

**Risks and Rewards of Regional Trading Arrangements in  
Africa: Economic Partnership Agreements (EPAs)  
Between the EU and SSA**

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## *Summary*

To replace the Cotonou trade preferences, which are scheduled to be phased out in 2008, the EU and ACP countries are negotiating Economic Partnership Agreements. Conceptualized as vehicles to promote development while bringing EU-ACP trade relations into compliance with WTO rules, the EPAs in Africa would have as their centerpieces negotiated reciprocal preferential trading arrangements between four regional trading blocks and the EU. The EPAs are envisaged to include mutual access to each others' markets, liberalization of trade in services, a regulatory agenda to promote investment and competition, and institutional provisions to facilitate trade as well as related technical and financial assistance for trade and development. The EPAs could, if designed and implemented in their most development-friendly form, have a profound positive impact on trade – and incomes -- in African countries. If the EPAs provide enhanced market access to the EU, tear down external and intra-regional trade barriers in the regional EPA groupings, and reduce institutional frictions to trade, the development gains could be great.

Realizing the potential of this substantial development stimulus, however, requires surmounting some important obstacles in the fundamental design of EPAs. This paper analyzes those associated with expanding merchandise trade, including:

- *Creating incentives for trade reform.* Many African countries are reluctant to undertake needed trade-related reforms. It is unclear whether the incentives in the current EPA design are sufficient to stimulate the required trade reforms. The enticement of improved and more stable access to the EU market is weak for the 33 LDCs in SSA because they already enjoy secure duty-free and quota-free access through the EU's Everything But Arms Initiative, and so their incentive to offer reciprocal concessions is low. For their part, the 13 non-LDCs in SSA will benefit in any case from preferential access under the EU's GSP system, although the GSP preferences are not as attractive as those under the Cotonou preferences and annual

reviews subject the GSP regime to protectionist forces and periodic product revocation. Whether offering the 13 non-LDCs complete tariff-free and quota-free market access in the EPAs plus the added security of a formal trade agreement will be sufficient inducement to elicit reforms remains to be seen. If the EU were to offer much less restrictive rules of origin for the EPAs than those under the GSP or Cotonou regimes as well as a more ambitious program of “aid for trade”, it might tip the incentives favorably. Reductions in export subsidies and domestic production support for agricultural products of particular interest to SSA – perhaps as part of a reformulated Doha position -- could also help to increase the incentive for trade reforms.

- *Reducing high tariffs and other border protections that would impose inefficiencies through trade diversion and monopoly pricing in EPA groupings.* Many SSA countries and some customs unions still have high tariffs and other restrictions on trade. Granting preferential access to the EU while maintaining high MFN tariffs is likely both to displace more efficient sources of supply and to induce losses in tariff revenues that result in trade and income losses rather than gains for SSA countries. EPAs that ratified and consolidated high levels of protection in SSA would entail severe risks and would likely be counterproductive. These risks could be attenuated if the preferential margin granted to EU imports is limited to no more than 5% and maximum MFN tariff rates are lowered to 15% at the same time as tariffs on imports from the EU are reduced.
- *Offsetting revenue losses resulting from lowering tariffs on imports from the EU to avoid undermining public finance in the SSA countries.* Many countries within EPA groups derive 10-30% of their revenues from import tariffs. Since the EU is a major source of these imports, granting it duty-free access would significantly reduce the revenue base of government. This loss could be offset through a combination of value-added and excise taxes collected at the border and domestically, but the required restructuring of indirect tax systems and related improvements in tax administration require institutional changes that will take time. In addition, to provide for necessary growth in public revenues some countries may need to maintain a revenue tariff of 5-10% on imports from the EU.

- *Reducing intra-regional barriers to trade in existing customs unions and FTAs.* All regional trade arrangements in Africa, save for SACU, have internal barriers to trade such as restrictive rules of origin and other controls that impede trade and protect existing industries. Although the interests behind these barriers will constitute formidable political voices against internal liberalization, achieving the regional integration objectives of the EPAs will require SSA countries to remove current barriers to intra-regional trade.
- *Reconciling common external tariff proposals with diverse levels of regional integration.* EPAs in their initial conception were envisaged to be agreements between the EU and customs unions that have the common external tariffs. However, the EPA country groupings in Africa exhibit considerable variation in degrees of integration; and few, if any, are capable in the medium term of reducing internal border barriers or in coordinating their trade regimes to the extent required in a full customs union. This diversity suggests that ultimate designs of the various different EPAs will have to permit flexible combinations of customs unions and free trade agreements.
- *Allowing for enough flexibility to accommodate differing conditions among countries within each EPA grouping.* The four EPA groupings of countries all comprise some LDCs along with non-LDCs. EPA groups also comprise small countries along side one or two dominant large countries. Commitment to trade reform, both in terms of external and intra-regional liberalization, also differs substantially. Accommodating these diverse interests may require enough flexibility in program design to allow for some differences in the trade regimes in the same EPA, at least in initial phases.

There are many obstacles to expanding production of tradable goods in Africa in addition to the trade-related reforms noted above, and the readiness of individual countries to use the EPA process to leverage a wide range of reforms will be critical in determining their success.

The investment and supply responses to the EPAs reforms will be much greater if they are followed by actions in other areas. Particularly important are (a) a competitive exchange rate policy that encourages the expansion and diversification of exports; (b) liberalization of services imports and related regulatory reforms in the services sector; (c) institutional reforms in customs administration and other areas of trade facilitation; (d) improvements in the investment climate

to encourage a supply response from the private sector; and (e) infrastructure investment. From the perspective of individual countries, some of the foregoing reforms may, in fact, be higher priorities than the EPA-related trade reforms. It may be possible to address some of these supply-side and behind-the-border reforms (investment, competition policy, trade facilitation) by including trade in services and some of the Singapore issues in the EPA process, and this possibility merits serious examination.<sup>1</sup> However, others reforms may have to be tackled unilaterally by the countries concerned if they are to benefit fully from the EPA process.

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<sup>1</sup> The potential role of trade in services, investment, and competition in EPAs will be examined in a subsequent paper.

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# **Risks and Rewards of Regional Trading Arrangements in Africa: Economic Partnership Agreements (EPAs) Between the EU and SSA**

## **1. Introduction: A Development Perspective on EPAs**

The Cotonou Agreement, signed in June 2000 between the EU and the African, Caribbean, and Pacific (ACP) countries, provides for negotiation of Economic Partnership Agreements (EPAs) between them. The negotiations are to be completed by December 2007, the EPAs are to go into effect in January 2008, and their implementation is to be phased in gradually over the subsequent 10 to 12 year period. The planned EPAs are intended to reformulate trade preferences accorded to the ACP countries under the Cotonou Agreement and the previous Lome Conventions to make them more effective in promoting ACP-EU trade, more supportive of broader development goals, and more compatible with World Trade Organization (WTO) rules. EPAs are also supposed to help coordinate the EU's trade relations with the ACP countries with its technical and financial development assistance to them.

The EU has repeatedly emphasized its desire to use the EPAs as instruments of development. The EPAs are expected to support economic development in the ACP countries by establishing free trade agreements with them and by strengthening the regional trade blocs among them, as well as through better coordination with the EU's technical and financial cooperation programs. Although the EPAs offer considerable potential benefits for sub-Saharan African (SSA) countries, implementing free trade with the EU will, as discussed in subsequent sections of this paper, pose a number of policy and administrative challenges for SSA countries, including among others: replacing forgone tariff revenues, avoiding serious costly trade distortions, and liberalizing

internal trade within SSA's regional economic communities (RECs).<sup>2</sup> Another reason to think long and hard about the development impact of the EPAs is that they may very well set the pattern for future trade relations between SSA and other industrial and middle income countries.

### *Objective and Organization of this Paper*

This paper examines the planned EPAs between SSA and the EU from a *development perspective*.<sup>3</sup> It assumes that both the EPA process and the Regional Economic Communities (RECs) in SSA are political-historical realities. Although EPAs and the current regional trade areas in SSA may not be the best arrangements from an economic point of view, there are strong political forces supporting their continuation; and the EPA process, although controversial, has already gathered substantial momentum in both the EU and SSA. The analytical problem is thus posed as one of maximizing the long term development impact of EPAs and the RECs in SSA.

This paper seeks to clarify some of the issues being considered by the EU and SSA countries and to suggest changes needed to make EPAs internally consistent and development friendly. The paper focuses primarily on issues related to the treatment of trade in goods (merchandise) in EPAs. The implications of including trade in services and the "Singapore issues" – investment, competition, trade facilitation, and procurement – in the EPAs will be considered in a related paper currently under preparation.

The remainder of the paper is organized as follows. Section 2 gives a brief overview of trade between the EU and SSA. Section 3 reviews the status of the EPA negotiation process and identifies many of the issues that are considered subsequently. Section 4 examines the

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<sup>2</sup> Regional Economic Community is a general term used in SSA to describe regional customs unions, free trade areas, and other preferential trade areas. In other contexts, the term regional trade areas (RTAs) is applied to the same types of organizations. The two terms are used interchangeably here.

<sup>3</sup> The terms "pro-development" and "development friendly" are used in this paper to refer to policies that will accelerate growth and trade integration in Africa.

geographical-organizational aspects of trade EPAs with SSA's heterogeneous customs unions and FTAs and the measures needed to promote intra-SSA trade. Section 5 deals with SSA's access to the EU market, the European Union's EBA initiative, and the relationship between the EPA negotiations and the WTO's Doha Round. Section 6 discusses the EU's access to SSA markets, the reductions of SSA tariffs on merchandise imports from the EU under the EPAs, and the complementary domestic reforms that would be required in SSA. And Section 8 examines the conditions for the EPAs to benefit SSA and accelerate its integration into the global economy and concludes.

## **2. The Empirical Context: An Overview of Africa's Trade with the EU**

Trade is quite important for most of the countries in sub-Saharan Africa (SSA), with total exports and imports of goods and non-factor services accounting, respectively, for 29% and 34% of GDP on average.<sup>4</sup> Partly for historical reasons, the EU is Sub-Saharan Africa's (SSA) largest single trading partner, buying an average 31% of SSA's merchandise exports and providing 40% of its merchandise imports. The trade relationship between SSA and the EU is thus important for the region's development, and proposed free trade agreements (FTAs) under the planned Economic Partnership Agreements between the EU and SSA could have a significant impact in most of SSA.

In the average SSA country, merchandise exports accounted for 24% of GDP in 2001, 31% of which were sold to the EU. Despite the trade preferences accorded to SSA under the Lome and Cotonou Agreements, SSA's share of the EU market for its exports has declined in parallel with the decline in its share of world exports. The share of the SSA EPA countries' exports in the EU

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<sup>4</sup> The averages cited in this section are population-weighted means unless otherwise noted. Figures for the EU are for the EU 15 before the EU's recent enlargement.

market has fallen steadily from 3% in 1985 to 0.9% in 2003, a reflection of competitiveness problems and supply constraints as well as restrictive rules of origin under the Lome Conventions and the Cotonou Agreement and declining real prices of some primary commodities. Inclusion of South Africa, SSA's largest economy and exporter, which has a separate free trade agreement with the EU and is not eligible for an EPA, raises SSA's share of the EU export market by 0.5% but does not alter the declining trend. There is also significant variation from the average in the EPA countries: 18 SSA countries sold between 50% and 80% of their merchandise exports to the EU, while the EU accounted for less than 15% of the exports in 4 countries. SSA's exports to the EU are heavily concentrated in petroleum and primary products, and there has been little diversification of SSA merchandise exports to the EU under the Lome and Cotonou Agreements. In the average SSA country, exports of non-factor services were about 1/5 the level of merchandise exports, accounting for an additional 5% of GDP; but no data were available on the share of SSA's non-factor service exports going to the EU.

Similarly, merchandise imports amounted to 24% of GDP in the average SSA country in 2001, with 40% of these being purchased from the EU. Five countries obtained 50% or more of their merchandise imports from the EU, headed by Gabon at 78%, while 4 countries obtained less than 20% of their merchandise imports from the EU. Merchandise imports from the EU are composed primarily of manufactures, machinery, and equipment, although agricultural products are important in a few cases. Imports of non-factor services amounted to an additional 10% of GDP in the average SSA country; but, as with exports of non-factor services, no data were available on the share of imports of non-factor services coming from the EU.

In contrast, trade between Africa and the EU is much less important for the EU than it is for Africa because the EU's economy is much larger than the economies of the SSA countries. Africa accounts for only 1.4% of the EU's total merchandise exports and 1.7% of its merchandise imports.

Thus, the impact on the EU of free trade arrangements with Africa is likely to be quite limited and much easier for the EU to adjust to than for Africa. The differences in economic size and the relative importance of EU-SSA trade to the two sides would give the EU a much stronger bargaining position than SSA if the negotiations were conducted strictly on commercial terms.

Intra-regional trade within SSA is also limited, amounting to only about 12% of the average SSA country's merchandise exports and 7% of its merchandise imports. Intra-SSA trade is particularly important for landlocked SSA countries and for a handful of coastal countries (such as South Africa, Nigeria, Cote d'Ivoire, and Kenya) that have some manufacturing capacity.

Import tariffs are still an important source of revenue in many SSA countries, and free trade arrangements with the EU could have significant fiscal implications for some countries. Import tariff revenues amount to about 2% of GDP and 15% of government revenues in the median SSA country. However, in the one-third of the SSA countries which are most dependent on tariff revenues, import tariffs amount 3% to 6% of GDP and account for 25% or more of government revenues (see Hinkle, Herrou-Aragon, and Kubota 2003 for an analysis of tariffs in SSA). For any of these latter countries which obtain a third or more of their imports from the EU, free trade arrangements with the EU could lead to revenue losses of 1-2% of GDP.

### **3. EPAs as Envisaged by the Cotonou Agreement and Phase I of the EPA Negotiations**

Starting in the 1970s, the EU provided unilateral preferential access to its market to Sub-Saharan Africa and other ACP countries under the Lomé Conventions (I through IV), and the Cotonou Agreement (June 2000) provides for a continuation of this preferential access until 2008. Under the Cotonou preferences, all imports of manufactured goods from the ACP countries enter

the EU duty-free but are still restricted by what are fairly demanding rules of origin for small low income economies. Many ACP agricultural products also enter the EU duty-free except for 990 tariff lines covering agricultural and processed agricultural products produced in the EU, which are granted only small tariff preferences. The most valuable preferences for SSA have been those extended to a few traditional primary exports – sugar, meat, and fish – some of which are governed by separate commodity protocols.

To bring the EU's trade relations with the ACP countries into line with its GATT/WTO commitments, among other reasons, the Cotonou Agreement also provides for replacing the unilateral trade preferences that it currently accords to the ACP with economic partnership agreements involving reciprocal obligations. According to the Cotonou Agreement's timetable, the EPA negotiations are to be completed by December 2007, and the EPAs are to come into force as of January 2008, although these deadlines could be modified by mutual agreement. EPA negotiations were launched at the all-ACP level in September of 2002.

### *Objectives of the EPA Process*

The EPA process has four important objectives: (a) replacement of unilateral preferences with reciprocal free trade arrangements in order to make the EPAs WTO-compatible; (b) differentiation in the treatment of LDCs and non-LDCs; (c) regional integration; and (d) coordination of aid and trade.

*Reciprocal free trade arrangements and WTO compatibility.* In order to make EU-ACP trade relations compatible with WTO rules, the Cotonou Agreement provides for replacing the existing relationship of unilateral preferential access by ACP countries to EU markets with *reciprocal* free trade agreements between the EU and the SSA countries. That is, not only will the

EU provide tariff-free access to its markets for ACP exports, but ACP countries are expected to provide tariff-free access to their own markets for EU exports.

The WTO-compatibility problem arises because the EU's special unilateral preferences for the ACP countries under the Cotonou Agreement, like those under the preceding Lome Conventions, are inconsistent with WTO's "enabling clause". This clause permits industrial countries to give unilateral preferential treatment to only two groups of countries: to LDCs or to all developing countries. Because the Cotonou preferences, like the earlier Lome ones, are not part of the EU's general system of preferences (GSP), they do not conform to GATT rules. Hence, the EU needed to obtain waivers from the WTO, first for the Lome Convention in 1994 and then for the Cotonou Agreement at Doha in 2001.

Even with the waivers, some aspects of the Cotonou regime are vulnerable to disputes in the WTO. The EU's commodity protocol governing preferential trade in bananas with the ACP countries has already been successfully challenged in the WTO. Recently, the EU's sugar protocol has similarly been challenged. The Cotonou Agreement also notes that the commodity protocols with the ACP countries will need to be reviewed in the context of the EPAs.

The EPAs, like other free trade agreements between developed and developing countries, are governed by WTO's Article xxiv rather than by its enabling clause, which applies to unilateral preferences and preferential agreements between developing countries.<sup>5</sup> Article xxiv requires that the countries entering into a reciprocal free trade agreement liberalize "substantially all trade" within a "reasonable length of time", without distinguishing between developed and developing countries. Although precise definitions of the two phrases in quotations have not been definitively

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<sup>5</sup> Although GATT and the WTO have thus far been notified by their members of more than 100 free and preferential trade agreements under the enabling clause and Article xxiv, none of these has yet been found not to be in conformity with GATT-WTO rules.

established, “substantially all trade” is generally interpreted to mean 90% or more of trade, and 10 years is considered to be a “reasonable length” of time except in special cases.

WTO-compatibility is thus an important consideration for the EU and weighed heavily in its launching of the EPA process. In contrast, because of their small size, many SSA countries have a low profile in the WTO, have thus far been exempted de facto from many WTO disciplines, and have not been involved directly in the disputes over the commodity protocols. Thus, WTO-compatibility is often perceived as a remote concern by many policy makers in SSA countries.

*Differentiation between LDCs and Non-LDCs.* In addition to reciprocity, a second guiding principle of the Cotonou Agreement is differentiation. The last part of Article 2 of the Agreement states: “differentiation and regionalization: cooperation arrangements and priorities shall vary according to a partner's level of development, its needs, its performance and its long-term development strategy. Particular emphasis shall be placed on the regional dimension...” Part 1 of Article 85 then adds that: “The least-developed ACP States shall be accorded a special treatment in order to enable them to overcome the serious economic and social difficulties hindering their development so as to step up their respective rates of development.” Thus, the LDCs may not expect to have to open their markets to EU exports as fast or as much as the non-LDCs in order to maintain their preferential access to EU markets. As discussed in Section 4 below, the differentiation principle creates some complications with respect to regional integration within SSA.

*Regional integration.* A third objective of the EPA process is to promote outward oriented regional integration among the ACP countries and limit the “hub and spoke” effect that bilateral free trade just between the EU and individual ACP countries could have.<sup>6</sup> Traditionally, the 77

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<sup>6</sup> In the case of free trade agreements, like the EPAs, when a hub country or region (the EU) signs FTAs with various small countries like those in SSA (the spokes) and the latter do not sign FTAs among themselves, the hub country benefits because it has free access to all markets whereas the spokes only have free access to the hub market. This “hub-and-spoke effect” increases the incentive for exporters to invest in the hub country, rather than in the spokes, in order to serve all of the markets.

ACP countries have been divided into 6 broad regional groupings: the Caribbean, the Pacific, and four loosely defined African sub-regions – western, central, eastern, and southern Africa. The EPAs are intended to establish free trade areas between the EU and each of these regional EPA negotiating blocs, the precise composition which was to be determined by the ACP countries themselves. The SSA countries subsequently formed into four regional EPA negotiating groups for pursuing regional integration among themselves as well as for negotiating EPAs with the EU as discussed in Section 4 below.

*Coordination of trade and aid policy.* A fourth objective of the planned EPAs is to more effectively coordinate trade and aid. The EU is one of SSA's largest aid donors. Thus, its financial and technical cooperation program can, in principle, provide for substantial assistance for overcoming problems and taking advantage of opportunities created by the improved market access and trade liberalization. The opportunity for effectively coordinating trade and aid with a major trading partner and aid donor is a distinct advantage of the EPA process relative both to multilateral trade negotiations and to most other bilateral trade negotiations, where the link between aid and trade is non-existent or, at best, tenuous.

Because the EPA negotiations are expected to involve reciprocal concessions by both sides, they will provide an opportunity for SSA to negotiate with the EU about trade and aid issues that are important to it. However, to achieve pro-development outcomes through the EPAs, it is essential both that the SSA countries and the regional organizations concerned be well prepared for these negotiations and that the EU adopt a benevolent, development oriented approach, subordinating its commercial interests to the development needs of the SSA countries when necessary. In addition, coordinating the programs of the EC's two large trade and aid directorates with different constituencies and different perspectives and the finance and trade ministries in SSA countries with similar differences is likely to be a challenge for all concerned.

### *Phase I of the EPA Negotiations*

Phase I of the EPA negotiations, during which ACP-wide issues were to be addressed with the group as a whole, ran for one year from September 2002 through September 2003. The ACP group believed that it was important to use the first phase to establish a common framework for issues that would arise in all EPAs and sought a formal agreement on common issues that would provide binding guidelines for the regional EPA negotiations in Phase II. In contrast, the EU maintained that the purpose of the ACP-level discussions was simply clarification of issues and that Phase I was not really essential as, in the EU's view, most of the general principles needed to guide the EPA negotiations are already contained in the Cotonou Agreement. It sees the smaller, more homogeneous regional negotiations as more productive fora than the larger disparate ACP-wide meetings.

After a year of discussions, on October 2, 2003, the ACP and the EU issued a joint ministerial statement declaring that Phase I of the EPA negotiations had proceeded "satisfactorily" and that there was a high degree of "convergence" on matters of principle. Both sides agreed that discussions on common ACP-wide issues would continue during Phase II in parallel with the EPA negotiations at the regional level. In fact, there appears to have been little agreement on many key issues between the ACP and the EU and even disagreement on some issues within the ACP itself. Issues that were still under discussion at the end of Phase I included: WTO-compatibility; the definition of the parties to the EPAs and the treatment of non-LDCs not entering into an EPA; rules of origin; technical barriers to trade (TBT) and sanitary and phyto-sanitary (SPS) issues; safeguards, anti-dumping, and dispute settlement; commodity protocols; an ACP-EU framework agreement on fisheries; the fiscal, economic, balance of payments, and social implications of EPAs; and implementation mechanisms.

One issue with particularly important implications for the EPA negotiations is the question of financial resources to support the trade liberalization process in SSA. The ACP group has argued that the financial resources currently available under the Cotonou Agreement are insufficient to support trade liberalization and expansion as well as the ACP countries' other needs. In response, the EU has stated that the amount of development finance available from it until 2008 under the 9<sup>th</sup> European Development Fund has already been set and is not open for renegotiation. Thus, from SSA's perspective, any discussion of compensatory or complementary financing for trade reforms during the Cotonou period will come from the effective utilization of the existing financial envelope and the more flexible, more efficient, or faster use of already programmed aid. However, the financial envelopes for the period after 2007, when the EPAs will be implemented, have not yet been determined; and their size and composition is presumably still negotiable.

The manner in which the above issues are resolved will have important implications for the development impact of the EPAs. There is a significant risk of unsatisfactory development outcomes from multiple negotiations with disparate regional organizations having limited technical capacity and inadequate time to prepare. Since many of the regional groupings have limited negotiating capacity but will need to face similar issues, it is desirable to have a common approach covering important provisions occurring in all agreements; and analytical work should continue on general SSA/ACP-wide issues.

#### **4. EPAs and Regional Trade Blocks in SSA**

An important objective of the EPA process is to promote outward oriented regional integration among the SSA countries and to limit the "hub and spoke" effect that bilateral free trade

just between the EU and individual SSA countries could have. However, determining the nature of the EPA groupings in SSA while also supporting existing regional trade agreements (RTAs) has been no simple matter. A major reason is the high degree of heterogeneity in SSA's RTAs, which include a number of overlapping PTAs, FTAs, and customs unions (CUs) with different structures, operational rules, and implementation levels.<sup>7</sup> Significant barriers remain to trade integration within "free" trade areas in SSA and even within customs "unions." However, the interaction of the EPA process and the political support for regional integration in SSA provide a useful dynamic impetus for rationalizing this situation and an opportunity for removing intra-regional trade barriers. Although the composition of the four regional EPA negotiating groups in SSA has now largely been determined, a number of important issues remain to be addressed as discussed below.

#### *The Initiation of Phase II Negotiations and Regional Groupings in SSA*

In parallel with Phase I, the EU initiated discussions of regional EPA groupings with SSA. Four regional sub-groupings in SSA have emerged from this process:

- i.) The Economic Community of West African States (ECOWAS) plus Mauritania has been agreed upon by its members as the EPA negotiating bloc for Western Africa.
- ii.) The Central African Economic and Monetary Community (CEMAC) plus Sao Tome and Principe grouping has been chosen by the Central African states.
- iii.) Sixteen countries, including most of the members of the Community of Eastern and Southern African (COMESA), have formed the Eastern and Southern Africa (ESA) group, for which COMESA will serve as the Secretariat. And
- iv.) Four Southern African Customs Union (SACU) members (Botswana, Lesotho, Namibia, and Swaziland, known as BLNS, or SACU minus South Africa) and three

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<sup>7</sup> See de la Rocha (2003) for more on the "spaghetti bowl" issue.

neighboring SADC countries (Angola, Mozambique and Tanzania) will be negotiating as the SADC group.

In October 2003, the Phase II negotiations were launched with two of the four SSA sub-regions -- CEMAC and ECOWAS. ESA subsequently initiated EPA negotiations with the EU in February, 2004. and the SADC group in July 2004. Broad road maps for the negotiating process have been agreed with ESA, SADC, and ECOWAS. These road maps set out the organizational arrangements for the negotiations. The first year of the negotiations will be devoted to regional integration within the four negotiating blocks in order to address measures for strengthening and integrating regional markets before considering steps to expand external trade.

#### *General Issues Concerning EPA Regional Negotiating Groups in SSA*

*The roles of FTAs and customs unions in EPAs.* Of the four EPA negotiating blocs in SSA, three (ECOWAS, ESA, and SADC) are FTAs that contain smaller CUs: UEMOA in ECOWAS, SACU in SADC, and EAC in ESA. The fourth negotiating block, CEMAC, is a CU. The member countries of a CU normally share the same external trade policy, including a common external tariff (CET). The existence of a common external trade policy permits the members of a CU (that is, UEMOA, CEMAC, SACU, and EAC) to enter into trade agreements, including EPAs, as a group since any trade agreement would apply equally to all member countries. The EC believes that, ideally, it would be desirable for all of the EPA regions to implement common external tariffs in time for the entry into force of the EPAs and that it might be desirable to pursue EPA negotiations first with a customs union to see what can be accomplished in this format.

The situation is different in free trade areas where each country is free to maintain its own external trade policy. Because of the different tariff levels and other trade policies in FTA members, arriving at a single unique EPA applying identical provisions to all of the SSA members

of an FTA is unlikely to be feasible except when the FTA is converging quickly and credibly to a common external tariff. On the other hand, in an FTA it is easier to provide for differential treatment of member countries since they do not all have to follow a common external trade policy. FTAs can play a useful role in the EPA process (by, for example, providing negotiating fora in which a common framework or umbrella agreement can be established and bilateral negotiations of country specific sub-agreements organized), but they would need to follow a somewhat different approach from the CUs that have a common trade policy.

*Customs unions with LDC and non-LDC members.* Another complication in negotiating trade EPAs is the potential inconsistency between the Cotonou Agreement's objective of differentiation in the treatment of LDCs and non-LDCs and its regional integration objective. All four of the CUs in SSA consist of a mix of both LDCs and non-LDCs. As discussed in Section 5 below, the EU has unilaterally granted full duty-free and quota-free EBA access to its market to the LDCs, without requiring preferential access to the LDCs' markets in return. Having already obtained EBA preferences, the LDCs may have little incentive to open their markets to the EU on a preferential basis under an EPA. In contrast, the non-LDCs in SSA must, in principle, agree to provide preferential access to EU exports in order to maintain preferential access for their own exports to the EU after the Cotonou Agreement expires in 2008. This problem of differing negotiating incentives is particularly serious for the CUs: the CU's common external tariffs cannot be maintained if their non-LDC members provide preferential access to imports from the EU while their LDC members do not. In contrast, in SSA's FTAs, in which each country can have an independent external trade policy, the tariffs of LDCs and non-LDCs on imports from the EU could differ.

*Barriers to intra-regional trade within FTAs and CUs in SSA.* Despite the proliferation of preferential trade agreements in Africa, significant barriers to intra-regional trade still remain within

“free” trade areas, and even within customs “unions”, in all four of the regional EPA negotiating groups in SSA. None of the three FTAs involved has even relatively free internal trade among its members. The ECOWAS FTA has not yet been effectively implemented. Only nine of COMESA’s members have started implementing its free trade agreement, and some countries that are doing so still maintain substantial barriers to free intra-regional trade. Internal trade among the SADC group, outside of SACU, is even more restricted.

Intra-regional trade is not much freer in SSA’s four customs unions. All of the customs unions in SSA, other than SACU, are, in fact, partial ones in the sense that, although they have common external tariffs, there is no pooling of customs revenue, member countries maintain customs barriers at intra-CU borders, and intra-CU trade is subject to restrictive rules of origin. In both CEMAC and UEMOA, substantial obstacles to internal free trade and country deviations from the common external tariff remain. As long as the CET is not fully implemented by all member countries, protected domestic producers are going to seek restrictive RoO and other protectionist measures to prevent imports from entering on more favorable terms through other CU member countries. The EAC customs union is just becoming operational but is likely to face similar problems since its design is similar. Only SACU is a fully functioning customs union with real internal free trade, a common external tariff observed by all of its members, common administration of the external tariff, and pooling of the revenues from it. The advantages of a “customs union” in which barriers to intra-CU trade remain in place or the members of which do not fully implement the CU’s common external tariff are limited.

Rules of origin (RoO) restricting intra-regional trade in SSA are a particular problem in both FTAs and CUs. Internal trade within all the free trade areas and all of the customs unions other than SACU is subject to rules of origin, most of which are quite restrictive; and there are protectionist pressures to increase their restrictiveness. Liberalization of intra-REC rules of origin

is thus an important regional integration issue in SSA. Inefficiencies and corruption in customs administration, cumbersome and costly transit arrangements, and informal road blocks and “tolls” on key transit routes are additional obstacles that need to be addressed under the rubric of intra-regional trade facilitation. (See IMF 2004 for a recent review of regional trade initiatives in SSA).

Although the political support for liberalization of intra-SSA trade is currently greater than for the liberalization of external trade in goods and services, SSA countries will still need to overcome the political and administrative obstacles to it, with which the EPAs may be able to help. To minimize the hub-and-spoke effect of the EPAs, further intra-CU and intra-FTA liberalization of trade in both goods and services are needed. There are several steps which should be taken in the context of the EPAs to strengthen regional integration in SSA. First, full intra-CU and intra-FTA free trade in goods and services needs to be implemented. Constraints on the free movement of labor also need to be reduced, a step which is particularly important for the landlocked and poorer members of the regional groupings. Second, SSA countries should take advantage of the EPA process to adopt simple, standardized, liberal RoO for the various FTAs and CUs in SSA and to address the other trade facilitation issues noted above. And, third, those member countries of customs unions that have not fully implemented their CU’s common external tariff (CET) need to do so as soon as possible.

### *Region-specific Issues*

In addition to the above general issues concerning all EPA negotiating groups, there are some important region-specific issues affecting EAC, SACU-SADC, and ECOWAS that have not yet been resolved.

*EAC.* An important unresolved geographical-organizational issue concerns the East African Community’s (EAC) customs union, two of whose members (Kenya and Uganda) are participating

in the ESA group while the third (Tanzania) elected to join the SADC group. Since the three EAC countries will start implementing a common external trade policy shortly, they need to negotiate a common EPA as a group.

*SADC and SACU.* The situation with the EPAs for the SACU countries is particularly complex. Four of the five SACU countries (Botswana, Lesotho, Namibia and Swaziland, or BLNS) are ACP countries and are participating in the EPA process. However, the fifth and by the far largest SACU member, South Africa, which has a central role in determining SACU's trade policies, is eligible neither for the trade benefits of the Cotonou Agreement nor for an EPA. Instead, South Africa has already signed a separate FTA with the EU, many aspects of which apply de facto to the other SACU countries. SACU is currently in the process of negotiating a free trade agreement with the US. (See Lewis, Robinson, and Thierfelder 2002 for an analysis of FTAs in the SADC region).

*ECOWAS.* The Economic Community of West African States (ECOWAS) is composed of the 8 members of UEMOA and 7 additional countries. A FTA has been adopted by the ECOWAS members, but its implementation has been very limited thus far. ECOWAS plans to create a CU, with the non-UEMOA countries adopting a 3 rate CET similar to UEMOA's CET by 2008, when the EPAs are supposed to come into effect, and thus in principle can negotiate a common EPA. However, Nigeria's economy is larger than that of all of the other ECOWAS countries put together, its trade policy is currently much more restrictive than that of the UEMOA, and it is an open question whether Nigeria will implement the ECOWAS CET any time in the near future. If full implementation of the ECOWAS customs union is substantially delayed, negotiation of the West Africa EPA could be more complicated than currently envisaged.

## **5. SSA's Access to the EU Market: EPAs, the "Everything But Arms" (EBA) Initiative, and WTO's Doha Round**

In addition to providing trade preferences to ACP countries under the Cotonou Agreement, the EU now provides preferences to LDCs, including those in SSA, under its Everything but Arms (EBA) Initiative adopted in 2001. The EBA Initiative has complicated the EPA process by creating different trading environments and negotiating incentives for the 33 LDCs and 13 non-LDCs in SSA eligible for EPAs.

### *Implications of the EBA Initiative for LDCs in SSA*

Under the EBA Initiative, the EU unilaterally grants to all 49 LDCs, including the non-ACP ones such as Bangladesh, quota-free and tariff-free access to its market for all products except arms without the LDCs' having to give preferential access to the EU in return.<sup>8</sup> Thus the 33 LDCs in SSA now have access to the EU market under the EBA initiative as well as under the Cotonou Agreement. However, this improvement in market access does not yet appear to have led to substantial increases in SSA exports because of other constraints to export diversification and expansion.

The EBA Initiative is part of the EU's General System of Preferences (GSP) and is compatible with WTO's enabling clause as it grants special preferences to a permissible grouping of countries, the LDCs. In contrast to the EU's broader GSP, which is revised every three years, the EBA Initiative runs for an unlimited period and is not subject to periodic reviews. Market access is thus more secure under the EBA Initiative than under GSP and is presumably more likely to encourage investment in new exports for this reason. However, the EBA Initiative has also

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<sup>8</sup> Implementation of full market access is immediate except for transition periods for bananas, rice, and sugar, for which tariff-rate quotas restricting LDC exports of these products to the EU are to be phased out over the next eight years.

eliminated the preference margin of ACP countries relative to non-ACP LDCs, although the Cotonou rules of origin are less restrictive than the EBA Initiative's RoO.

As the EBA preferences were provided unilaterally by the EU without a quid pro quo from the LDCs, the LDCs have little to gain in terms of lower tariffs on their exports from entering into reciprocal free trade with the EU under EPAs. For the LDCs to obtain something in return for giving EU imports tariff-free access to their markets, the EPAs need to offer benefits beyond those provided by the EBA Initiative.<sup>9</sup>

#### *Market Access for the Non-LDCs in SSA*

In contrast to the 33 LDCs in SSA which benefit from EBA and whose access to the EU market would presumably not be greatly affected if they decided not to enter into EPAs, when the Cotonou Agreement's trade preferences expire in 2008, any of the 13 non-LDCs that do not sign EPAs would presumably revert to GSP status. The EU's GSP provides less favorable preferential access than the Cotonou Agreement: narrower product coverage, smaller margins of preference, and more restrictive rules of origin. The value of Cotonou preferences, and hence the impact of reverting to the EU's less favorable GSP, varies considerably among the 13 non-LDCs in SSA. For 3 non-LDCs, in 2002 the value of Cotonou preferences exceeded that of the GSP preferences by 16% to 39% of their total exports to the EU: Swaziland 39% (meat), Mauritius 20% (sugar and knit garments), and Seychelles 16% (fish). But for the other 10 non-LDCs the value of Cotonou preferences for current exports is small. For five non-LDCs (Namibia, Zimbabwe, Ivory Coast, Cameroon, and Kenya) the cost would be 3% to 6% of the value of their merchandise exports to the

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Such benefits could come from a combination of (a) improvements in the Cotonou and the EBA rules of origin (ROO) and reduction in the EU's agricultural export and production subsidies on products of particular interest to SSA as discussed below; (b) increased financial assistance to offset the revenues lost from an FTA with the EU because tariffs would no longer be charged on imports from the EU as discussed in Section 6; (c) regional measures (such as trade facilitation, liberalization of intra-REC trade and labor flows); or (d) pro-development treatment of services and the "Singapore issues".<sup>9</sup>

EU, and for the remaining 5 non-LDCs (Ghana, Botswana, Congo, Gabon, and Nigeria) the loss would 2% or less. Thus, these 10 countries would not lose much in the medium term from reverting to the EU's GSP

Similarly, the immediate effect of moving from the Cotonou to the EBA regime would also vary significantly among the 13 non-LDCs in SSA. For four countries (Botswana, Namibia, Cameroon, and Ivory Coast), moving from Cotonou to EBA preferences would be worth from 3% to 8% of the value of their current exports to the EU. But for the other 9 non-LDCs, the immediate gain from moving from Cotonou to EBA would be less than 1% of the value of their current exports to the EU. Thus, in the near term, the gain solely from moving from Cotonou to EBA access is likely to be small.<sup>10</sup>

However, the above figures apply only to current export products and quantities – they do not take into account the effect of improved prices or market access on either the expansion of existing exports or the diversification into new products that would be possible with EBA access to the EU market. These figures also underline the importance of addressing other constraints to export diversification such as the EU's restrictive RoO and competitiveness and supply problems in the SSA countries.

The non-LDCs will, in any case, need to obtain improved market access through EPAs to create opportunities for diversifying and expand exports in the long term. Since discriminating under EPAs between the exports of the LDC and non-LDC members of the same customs union or free trade area could undermine regional integration efforts in SSA, the most development-friendly option would be for the EU to provide EBA market access to all SSA countries signing EPAs.

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<sup>10</sup> This paper uses the term "EBA access" to refer to tariff-free, quota-free market access for everything but arms. The EU's EBA *initiative* is one way of providing EBA *access* to its markets. Such access could also be provided by EPAs as is recommended here.

Country groupings such as SSA and the ACP are not recognized by the enabling clause. Thus, until recently providing unilateral EBA access to all ACP or SSA under the EU's GSP countries has not been considered WTO compatible. However, a ruling in a recent WTO case appears to have opened the possibility that EBA access could be provided for the non-LDCs in SSA under the EU's GSP. India challenged the EU's GSP as it applied to drug exports on the grounds that they were inconsistent with the Enabling Clause and illegally discriminated among different non-LDCs developing countries. The EU has interpreted the ruling in this case to imply that it is permissible to differentiate between different non-LDCs as long as the distinctions among countries are not arbitrary. Accordingly, the EU's new GSP for the period 2005-08 provides for greater preferences for small and vulnerable LDCs than for other LDCs. Furthermore, the limitations on country groupings might further be relaxed in the Doha round if the G-77 becomes a legitimate group under the Enabling Clause. Hence, it may become possible for the EU to provide EBA access to the non-LDCs in SSA in its 2008 revision of the GSP if necessary to support the EPA process.

### *The EU's Rules of Origin*

The rules of origin (RoO) under both the Cotonou Agreement and the EBA Initiative are complex and restrict SSA exports. The RoO under the EBA Initiative are the same as those under the EU's GSP and are the more restrictive than those under Cotonou. In fact, Brenton (2003) shows that SSA LDCs make little use of EBA preferences and prefer to export to the EU under Cotonou preferences. Even though Cotonou preferences are less generous than EBA preferences, the RoO that apply under Cotonou are sufficiently less restrictive to make exporting under the latter more attractive to most SSA exporters. Two examples which illustrate the potential benefits from liberalizing restrictive RoO are; the success of garment exports from SSA under the provision of

the US AGOA preferences which, as an exception to the US's standard RoO, permits SSA garment exporters to utilize fabrics imported from third countries outside the region; and Mauritius's exports of knit products to the EU which gets around the EU's two stage processing RoO governing textiles and garments. Unless RoO are liberalized and simplified under EPAs, the benefits of even full tariff-free, quota-free market access will be limited.

A simpler, less restrictive rule of origin for the EPAs would be to give SSA exporters the choice between meeting a "change of tariff heading" rule<sup>11</sup> or a uniform 20-25% value-added rule, together with liberalization of the EU's "general tolerance" rule to permit 25% imported inputs and full cumulation among all ACP countries, other LDCs, South Africa, and the EU. Independent reviews of the EU's import safeguard measures (such as anti-dumping) and sanitary and phytosanitary (SPS) regulations (such as those on groundnuts) should also be undertaken to see if more development friendly provisions concerning these can be included in the EPAs.

#### *Relationship of EPAs to WTO's Doha Round*

*Reductions in the EU's MFN Tariffs and Preference Erosion.* The MFN tariff rates to which the EU agrees in the Doha round, rather than its current MFN rates, will determine the preference margin that SSA countries will actually have under the trade EPAs, and SSA countries are worried about potential preference erosion in the Doha round. However, long-term competitiveness and sustainable development cannot be built solely upon special preferences allowing SSA countries to benefit from transient distortions in world trade policies. Adjustment to preference erosion is going to be necessary sooner or later in any case. Excessive concern about preference erosion could also detract attention from the potential gains to SSA from other components of the Doha and EPA negotiations such as improvements in rules of origin, MFN and intra-REC liberalization of trade in

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<sup>11</sup> Note that a "change of tariff heading" rule would allow garment exporters to utilize third country fabrics, which have been a key to the expansion of garment exports under AGOA.

merchandise and services, and accompanying domestic reforms, and reductions in agricultural subsidies. SSA countries would gain significantly, if in the discussions of special and differential treatment (S&DT), other industrial countries could be persuaded to offer them EBA market access (or at least substantially improved preferential access) as the EU has done.

The EPA process provides an opportunity to commence this adjustment to preference erosion in favorable circumstances. Improvements under the EPAs in the EU's rules of origin and other aspects of market access could also offset the effects of preference erosion. In addition, the financial cooperation accompanying the EPAs could be used for providing adjustment assistance for any countries facing significant transitional costs from preference erosion as a result of the Doha round. The World Bank and IMF are also prepared to help with financing any transitional costs of adjusting to preference erosion.

*Agriculture.* Another important link between the Doha and the EPA negotiations is the question of agricultural trade policies -- market access (tariffs and tariff-rate quotas), export subsidies, and trade-distorting domestic production support. Quantitatively, market access is the most important of these. As discussed above, the EBA Initiative provides the LDCs in SSA with full quota-free and tariff-free access to the EU's agricultural markets, and the EPAs could provide similar market access for the non-LDCs' agricultural exports to the EU. However, SSA still has much to gain from improved access to the agricultural markets of other industrial countries. In view of the magnitude of the barriers to accessing agricultural markets in industrial countries and the time that it is likely to take to dismantle these, pressing in the discussions of S&DT for other industrial countries to follow the EU's example and provide EBA access for SSA's exports may be the quickest way to make progress. Export subsidies and trade-distorting domestic production support will also need to be addressed in the WTO's Doha negotiations because of the large number of OECD and developing countries involved and the difficulty and importance of the issues.

The EU is proceeding gradually with unilateral reforms of its common agricultural policy (CAP), and the EU has said that it is prepared to reduce export subsidies to zero on key products of interest to developing countries.<sup>12</sup> The SSA countries should press to obtain early progress in the EU's CAP reforms on products of particular interest for SSA as part of the EPA negotiations. SSA countries could identify existing and promising agricultural exports that are important for them (such as cotton) and ask that these specific products receive priority treatment in the EU's decoupling of agricultural support from production and eliminating of export subsidies. However, what will be achievable in agriculture through the EPAs will depend heavily upon how far the EU is prepared to go in the Doha negotiations.

In addition to requesting that the EU give priority attention to its concerns in negotiating agricultural reforms in the Doha round, in the EPA negotiations SSA countries could also seek to limit the impact of the EU's agricultural subsidies on their imports from the EU. For African producers, the most damaging to SSA of the EU's subsidies for its agricultural exports currently appear to be those for dairy and meat products, processed sugar, and cereals. A limited but potentially helpful step for some SSA countries would be the phasing out of the EU's export subsidies on sales to African countries.<sup>13</sup> Any net food importing countries that benefits on balance from the EU's agricultural subsidies could request increased assistance under the EU's aid program to offset the loss of subsidies.

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<sup>12</sup> To the extent that CAP reform leads to lower internal prices in the EU market, it could also lead de facto to some erosion in the value of preferential market access.

<sup>13</sup> This reform may be an attainable objective as suspension of such subsidies was part of the French proposal to the G8 in its action plan for Africa in June 2002.

## **6. The EU's Access to SSA Markets: Reductions in Tariffs on Imports from the EU and Necessary Complementary Reforms in SSA**

In addition to improving the access of SSA countries to the EU market, EPAs are also supposed to provide for preferential reductions in tariffs on SSA's merchandise imports from the EU. WTO's Article xxiv governing free trade agreements requires that tariffs be completely eliminated on "substantially all trade" (generally interpreted to be 90%) by participants in a free trade agreement within a "reasonable length of time" (normally, 10 years), but this objective has been difficult to fully achieve in practice. The EU believes that the product coverage for liberalization of trade between the EU and the ACP should be 90% in line with the requirements of WTO's article xxiv. The 90% figure seems to refer to the existing level of trade -- which is affected by existing tariffs and other trade restrictions — rather than the potential trade level once trade liberalization has taken place. A target of liberalizing 90% of existing trade would probably allow most of the important import-competing sectors in SSA to be exempted because with current high tariffs (and quantitative restrictions in a few cases) imports of products that compete with domestic productions are likely to be small. Moreover, the ACP countries have argued that the scope of the preferential liberalization should be limited to 80-85% of current trade. A possible compromise outcome, along the lines of the EU-South Africa FTA, would have the EU liberalize 100% of its imports from SSA and SSA liberalize 80% of its imports from the EU to arrive at the target average liberalization of 90%. Designing the required liberalization of SSA trade in a pro-development fashion is one of the more complex and controversial aspects of the EPA process and will require two important complementary reforms in SSA reforms: restructuring of indirect tax systems and MFN tariff liberalization.

### *Potential Revenue Losses and the Restructuring of Indirect Tax Systems*

An important fiscal issue posed by EPAs is the impact on government revenues of preferential reductions in SSA tariffs on merchandise imports from the EU. Revenues from tariffs still amount to 2% of GDP in the median SSA country; and some countries depend even more heavily on tariff revenues, with these amounting to 4% to 6% of GDP (Hinkle and associates, 2003). Since the EU is the largest source of imports for most SSA countries, supplying 40% of total imports in the average country, some countries are likely to lose significant tariff revenue from reducing tariffs on imports from the EU. For example, even assuming no trade diversion, an average country, in which tariff revenues are 2% of GDP and 40% of imports come from the EU, would lose tariff revenues equivalent to 0.8% of GDP (7% to 10% of government revenues) from eliminating tariffs on all imports from the EU. The revenues losses would be significantly greater in countries that are highly dependent on tariff revenues: countries obtaining revenues of 4% or more of GDP from tariffs could lose revenues of 1.5% or more of GDP (15% to 20% of government revenues) from eliminating tariffs on imports from the EU.

Any trade diversion from non-EU to EU suppliers because of the elimination of tariffs on imports from the EU would lead to further loss of revenues. For example, Busse, Borrmann, and Grossmann 2004 analyze the effects on the ECOWAS countries of preferential elimination of tariffs on all imports from the EU using a partial equilibrium model. They find that, as a result, imports from the EU would increase by between 5% (Guinea-Bissau) and 21% (Nigeria) and rise by about 9% in the median country. The loss of government tariff revenues would range from a low of 0.3% of GDP (3.6% of government revenues) in Niger to a high of 4.1% of GDP (19.8% of revenues) in Cape Verde. Typical mid-range countries such as Ghana and Senegal would experience revenue losses of 1.8-1.9% of GDP (10-11% of total revenues).

Revenue losses of the above magnitude would be a large fiscal shock. To protect their fiscal positions and maintain macroeconomic stability, the SSA countries will need to reform their indirect tax systems so that revenues from the VAT and non-discriminatory excise taxes levied at equal rates on imports and domestic products replace the forgone tariff revenues. Improvements in tax administration could also yield large revenue gains in some countries. Countries that face particularly large revenue losses may need to consider strengthening other components of their tax and revenue systems. Moreover, in view of the unmet expenditure needs for government spending on health, education, and infrastructure, the debt burden, and structural constraints to increasing government revenues, many countries may need to retain *a low revenue tariff on imports including those from the EU*. If, in addition, the preferential tariff reductions are phased in gradually over a decade or so, the adjustment may be manageable (0.1% to 0.3% of GDP per year), except in some extreme cases that may require special attention. Nevertheless, detailed country-by-country analysis of the revenue implications of preferential tariff reductions and plans for accompanying tax reforms is essential.

Restructuring indirect tax systems and strengthening tax administration will be complex legal and administrative undertakings and require some of the most demanding and time consuming reforms facing SSA countries. However, restructuring of indirect tax systems is, in any case, necessary in the long term as all countries desiring to integrate into the world trading system will need to accomplish it sooner or later. Some SSA countries (for example, those in SACU and UEMOA) have already embarked on this process in the course of ongoing reform programs.

The required restructuring of the indirect tax system needs to be started no later than, and preferably before, the tariff reductions on EU imports are implemented. In addition to being given enough time to plan and implement the required reforms, the SSA countries, particularly the least developed ones, may require substantial technical and financial assistance during the implement-

ation period if elimination of tariffs on imports from the EU is not to undermine their fiscal positions. Thus, the EU would need to support technically and financially the indirect tax reforms accompanying the implementation of the trade EPAs, for example by providing grant-financing for tariff revenue losses until the tax reform has been completed, tax administration has improved, and foregone revenues have been replaced.

### *Problematic Partial Trade Liberalization with the EU*

Many SSA countries still have high and distorted MFN tariffs. Even uniform preferential tariff reductions under EPAs can, in the presence of high MFN tariffs, lead to costly diversion of trade from low cost non-EU to high cost EU suppliers, as well as to substantial transfers of tariff revenues from SSA governments to EU exporters. What happens when tariffs are reduced or eliminated on a preferential basis on imports from the EU depends upon how much competition there is among suppliers and how efficient these suppliers are relative to other exporters. If, on the one hand, there is little competition among EU suppliers of a particular product to a particular SSA country, when tariffs are cut, these suppliers may well decide to maintain their prices at or near current levels to increase their profits so that the tariff revenues forgone by the government end up, in effect, being transferred to the EU suppliers. On the other hand, if there is enough competition among EU suppliers of a product, each supplier will be forced to reduce prices by the amount of the tariff cut so that there will be no implicit transfer of tariff revenues to them. In this case, however, unless the EU exporters are the world's most efficient supplier of the product concerned, some diversion of trade is likely from lower cost non-EU suppliers who must pay the tariff to higher cost EU suppliers who do not have to pay the tariff.<sup>14</sup> Only in the case where the EU is the

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<sup>14</sup> Price changes will also depend upon whether goods are homogeneous or heterogeneous. In the case of homogeneous goods, as long as SSA countries continue to import some units from non-EU sources after reducing tariffs on imports from the EU, domestic prices will remain unchanged. Then, EU exporters can capture the tariff revenue previously

world's most efficient supplier of a particular product to a particular country and there is sufficient competition among EU producers to ensure that the product's price falls by the full amount of the tariff cut will there be an unambiguous gain for the country concerned from the preferential reduction of tariffs on EU imports. Determining the likely outcome of preferential reductions for an individual country is a complex empirical problem. In the absence of convincing evidence that transfers of tariff revenues and trade diversion are unlikely, the simplest approach for limiting these potential negative effects is for the SSA countries to *limit the maximum preference margin accorded to EU imports to no more than 5%*. In fact, from a development perspective, the only rationale for maintaining even such a small preference margin for imports from the EU is to use the availability of this margin as an incentive to encourage other countries to enter into similar agreements.

As noted above, it is likely that the preferential elimination of SSA tariffs on imports from the EU will not cover all sectors. Line-by-line negotiation of which specific imports are to be excluded from free trade with the EU are likely to be dominated by protectionist interests and will not lead to pro-development outcomes. Preferential liberalization may well be restricted to sectors with little or no domestic production, while the main import-competing industries (where the largest efficiency gains might occur) may be excluded because of opposition from currently protected firms as happened in the case of the EU-South Africa FTA. Furthermore, elimination of tariffs on inputs imported from the EU would raise effective protection rates for import competing industries and reduce the incentive to export, even to the EU. Thus, the EPAs could create a distorted tariff regime that would actually increase the already high effective protection rates for import-competing

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collected on imports from the EU by raising their prices in SSA markets (such a price increase is equivalent to a worsening of SSA's terms of trade), and SSA countries lose these tariff revenues to the EU exporters. By slightly reducing their prices, EU exporters may also increase their market share. In the case of heterogeneous goods, domestic prices in SSA of imports from the EU will fall at least somewhat unless the demand for them is completely inelastic, and imports from the EU will increase. This increase in imports from the EU will be accompanied by a reduction in imports from other sources and result in a loss of tariff revenues previously collected on the imports from other countries. (See Hinkle and Schiff 2004 and Schiff and Winters 2003 for a further discussion of this topic.).

domestic industries while eliminating the revenues from tariffs on imports from the EU that do not compete with domestic production. Subsequent negotiation of similar such selective partial “free” trade agreements with additional OECD countries (as, for example, SACU is currently doing with the US) would aggravate the distortions.

#### *Need for Accompanying MFN Tariff Reductions*

Thus, a tariff structure resulting from selective preferential tariff reductions on imports from the EU would be problematic both for the sectors for which imports are liberalized and for those for which they are not. The sectors for which tariffs on EU imports are eliminated may experience transfers of tariff revenues to the EU and/or trade diversion, and the sectors for which current high tariff rates are maintained would continue to have no incentive to increase their efficiency or reduce monopolistic profits. Experience with preferential trade agreements in other developing countries (Chile, Mexico, and Bolivia) suggests that the best way to limit these negative effects is to lower the MFN tariff to 10% or so before selectively eliminating tariffs on a preferential basis by entering into FTAs.

Prior or simultaneous unilateral MFN liberalization would increase competition and lower prices of tradable goods in SSA. World Bank (2003) argues that a pro-development outcome of the Doha round would include developing countries’ achieving average tariffs of 5% for manufacturing, with a maximum tariff of 10%, and average tariffs of 10% for agriculture, with a maximum of 15%. Such a liberalization would be beneficial both because of the standard, but often overlooked, static benefits from increases in MFN trade and dynamic gains from a more open economy as well as because of the reduction in trade diversion and the implicit transfer of tariff revenues to suppliers in the EU under the EPAs. The continued inefficiency that would result from a distorted partial preferential liberalization is an additional reason why SSA countries need to achieve MFN

liberalization in all sectors, including especially the main domestic import-competing industries. If the EPAs are accompanied by adequate reductions in SSA's MFN tariffs (or CETs), prices of imports will necessarily decline; and, if they decline sufficiently, the combination of trade EPAs and MFN liberalization is likely to be unambiguously beneficial for SSA. Simultaneous MFN trade liberalization will also facilitate expansion of intra-African trade generally since SSA trading partners in other RECs would also benefit from it and would reduce the "hub-and-spoke" problem that could be caused by the EU signing separate trade EPAs with various RECs in SSA. A well designed MFN liberalization would make it easier for the countries concerned to move towards a common external tariff and create a favorable environment for further liberalization of inter-REC trade.

*Guidelines for tariff reductions.* The foregoing discussion would suggest three guidelines to keep in mind in designing the MFN tariff and preferential reductions:

1. First, because of their need for public financial resources, many countries may need to retain a revenue tariff of 5% to 10% on all imports, including those from the EU.
2. Second, the maximum preference margin for the EU also should be limited to 5% , and a zero margin (no preferences for EU imports) would be the most development friendly outcome since it would eliminate any risk of transfers of tariff revenues or trade diversion.
3. And, third, to avoid excessively protecting any industries and put competitive pressure on import-competing sectors to operate more efficiently, the maximum tariff should not exceed the revenue tariff by more than 10%.

Together the above guidelines suggest a MFN revenue tariff of 5 to 10% with a maximum rate of no more than 15% for sensitive sectors, with a preferential reduction of 0-5% in the tariffs on imports from the EU. For a country not needing or desiring to maintain a low revenue tariff on all imports from the EU and following the conventional approach of completely eliminating tariffs on most imports from the EU, the above guidelines would suggest a maximum MFN tariff of no more than 10%.<sup>15</sup>

Because of the potential loss of revenues from preferential liberalization with the EU, the MFN tariff reductions would have to be carried out in a way that would maintain revenues from tariffs on non-EU imports. Empirical analysis of current tariff regimes in SSA shows that tariff exemptions (which can be eliminated) are quite large in many countries and that only small quantities of imports are actually subject to peak (quasi-prohibitive) tariff rates. Thus, the reduction in MFN tariffs need not result in revenue losses because exemptions can be reduced and the volume of imports subject to higher tariff rates is likely to increase. In fact, most SSA countries could probably obtain greater revenues from a uniform revenue tariff of 10% to 15% than from their current highly differentiated tariff regimes (Hinkle and associates, 2003). In any case, whether revenues will be lost or increased by MFN tariff reductions, any revenue losses are likely to be smaller, and thus easier to manage, than those that would result from elimination of all tariffs on imports from the EU.

In any case, the required MFN liberalization needs to be completed before, or at the same time, as the preferential tariff reduction with the EU takes place so that trade diversion is minimized and EU suppliers do not have a chance to sell into highly protected domestic markets in SSA, and thus obtain large implicit transfers of tariff revenues, until the MFN tariff is reduced. In cases where the MFN reductions is likely to cause particularly difficult adjustment problems, it would be

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<sup>15</sup> For a discussion of additional measures for reducing the distortionary effects of preferential liberalizations see Schiff and Winters 2003, p. 253.

better to allow a longer time period for phasing in the tariff reductions and to provide more adjustment assistance under the financial cooperation component than to postpone indefinitely the required structural adjustment by exempting some industries from the liberalization.

### *Relationship of EPA Tariff Reductions to WTO's Doha Development Round*

From the point of liberalization of SSA's own trade policies, the EPA and WTO negotiations are likely to be mutually reinforcing. In SSA, bound MFN tariff rates are very much higher than the current applied MFN rates.<sup>16</sup> Thus, most SSA countries have substantial scope to lower their bound MFN rates in the WTO negotiations, in response to reciprocal reductions in their trading partners' MFN tariff rates, without having to change their applied rates at all. Although some countries view large gaps between their bound and applied rates as a form of strategic insurance or "policy space", these gaps have the disadvantage of deterring investment by suggesting that governments are not committed to trade liberalization and that the risk of policy reversal is significant. Thus "locking-in" lower applied MFN rates by binding them in the WTO may have net advantages for SSA countries, particularly for those that need to increase the credibility of their reform efforts.

### *Conclusion*

The MFN tariff reductions, like the restructuring of indirect tax systems, is essential if EPAs are to achieve their development objective. In the EPA process, the EU needs, therefore, to push for well designed MFN tariff reduction rather than just for preferential reductions in tariffs on EU imports. The necessary MFN tariff reductions could be made by the SSA countries unilaterally

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As explained in Section 7, WTO negotiations concern bound tariff levels. The tariffs of most African countries are currently either not bound or are bound at so much higher levels than their applied tariffs that only the most optimistic assumptions about the outcome of the Doha round would lead to any significant reduction in the tariffs actually applied by SSA countries. <sup>16</sup>

reducing their MFN tariffs at the same time as they lower their tariffs on imports from the EU under EPAs or by including the MFN tariff reductions in the EPAs themselves. The latter approach would have the advantage of “locking-in” the MFN reforms and thereby increasing their credibility in the eyes of investors.

With a pro-development combination of MFN and preferential trade liberalization, the EU would not gain as much commercially from preferential access to SSA markets as it would without the accompanying MFN liberalization. However, the EU’s stated objective is to use the trade EPAs to promote development outcomes in SSA and other ACP countries. To be consistent with this objective, the EU needs to support the reduction in MFN tariffs in SSA rather than seeking commercially advantageous preferential tariff reductions on its exports in the EPAs.

## **7. Conclusion: An Opportunity to Accelerate Trade Integration in SSA ?**

“We see the EPA as a means of unlocking the future, not imprisoning ... ACP countries in the past.” --- EU Trade Commissioner Mandelson<sup>17</sup>

### *Risks and Rewards of EPAs*

Without the impetus from the EPA process, African countries as a group would miss an opportunity to external and intra-regional obstacles to trade. In many SSA countries the political-economy environment for trade liberalization is difficult because of powerful, well organized vested protectionist interests, and political enthusiasm for unilateral liberalization is limited. Moreover, the Doha round may not lead to significant reductions in applied MFN tariff rates in SSA; and the prospects for regional integration efforts are at best uncertain. Thus, in the medium term unilateral progress is likely to be confined to a handful of countries. In contrast, EPAs have considerable

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<sup>17</sup> WTO News, January 3, 2004.

political momentum and are catalyzing an active debate over, and some actions on, trade reform and regional integration. Hence, implementation of EPAs involving liberalization of both intra-regional and external trade may be more feasible to engineer politically than unilateral or intra-regional trade liberalization by themselves since a quid pro quo, in the form of improved access to the EU market, would be involved.

The EPAs offer an important opportunity. To be sure, tariff-free access to the EU market – in isolation -- is not likely to have much impact in the medium term. Partial preferential liberalization of trade between SSA and the EU under EPAs by itself would also be problematic, probably even disadvantageous on balance, for many SSA countries because of the loss of tariff revenues and the probability of significant costly trade diversion. However, the EPAs could be quite beneficial economically for SSA *if they can be used to leverage important policy reforms*. The necessity for the SSA countries to liberalize imports from the EU to improve their access to the EU market also provides an opportunity for them to integrate into the global economy, to strengthen regional integration in Africa, to accelerate their trade-related reforms under potentially favorable conditions, and to lock in these reforms in a way that makes them credible to prospective investors. Moreover, inclusion of trade in services, investment, and trade facilitation in EPAs could provide an opportunity to use the leverage of the EPA process to address a broad range of obstacles to a supply response in trade-related sectors. The EPAs' negotiating schedules and deadlines create a useful dynamic impetus for global and regional integration in a situation where progress may otherwise be halting, and the technical and financial assistance from the EU could provide more generous support than is often available for countries undertaking trade reforms.

The EPA process also entails some *serious risks* for Africa. The EPAs could go astray because, despite the EU's good intentions, at critical moments lobbying by politically powerful business interests could lead to commercially advantageous decisions for the EU rather than pro-

development ones or because the management of a truly development-oriented EPA process proves too complex. Similarly, on the African side, some countries may not be able to agree to the necessary liberalization or to satisfactorily implement the required accompanying reforms as a result of lack of political support or limited institutional capacity and may suffer from losses of fiscal revenue, trade diversion, and monopolistic behavior in the services sector until they do so.

### *Determinants of Success or Failure*

The fundamental condition for realizing the potential benefits of the EPAs will be to actually utilize them as instruments for development. Doing so will pose challenges for both the EU and SSA. For the EU, the challenges will be (a) to maintain the development objective of the EPA process in the face of pressures from commercial interests, a difficult task for trade negotiators accustomed to thinking in terms of mercantilist commercial advantage, and (b) to simultaneously address complex development issues in multiple diverse regions and to effectively coordinate trade and development assistance. Because of its central role in the whole EPA process, if the EU cannot rise to these challenges, the EPAs may end up doing more harm than good for SSA, at least in the medium term until the SSA countries are able to implement the necessary complementary reforms on their own.

For the SSA countries, the key requirement is commitment to utilizing the EPAs to accelerate reforms that are necessary in the long term for integrating with the global and regional economies. Careful attention will need to be given to the design, sequencing, and timing of the EPAs and accompanying reforms in order both to ensure that the SSA countries can overcome the technical and administrative constraints to implementing them and to establish a sound basis for future trade liberalizations, whether bilateral or multilateral. Furthermore, if the EPAs are to be

credible instruments for leveraging reforms, they will need to be enforced; and a development-friendly approach will need to be found for handling enforcement and dispute settlement problems.

Moreover, there are many obstacles to expanding production of tradable goods in Africa in addition to the trade-related reforms discussed in this paper. The supply response to the EPA reforms will be much greater if these trade-related reforms are followed by actions in other areas. Particularly important are (a) a competitive exchange rate policy that encourages the expansion and diversification of exports; (b) liberalization of services imports and related regulatory reforms in the services sector; (c) institutional reforms in customs administration and other areas of trade facilitation; (d) improvements in the investment climate to encourage a supply response from the private sector; and (e) infrastructure investment. From the perspective of individual countries, some of the foregoing reforms may, in fact, be higher priorities than the EPA-related trade reforms. It may be possible to address some of these supply-side and behind-the-border reforms (investment, competition policy, trade facilitation) by including trade in services and some of the Singapore issues in the EPA process; but others may have to be tackled unilaterally by the countries concerned.

### *Broad EPA Design Issues*

Three critical design issues still remain to be faced in the EPA negotiating process: creating effective incentives to reform, allowing enough flexibility to deal with wide variations in regional and country conditions, and phasing and sequencing of a long list of complex policy actions.

*Incentives to reform.* In other cases where trade agreements have been used to leverage a wide range of reforms (as in the accession of the Central and Eastern European countries to the EU), the trade agreement with the EU has been perceived by the reforming countries as attractive both economically and *politically*. Unfortunately, the perception of the potential gains from EPAs

currently appears to be negative in some African countries. The LDCs will have access to the EU market under the EBA initiative regardless of the outcome of the EPA process; and the non-LDC have had the Cotonou-Lome preferences for several decades, and many have not substantially benefited. The liberalization of merchandise trade under EPAs will also be far more demanding for SSA countries than for the EU. Much greater tariff reductions will have to be made under the EPAs by SSA countries than by the EU, and SSA countries will also have to undertake very substantial complementary reforms.

For the EPAs to be attractive in political economy terms, they will need to include measures to accelerate growth by diversifying and expanding exports and raising investment levels as well as trade liberalization. The EU will need to include generous treatment of SSA exports in the EPAs in areas such as liberalizing its restrictive rules of origin, extending market access for everything but arms to the non-LDCs in SSA, eliminating agricultural export subsidies and decoupling agricultural production support in products of particular interest to SSA, and in general facilitating exports from SSA in whatever way possible under EPAs. Pro-development agreements on investment and trade in services could also play potentially important roles, although more analysis of these is still needed. Attractive technical and financial support for the implementation of the EPAs will also be an important incentive. In particular, the financial envelopes supporting the EPAs should increase in real terms from the current levels by more than the amount needed to finance the transitional costs associated with the EPAs and related reforms.

*Flexibility in regional and country design.* The regional EPA negotiating groups in SSA are diverse combinations of customs unions, free trade areas, and independent countries with wide variations in trade policies and commitment to outward-oriented regional integration. An approach which may work in one may not be feasible in another. Country-conditions within the regional groupings are equally diverse, and protectionist and interventionist forces hostile to trade

liberalization are strong in a number of them. For a variety of reasons, some countries may be unwilling or unable to implement the reforms required by the EPA process. Some countries, or even sub-regions, may have such political difficulties (for example, civil unrest or strong vested interests) that they end up having to fall back for a period of time on the GSP or EBA initiative for access to the EU market until they are ready to implement the EPA-related reforms. Hence, some flexibility and selectivity will be needed in the treatment of both regions and the countries within them. Moreover, it may be desirable to limit EPAs to those regions and countries that can use them effectively to leverage their reform programs and let the others fall back on the GSP and EBA initiative for access to the EU market until they are ready to reform.

*The phasing and sequencing of EPA-related reforms.* The Cotonou Agreement envisages EPAs addressing a wide range of difficult development issues in multiple sectors in all of the countries in diverse regional groups in a period of 10-12 years. Even for middle income countries with substantial institutional capacity, dynamic leadership, and strong political support for reforms, implementation of such programs would be a challenge. For least developed and other low income countries with serious capacity constraints and lukewarm political support for reform, the list of actions envisaged is daunting. Hence, the reform process will have to be carefully steered, on the one hand, to take advantage of the dynamism provided by the EPAs while, on the other hand, avoiding initiatives that would not be sustainable institutionally or politically.

A single mega-agreement with a 10-12 year implementation period may be too demanding to negotiate and implement. In any case, SSA countries will need some time to mobilize the necessary political support and to develop the institutional capacity for the trade and related reforms that need to accompany the EPAs. Hence, a series of agreements with careful attention to the timing and sequencing of reforms may be a more realistic path than a single comprehensive EPA.

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