaller than TD for Tanzania and equal to TD for Uganda	Large losses	Small negative for Tanzania; negligible for Uganda	Tanzania (loser)
COMESA [a]	TC larger than TD	Loss	Positive	Kenya, Mauritius, Sudan and Ethiopia (gainers)

SADC[d]	TC larger than TD	Large losses	Large positive (EPA with regional integration) Small positive (EPA with no regional integration)	South Africa, Zimbabwe and Mauritius (gainers); Zambia, Tanzania, Mozambique, Swaziland (losers)
Caribbean[e]	TC smaller than TD (for simultaneous MFN tariffs cuts <50%) TC larger than TD (for simultaneous MFN tariffs cuts > 50%)	Small losses	Small negative (for simultaneous MFN tariff cuts <20%) Small positive (for simultaneous MFN tariff cuts >20%)	
Pacific[f]	TC larger than TD	Small losses	Small Positive	Papua New Guinea and Fiji (gainers)

Source: ODI (2006) 'The Potential Effects of Economic Partnership Agreements: What Quantitative Models Say', June 2006.
a.) S. Karingi et al (2005c) 'Economic and Welfare Impacts of the EU-African Economic Partnership Agreements', ATPC Work in Progress No. 10, UNECA. September.
b.) M. Busse and H. Großmann (2004) 'The Impact of ACP/EU Economic Partnership Agreements on ECOWAS Countries: An Empirical Analysis of the Trade and Budget Effects', Hamburg Institute of International Economics (HWWA) Discussion Paper No. 294.
c.) C. Milner et al (2005) 'Some Simple Analytics of the Trade and Welfare Effects of Economic Partnership Agreements, Journal of African Economies, 14(3), pp. 327-58
d.) M. Tekere and D. Ndelela (2003) 'Impact Assessment of Economic Partnership Agreements on Southern African Development Community and Preliminary Adjustment Scenarios'. Final Report. Trade and Developments Studies Centre. Harare, Zimbabwe. A. Keck and R. Piermatini (2005) 'The Economic Impact of EPAs in SADC Countries', Staff Working Paper. ERSD-2005-04. WTO. August
e.) D. Evans et al (2006) 'An EU – Caribbean Economic Partnership Agreement: Case Study', in Assessing Regional Trade Agreements with Developing Countries. Final Report to DFID. M. Gasiorek and A. Winters (2004) 'What Role for the EPAs in the Caribbean?', The World Economy pp. 1335-62. D. Greenway and C. Milner (2003) 'A Grim REPA'. University of Nottingham Internationalisation of Economic Policy Research Paper. 2003/30.
f.) V. Roza and S. Szepesi (2003) 'EPA Impact Studies: Perspectives for the Pacific', ECDPM InBrief 2A. Maastricht: ECDPM.

III. WOULD CONSUMERS REALLY BENEFIT FROM AN EPA?

18. The EC has consistently argued that, despite the difficulties of reciprocal trade liberalisation under the EPAs, one of their main benefits would be the provision of a wider variety of cheaper goods and services to consumers in ACP countries. This would occur where the lowering of tariffs on EU imports makes products cheaper for ACP consumers (essentially the benefit derived from 'trade creation').

19. However, it is not necessarily the case that consumers will always benefit from trade liberalisation under an EPA. Consumers may be adversely affected by the impact of 'trade diversion' in which lower cost third party producers are substituted for less efficient EU producers simply because of the granting of preferential treatment to EU exporters into ACP markets. In this scenario, prices stay the same and instead of the consumer benefiting, the removal of trade taxes benefits EU producers through increased exports to the ACP countries. Similarly, the lowering of tariffs in ACP markets might not provide benefits to ACP consumers if EU producers are able to exert monopoly power in order to bid up the price of goods to their previous level before liberalisation[3]. In both of these cases, the revenue from trade taxes, which previously accrued to ACP governments is lost, with EU producers benefiting from increased exports, possibly at above competitive market clearing prices.

20. In order to avoid these negative welfare impacts some commentators have argued that if ACP countries sign an EPA and provide preferential reduction on tariffs on imports from the EU, this needs to be done in conjunction with reductions in their MFN tariff levels[4]. Preferential tariff reductions under EPAs, in the presence of high MFN tariffs, would otherwise lead to costly diversions of trade from low cost (non-EU) to high cost (EU) foreign suppliers.

IV. DOMESTIC PRODUCERS: IMPACT ON FUTURE INDUSTRIAL DEVELOPMENT OF THE ACP

A. Domestic Producers and Liberalisation:

21. How will domestic producers in ACP countries be affected by the removal of tariffs? This is not an easy question, since the level of competitiveness of ACP and EU firms varies tremendously and industries in ACP countries are extremely heterogeneous. However, it is a question of enormous importance for ACP negotiators, because it influences the judgement about the overall benefits of an EPA. Moreover, it is also relevant for the determination of sectors and products which should be deemed sensitive and hence isolated from full tariff liberalisation.

22. Where firms in ACP countries are able to upgrade their quality and adapt rapidly to increased competition and to out-compete EU imports, they could displace EU firms and expand their markets. Moreover, ACP sectors which rely on imported capital goods, e.g. machinery, equipment etc, for their production processes, are likely to benefit if the price of these inputs falls as a result of the

[3] M. Gasiorek and A. Winters (2004) 'What Role for the EPAs in the Caribbean?' The World Economy pp. 1335-62.
[4]See for example, L. Hinkle and M. Schiff (2004) Economic Partnership Agreements between Sub-Saharan Africa and the EU: A Development Perspective', World Economy 27(9) pp. 1321-33.

lowering of tariffs. Increased import competition is also likely to improve the cost-efficiency of producers that did not require border protection (interest groups and mismanagement etc.).

23. Nonetheless, tariff reduction is equally likely to result in ACP producers being out-competed by EU producers and forced to close down, for instance where:

(a) ACP firms are unable to access inputs at a cheaper cost than EU firms (e.g. if electricity supply is erratic or more costly in an ACP country, or they cannot access finance at a reasonable interest rate); or
(b) EU producers are more heavily subsidized than their ACP competitors (as is the case for many EU agricultural producers); or
(c) ACP firms are less able to upgrade production facilities or acquire technology to compete with EU competitors.

24. A key point to note is that in instances where ACP producers are faced with direct competition from EU producers, it is highly unlikely that they will remain profitable. The ability of ACP producers to compete with EU producers is highly constrained by severe supply-side constraints. This problem is particularly acute for the 39 LDC ACP countries. Indeed, the recent UNCTAD LDC Report (2006) identifies 'productive capacity'– that is, productive resources, entrepreneurial skills and production linkages, which the LDCs lack, as vital to a country's ability to engage in tradable goods and services[5]. While, it is the capacity to produce in an internationally competitive manner that matters, the majority of ACP producers are hindered by: the lack of infrastructure (particularly in energy); weak institutions, notably firms, domestic financial systems and domestic knowledge system; and the lack of demand.

25. In assessing the impact of tariff reductions, it is also important to keep in mind that many ACP countries have already undergone substantial trade liberalisation processes in the context of structural adjustment policies. Table 3.2 below shows the simple average applied tariffs in ACP countries[6].

Table 2: Simple tariff averages in ACP countries by EPA Group

EPA Group and country	Simple Tariff Average (%)
Central African Group	
CEMAC[7]	18
Sao Tome and Principe	n/a
West African Group	
WAEMU[8]	12

[5] UNCTAD (2006) LDC Report 'Developing Productive Capacities', Geneva, UNCTAD.
[6] The 'simple average' level of tariffs is the average unweighted by the volume of trade.
[7] CEMAC, Communaute Economique et Monetaire de l'Afrique Centrale, consisting of Cameroon, CAR, Chad, Congo, Gabon, Equatorial Guinea.
[8] WAEMU, West African Economic and Monetary Union, consisting of Benin, Burkina Faso, Cote d'Ivoire, Guinea-Bissau, Mali, Niger, Senegal, Togo.

Cape Verde	n/a
Gambia	12.7
Ghana	13.1
Guinea	6.5
Liberia	n/a
Nigeria	30.0
Sierra Leone	14.9
Mauritania	10.9
ESA Group	
EAC (Kenya, Uganda)	12.3
Burundi	23.4
Comoros	n/a
Djibouti	30.8
DRC	12.0
Eritrea	7.9
Ethiopia	18.8
Madagascar	4.6
Malawi	13.1
Mauritius	18.4
Rwanda	17.4
Seychelles	28.3
Sudan	24.5
Zambia	14.0
Zimbabwe	16.4
SADC Group	
SACU (Botswana, Lesotho, Namibia, Swaziland, RSA)	11.4
Angola	8.8
Mozambique	12.1
Tanzania (also EAC member)	12.3
CARIFORUM	
OECS, Antigua	9.6
Dominica	9.9
Grenada	10.5
St. Kitts and Nevis	9.4
St. Lucia	8.9
St Vincent & the Grenad.	9.8
Bahamas	30.6
Barbados	13.1
Belize	10.5
Guyana	11.0
Haiti	n/a
Jamaica	7.2
Suriname	17.5
Trinidad and Tobago	7.9
Dominican Republic	8.5
Pacific Group	
Cook Islands	n/a
East Timor	n/a
Fiji	7.3
Kiribati	n/a
Marshall Islands	n/a

Micronesia	n/a
Nauru	n/a
Niue	n/a
Palau	n/a
Papua New Guinea	6.0
Samoa	n/a
Solomon Islands	22.2
Tonga	n/a
Tuvalu	n/a
Vanuatu	13.8

Source: L. Hinkle et al (2005) 'Beyond Cotonou: Economic Partnership Agreements in Africa'. In: Trade, Doha, and Development: A window into the issues, R. Newfarmer (ed.) Washington DC: The World Bank.

26. The effective rate of protection for some products is likely to be larger than the average tariff rates suggest because of the existence of peak tariff rates and, in some cases, a total ban on specific imports in ACP countries. Nevertheless, the figures in the above table do show that the levels of applied tariffs vary between ACP countries, and are often lower than is frequently suggested.

B. Industrial Policy – Future Development

27. Beyond the one-off effect of lowering tariffs, an EPA will also affect an ACP country's future development by setting tariffs at a permanently low level: tariff reduction commitments would be 'binding' on ACP countries. It is crucial to highlight that EPAs will have an impact both on a country's present and future prospects. By forbidding access to tariffs, the EPAs curtails the ability of ACP governments to use tariff policy as a means of encouraging production, sheltering industries and nurturing them to move up the 'value-chain', that is, into areas where there is more value-added on the goods that are produced.

28. Although, tariff policy is not the only mechanism available to governments to help industrial development, it can play an important part of a government's policy strategy, particularly in resource-constrained countries where access to other instruments is scarce. ACP countries typically do not apply safeguard measures (and it is not clear whether a safeguard mechanism would be part of the EPAs), do not apply anti-dumping duties, do not have resources to subsidise their production or to support the income of their producers. Tariffs, in contrast, are easy to establish and administer.

29. Other mechanisms include exchange rate policy, tax incentives, subsidies, export taxes, policies to improve infrastructure and human capital accumulation, etc. Nevertheless, access to many of these instruments has already been forbidden by multilateral trade rules or are likely to fall under new restrictions negotiated under the EPAs.

C. The Political Economy of Tariff Reduction Negotiations

30. It is also important to understand the political economy of trade liberalisation in the context of EPAs negotiations. If ACP countries conclude an EPA they will be allowed to exclude a limited amount of their trade with the EU. The internal negotiations in each ACP country about what products to include in national exclusion lists are likely to be very difficult, with governments facing competing policy objectives and having to respond to competing pressure groups. Moreover, since the EPAs are intended to be agreed between the EU and groupings of countries which form customs unions, a similar negotiation has to be repeated at the regional level between the countries in such a group. The process of cherry-picking which products to exclude from liberalisation can have undesirable development implications as countries tend to protect existing sensitive products (status quo), rather than providing spaces for areas which may provide key growth opportunities in the future.

V. ASSESSING THE IMPACT OF EPAS – SECTORAL STUDIES

A. The Problem of Chasing a Moving Target: ACP Exclusion Lists

31. The difficulty with analyzing the impact of EPA negotiations at a sector-specific level is that it is impossible to identify all the sectors that will undergo tariff reductions until ACP countries' exclusions lists have been finalised. Each group of ACP countries has a margin of products that it can fully or partly exempt from liberalisation (likely to consist of around 20% of its trade with the EU). Hence, any analysis that tries to pin down certain sectors and industries that will be affected by an EPA suffers from the problem that the products covered under the exclusions lists have not been selected yet, and are essentially a 'moving target'.

32. Moreover, in addition to the exclusion lists, ACP countries can negotiate an implementation schedule for the gradual elimination of tariffs for different products, leaving the more sensitive products to be liberalised at the end of the implementation period.

B. Liberalisation and Sustainability Impact Assessments (SIAs)

33. In order to examine the impact of tariff liberalisation under an EPA, the EU commissioned a series of Sustainability Impact Assessments (SIAs). The SIAs, which are based on a combination of quantitative (economic modelling) and qualitative (consultations and interviews) research techniques, attempt to assess the development impact on ACP countries of concluding an EPA. An individual

SIA Report exists for each of the six EPA Groupings. The results of these reports are shown in Table 3.3 below.

1. Identifying Sectors unable to Compete

34. Of all the SIAs carried out, only the study on West African Agro-food examines in detail the impact on a sector that is likely to face direct competition from EU producers under liberalisation, resulting in consumers switching from domestically produced goods to EU imports. The Report finds that under full liberalisation the agro-industry in West Africa would be affected by import surges in the potato, onion, beef and poultry sectors[9]. The study takes into account the reduction in the price of inputs such as machinery and packaging (all imported from the EU), but shows that since West African countries already apply low tariffs on these inputs (a 5% applied tariff in the WAEMU), the benefits from full liberalisation are likely to be low.

35. The other SIA Reports tend to concentrate on what the consequences of more liberalised rules on market access into the EU will be, and the potential impact of greater regional integration.

2. Static Assessments: Current Imports and Exports

36. One of the difficulties of impact assessments is that their analysis is largely static: it only looks at the sectors in which ACP economies currently have a domestic production. Thus, it is unable to capture the extent to which reciprocal liberalisation might impact dynamically on future areas of productive activity in ACP economies, by foreclosing these potential areas of value-addition. This dimension is not easily captured as it is difficult to rigorously 'predict' what the possible future growth sectors are in ACP countries, and what might happen to these sectors in the absence of an EPA.

37. Aside from the SIA studies, there is also the problem that some of the literature on EPAs tends to look at sectors that were affected by previous tariff liberalisations under Structural Adjustment Programmes (SAPs) of the 1990s, and then tries to extrapolate on the basis of this, the areas where ACP countries might be affected. Unfortunately, this type of analysis tends to identify sectors that have already been largely affected by liberalisation, and which are only likely to be marginally more affected under an EPA.

[9] Sustainability Impact Assessment of the EU-ACP Economic Partnership Agreements (2005) Phase II, Full Report, 27 July 2005. Section on 'West Africa: Agro Industry'.

Table 3: Sustainability Impact Assessments (SIAs)

Report (EPA Group)	Case Study	Conclusions
SADC Rules of Origin in the SADC Group of Countries	Lesotho – Garments Namibia – Marine Fisheries	Garments: substantial growth but off a small base for Lesotho, Namibia and Swaziland. Botswana greatest absolute growth. Largest gains for knit clothing. Fisheries: large increases in exports of fish from Angola (from low base), small increases of processed fish from Tanzania and Mozambique
Central Africa Financial Services in Central Africa	Central African Financial Sector in the context of an EPA	Imports of Financial Services: Very few trade creation and trade diversion effects. Largely because access to CEMAC financial services market is already free and there are no restrictions on national treatment. Exports of Financial Services: Increase FDI in financial sector; development of banking activities (export credit or insurance) Strengthening of Financial Integration
ESA Horticulture in Eastern and Southern Africa	Horticultural Sector (roses, green beans and peas) in Kenya, Zambia, and Ethiopia	For both LDC and non-LDC ACP countries exports of horticultural products will grow. Producers will also benefit from cheaper horticultural inputs due to tariff liberalisation. Kenya: exports to the EU will continue to grow and horticulture remains competitive. Zambia and Ethiopia: The EPA scenario corresponds to the present scenario in these countries whereby exports are likely to increase under EBA. An SPS protocol could reduce compliance costs; regional integration could develop vegetable exports within the region (e.g. second-grade beans).

West Africa West Africa: Agro-Industry	Fruits and Vegetables (Tropical fruits and vegetables for export - mangoes, pineapples and green beans; Vegetables produced for the regional market - potatoes, onions and tomatoes) Cereals (wheat and wheat products) Meat (beef and poultry) Cotton (cotton yarn and unbleached fabrics)	Under Full Liberalisation: Estimated that there will be import surges in the agro-industry. Imports will increase by 16% for onions, 15% for potatoes, 16% for beef, and 18% for poultry. Wheat not sensitive to price changes in WAEMU countries. Under the EPA Scenario: The SIA study recommends that the following products are included in West Africa's exclusion lists: potatoes, onions, prepared tomatoes and poultry. For Fruits and Vegetables: Liberalisation of EU market will benefit the non-LDCs only. Tariffs exist only for limited mango products and the gains are likely to be very small.
Caribbean Caribbean Region: Tourism Services	Tourism, tourism related services (e.g. construction) and cruise ships	Modes 1 and 2: no changes since the EU regime is already open in this regard. Mode 3: there are few restrictions in the EU regime, but opportunities for Caribbean limited by lack of investment capacity. Mode 4: Potential increase for Caribbean exports to the EU under liberalisation, but there are barriers to this including high costs and the difficulty obtaining visas, etc. On the basis of the above, simulations for Jamaica and Trinidad & Tobago show marginal increases in production in tourism and related sectors, and increases in FDI flows. Positive Regional Integration Effects.
Pacific Pacific Region: Fisheries	Pacific fisheries, with a particular emphasis on tuna fishery, as it is the most important sector for the region (along with tourism).	Insignificant Impact on trade flow. PACP countries already have free access to the EU market for all fish and fish products; an EPA will not change the status quo with respect to their ability to continue exporting to the EU. EU access to PACP markets is limited as fish products are among the most heavily protected goods. This is mainly to protect internal markets from powerful neighbouring countries such as Australia and New Zealand. The report recommends that fish products be included in PACP list of 'sensitive products'.

Source: The full SIA reports can be accessed at http://www.sia-acp.org/acp/uk/news.php

VI. GOVERNMENT REVENUE LOSSES AND THEIR IMPACT ON SPENDING

38. In addition to the difficulties relating to increased imports from the EU and the elimination of tariffs which could have been used to promote future industries, ACP countries will have to face an additional, more immediate challenge as a consequence of the EPAs. The lowering of tariffs collected on EU imports is indeed likely to result in significant losses in government revenue.

39. The impact of an EPA will be considerable for two reasons. Firstly, ACP governments are heavily dependent on import taxes as a source of money for their budgets. This dependence is partly because import taxes are relatively cost efficient and easy to administer, and in many ACP countries the formal private sector is small[10]. The share of tariffs as a total of tax collected can be as high as 53% as reported in Table 3.4 below.

Table 4: Import duties as a share of Total Tax Revenue 2001[11]

Country	Share (%)
Burundi	16.4%
Cameroon	31.6%
Congo D.R.	33.7%
Congo R.	23.2%
Cote d'Ivoire	27.6%
Ethiopia	26.3%
Guinea	42.9%
Madagascar	53.5%
Mauritius	29.3%
Papua New Guinea	24.2%
Sierra Leone	49.8%
Swaziland	54.7%
Uganda	50.3%

Source: Table 5.6 of the *World Development Indicators*, 2003, World Bank, p.281.

40. A World Bank study estimates that for countries in sub-Saharan Africa, tariff revenues account for on average 7-10% of government revenue[12]. At the highest end of the scale, nearly 34% of Gambia's government budget comes from import duties, while in Senegal and Togo the figure is over 17%[13].

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[10] In general, the use of income tax is also a difficult means for collecting government revenue because a large proportion of economic activity in ACP countries is carried out in the informal sector.

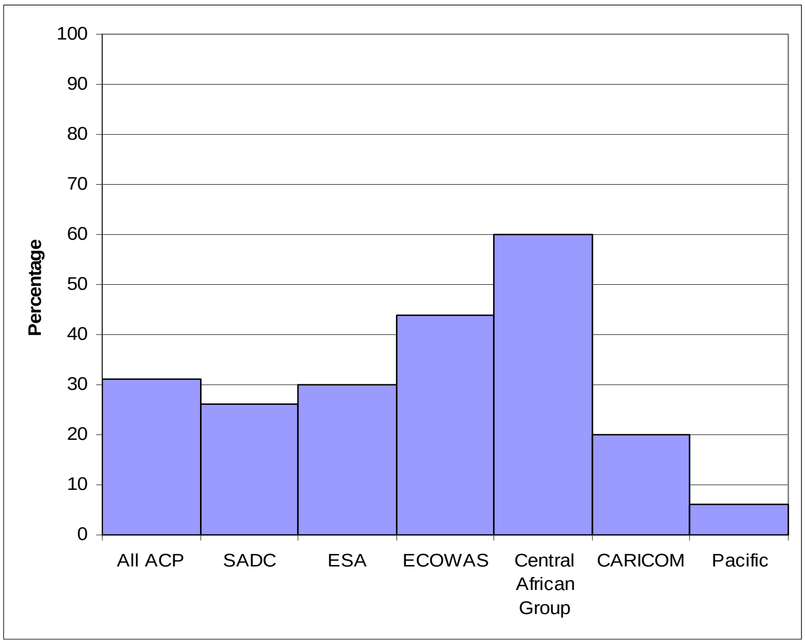
[11] Import duties comprise all levies collected on imported goods at the point of entry into the country.

[12] L. Hinkle et al (2005) Beyond Cotonou: Economic Partnership Agreements in Africa. In: Trade, Doha, and Development: A window into the issues, Newfarmer, R. Washington DC: The World Bank: pp. 267-280.

[13] M. Busse and H. Großmann (2004) p.13.

41. Secondly, an EPA will have a significant impact because the vast majority of ACP imports, and hence import taxes, come from the EU. Diagram 3.1 below shows the share of total ACP imports from the EU. For countries in Central and West Africa over 40% of all their imports come from the EU. In Cape Verde 74.3% of all imports come from the EU, and in Gambia 61.8%[14].

Diagram 1: ACP Imports from EU as a share of total ACP Imports (2004)



Source: 2004 COMTRADE data, available at www.trademap.org
Note: The diagram is based on all imports, except oil.

A. Estimating Government Revenue Losses

42. Various studies have attempted to estimate the impact of an EPA on government revenue using current levels of applied tariffs to calculate the impact of a fully-phased in liberalisation of all imports from the EU[15]. Most studies have focused on specific EPA negotiating groups in Africa[16]. The results of these

[14] *Ibid*, p.14
[15] These studies use partial equilibrium models to estimate tariff revenue losses. M. Busse and H. Großmann (2004); P. Khandelwal (2004) 'COMESA and SADC: Prospects and Challenges for Regional Trade Integration', WP/04/227, International Monetary Fund, Washington, DC.; Karingi et al. UNECA (2005a) 'EU-SADC Economic Partnership Agreement: A Regional Perspective', African Trade and Policy Centre (ATPC) Work in Progress No. 28; Karingi et al. UNECA (2005b) 'Assessment of the Impact of the Economic Partnership Agreement between the ECOWAS Countries and the European Union', African Trade and Policy Centre (ATPC) Work in Progress No. 29.
[16] Further research needs to be done to explore the tariff revenue losses in the Caribbean and the Pacific. The impact of an EPA on revenue is likely to be less in these regions given that imports from the EU account for less than 20% of all Caribbean imports and less than 10% in the case of the Pacific. Karingi et al. UNECA (2005a) suggest that the impact of EPA on countries in SACU is not likely to result in significant losses in tariff revenue, due to the tariff revenue sharing formula which operates in the customs union. The revenue effects in Lesotho

studies are shown below in Table 3.5 below and concern 'worst case scenarios' figures, that is, liberalisation of 100% of ACP imports from the EU. As can be seen, both Gambia and Cape Verde would lose nearly 20% of their government revenue. This is equivalent to over 3.5% of their GDP. Similarly, Ghana and Senegal are estimated to face a decline in government revenue between 10-11% of GDP.

Table 5: Estimated Tariff Revenue Losses for African Countries

	Absolute Loss	GDP %	Expenditure %
ECOWAS[17]			
Benin	27.6 - 39.5	1.2	6.7 - 8.6
Burkina Faso	17.5 - 22.0	0.7	5.6 - 6.1
Cape Verde	24.0	4.1	9.8
Côte d'Ivoire	82.9 - 112.2	0.8	4.6 - 5.6
The Gambia	13.8	3.5	21.9
Ghana	90.8 - 193.7	1.8	10.3 - 19.2
Guinea	16.7	0.6	4.9
Guinea-Bissau	2.2 - 7.2	1.1	5.6 - 19.4
Liberia	-	-	-
Mali	16.6 - 33.1	0.6	3.8 - 4.5
Mauritania	11.8 - 14.6	1.2	6.3 - 7.1
Niger	6.6 - 20.5	0.3	3.6 - 7.6
Nigeria	426.9 - 487.8	1.2	2.3 - 2.5
Senegal	80.2 - 87.9	1.9	6.0 - 10.7
Sierra Leone	-	-	-
Togo	12.9 - 35.5	1.0	7.4 - 12.5
ESA[18]			
Burundi	-	1.6	6.9
Comoros	-	1.6	6.3
Djibouti	-	-	-
DRC	-	-	-
Eritrea	-	-	-
Ethiopia	-	-	-
Kenya	-	0.6	7.7
Madagascar	-	0.2	1.9
Malawi	-	-	3.3
Mauritius	-	1.8	11.8
Rwanda	-	0.8	10.2
Seychelles	-	-	-
Uganda	-	0.2	0.7
Zambia	-	0.5	4.0
Zimbabwe	-	-	
CEMAC[19]			

and Swaziland would be US$256,314 and US$811,140 respectively. In Botswana it is US$5.2million and Namibia US$3.8 million.

[17] UNECA (2005b) No. 29 and Busse et al. (2004). M. Busse et al (2004) is the only study examined in this paper which takes into account collection rates.

[18] Khandelwal (2004)

[19] UNECA (2005a) No. 28.

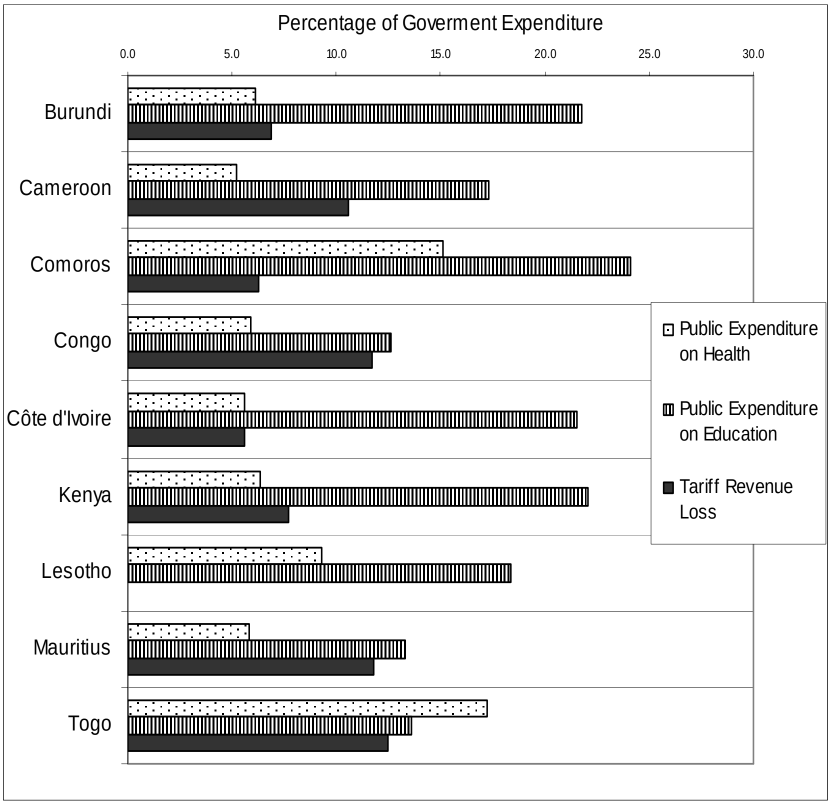
Cameroon	-	-	10.6
CAR	-	-	
Chad	-	-	13.6
Congo	-	-	11.7
Gabon	-	-	-
Equatorial Guinea	-	-	-
Sao Tome and Principe	-	-	-
SADC[20]			
Angola	103.2	0.6	2.4
Botswana	5.2	0.1	0.2
Lesotho	0.2	0.0	0.1
Mozambique	7.6	0.2	1.5
Namibia	3.8	0.2	0.5
Swaziland	0.8	0.1	0.4
Tanzania	32.5	0.3	2.3

B. The Potential Impact on Government Spending

43. If ACP countries are unable to mitigate the losses of trade taxes by raising revenue in other ways, they may be forced to cut government expenditure on essential public services. Diagram 3.2 below shows that even seemingly low losses, may represent important items of government expenditure. For instance, for Burundi, Cameroon, Congo, Kenya and Mauritius the loss in tariff revenue, could be greater than their entire spending on health. In Congo, Mauritius and Togo, the drop in their government revenue from trade liberalisation under an EPA is nearly equivalent to their government expenditure on education.

Diagram 2: Tariff Revenue Loss compared to Government Expenditure on Education and Health

[20] UNECA (2005a) No. 28



Source: Data on tariff revenue loss from UNECA (2005a), UNECA (2005b) and Khandelwal (2004). Data on public expenditure on education sourced from UNDP Human Development Report (2005), figures are for the period 2000-2002. Data on public expenditure on health from UNDP Human Development Report (2003, 2005) – figures are calculated on the average expenditure over the period 2000-2002.

C. How to Mitigate expected losses of fiscal revenue

44. The results presented above are 'worst case scenario' figures, which means the actual tariff revenue losses ACP countries are likely to face will be less or that the losses would be phased in over several years, and not happen at once. However, the fiscal impact of EPAs is likely to be very substantial, and ACP governments will need to find ways to minimise or offset their losses:

45. *Exclusion Lists.* The loss in government revenue could be limited if ACP countries exclude from liberalisation those imports from the EU that yield the most tariff revenue. ACP countries would then have to juggle the products to be included in their exclusion lists between those they want to protect for domestic competition reasons and for tariff revenue reasons.

46. *Improve Collection Efficiency and Tax Administration*. Countries could lessen the impact of reduced tariff rates by improving their tariff administration and

collection rates[21]. Collection rates are generally low in ACP countries. Busse et al. (2004) find that on average tariff collection rates are 70% or less of potential tariff revenues for West Africa. In Ghana, Guinea-Bissau and Mali collections rates are below 35%. Hence there is room for improvement, but fiscal reforms are lengthy and complex to implement and enforce.

47. *Broaden the Tax Base.* The EC has consistently argued that ACP countries ought to switch from trade taxes to levying a Value-Added-Tax (VAT) in order to broaden their tax base. While VAT has the advantage of being non-distortionary, as a consumption tax it tends to be regressive – that is it hurts the poorest the most because most of their income is used to buy food items. There are also likely to be significant costs associated with changing tax systems. Income and consumption tax are timely to administer, human capital demanding and require complex legal systems, whereas trade taxes are relatively simple and cost-efficient. Moreover, some ACP countries already have VAT systems in place

48. *Offset Tariff Revenue Losses with Aid.* The EC has also suggested that although ACP countries will face tariff revenue losses, these can be offset by increased assistance through the European Development Fund (EDF) which will be used to help ACP restructuring and adjustment costs. The feasibility of this is dependent on whether in fact there will be any additional financial assistance for EPAs. Nevertheless, this is not an ideal solution because aid and technical assistance tend to be conditional and are not certain.

49. Though there is a well-established body of theory and policy advice on how to develop alternative sources of government revenue, revenue recovery in low-income countries from past episodes of trade liberalisation has been particularly weak. For each $1 of trade tax revenue low-income countries have lost from liberalisation, they have recovered no more than 30c at best[22]. Baunsgaard and Keen (2004) conclude that there is not much evidence that the presence of a value-added tax has in itself made it easier to cope with the revenue effects of trade liberalisation. Nevertheless, the EC has consistently argued that the switch to indirect tax systems is necessary in the long term to modernise revenue systems, and that all countries desiring to integrate into the world trading system will need to accomplish this sooner or later.

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[21] D. Greenway and C. Milner (1991) find evidence to suggest that Mauritius, Kenya and Jamaica were able to enhance their government revenue while instituting previous trade liberalisation policies due to improvements in their tariff administration and collection efficiency. D. Greenway and C. Milner (1991) 'Fiscal Dependence on Trade Taxes and Trade Policy Reform', *Journal of Development Studies* 27 (April): 95-132.

[22] Results based on panel data for 111 countries over the period 1975-2000. see T. Baunsgaard and M. Keen (2004) 'Tax Revenue and (or?) Trade Liberalisation', *IMF Working Paper*, WP/05/112.

VII. FOOD SECURITY

50. Long-term trends in food security and poverty indicators have generally been positive for the developing countries as a whole. However, improvements have been slow and highly divergent across countries and regions. In particular, the ACP countries have not participated fully in the progress achieved. ACP states in general depend relatively highly on trade for their food security.

51. The major challenges, which are expected to arise from tariff liberalization from the perspective of food security relate to: the effective creation of regional customs unions and the adoption of common external tariffs, the improvement of competitiveness of the ACP agriculture systems and, liberalization of trade in agricultural and food products imported from Europe.

52. In some ACP regions, products imported from the European Union currently compete with local production, in a context of unequal productivities and rules given EU subsidies. In the case of West Africa, imported products currently compete with 70% of locally produced goods (e.g. cereals, milk, and vegetables).

53. For communities depending on such goods, further liberalization could entail a potential increase of import surges, thus threatening their livelihood security. For these countries, this could mean increased dependence on food imports, changes in consumption and dietary preferences, potential weakening of existent agriculture regional complementarities and reduced attraction of aid and financial resources for investment in the rural sector in the region.

54. Although EPA negotiations are well advanced, there is still much to negotiate on agriculture and food security within EPAs and the WTO. It is important that the policy changes incorporated into EPAs support their livelihoods, for example by facilitating trade for which poor people can benefit as producers or consumers. According to FAO[23], regional integration schemes can foster pro-poor food security policies, through trade facilitation, the harmonization of national agricultural policies and support to national Special Programs for Food Security.

CONCLUSION

55. Despite the fact that tariff reductions are at the core of any FTA, ACP countries face significant challenges in the negotiation of an EPA with the EU. Negotiators will need to take into account the difficult move towards reciprocity with the EU and the consequences that full liberalisation will have for the viability of domestic producers, for the promotion of manufacturing activities in

[23] FAO (2006). The Agricultural Dimension of the ACP-EU Economic Partnership Agreements. Rome.

the future, for the collection of revenue to support governmental action and for the protection of food security.

56. Unfortunately, it is extremely difficult, if not impossible, to predict with certainty and precision the overall effect of liberalisation. Moreover, ACP negotiators negotiate in a vacuum, since they lack knowledge about the possible sectoral effects of the EPAs on national producers. And participation of private sector representatives in the EPA negotiations is far from being effective and well informed. Negotiators also lack, furthermore, capacity to identify, prospectively, sectors that might need selective tariff protection in the future. As a matter of fact, few ACP countries have a well-defined development framework, from which negotiating positions may be derived. Short of a definition of national and regional development priorities, ACP negotiators can at best react to EC proposals, undermining their leverage to negotiate a real pro-developmental FTA with the EU.

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