

Economic Partnership Agreements (EPAs) between the EU and SSA: Risks, Rewards, and Alternatives

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Introduction

An overview of Africa's trade with the EU

Trade is vitally important for Sub-Saharan Africa's small economies, with total exports and imports of goods and non-factor services accounting, respectively, for 29% and 34% of GDP on average.¹ Partly for historical reasons, the EU is Sub-Saharan Africa's (SSA) largest single trading partner, buying on average 31% of SSA's merchandise exports and providing 40% of its merchandise imports.

Starting in the 1970s, the EU provided unilateral preferential access to its market to 77 African, Caribbean, and Pacific (ACP) countries under the Lomé Conventions (I through IV). The Cotonou Agreement (June 2000) provides for a continuation of this preferential access until 2008. Under the Cotonou trade preferences, all imports of manufactured goods from the ACP countries enter the EU duty-free, although these are still restricted by what are very demanding rules of origin (RoO) 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 less favourable tariff preferences. The most valuable of the EU's 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. Subsequently, in 2002 the EU unilaterally began providing complete tariff-free, quota-free market access for all imports other than arms from the 49 least-developed coun-

tries – 33 of which are in SSA – under its 'Everything but Arms' (EBA) initiative.

Despite the trade preferences accorded to SSA under the Lomé 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 market has fallen steadily from 3% in 1985 to 0.9% in 2003, a reflection of competitiveness problems and supply constraints as well as declining real prices of some primary commodities and restrictive rules of origin. In addition, SSA's exports to the EU are heavily concentrated in primary products and petroleum, which themselves are concentrated in a handful of countries. There has been little diversification of SSA merchandise exports to the EU under the Lomé and Cotonou Agreements.

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 under the planned Economic Partnership Agreements is likely to be quite limited and much easier for the EU to adjust to than for Africa. Furthermore, if the EPA negotiations were conducted on commercial terms, the differences in economic size and in the relative importance of EU–SSA trade to the two sides would give the EU a much stronger bargaining position than the SSA countries.

This paper was originally presented at the World Bank's Annual Bank Conference on Development Economics in Senegal in January 2005, as 'Risks and Rewards of Regional Trading Arrangements in Africa: Economic Partnership Agreements (EPAs) Between the EU and SSA', by Lawrence E. Hinkle and Richard S. Newfarmer. The views expressed in the paper are those of the authors, not of the World Bank.

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A development perspective on EPAs

The trade relationship between SSA and the EU is thus quite important for the region's development. The planned economic partnership agreements (EPAs) between the EU and Sub-Saharan African countries, which are to replace the Cotonou trade preferences in 2008, could offer considerable potential benefits for SSA. This chapter examines the planned EPAs from a development perspective. It seeks to clarify some of the issues faced by the EU and SSA countries and to suggest changes needed to make EPAs internally consistent and development friendly. (The terms 'pro-development' and 'development friendly,' as used here in assessing EPAs, refer to policies that will accelerate the growth of real GDP and global and regional trade integration in Africa.)

EPAs as envisaged by the Cotonou Agreement and the EU

The Cotonou Agreement, signed in June 2000 between the EU and the ACP countries, provides for negotiation of Economic Partnership Agreements (EPAs) between them. EPAs are intended to reformulate the trade preferences accorded to the ACP countries under the Cotonou Agreement and the previous Lomé Conventions to make them more supportive of broader development goals, more effective in promoting ACP–EU trade, and more compatible with World Trade Organization (WTO) rules.

EPA negotiations were launched at the all-ACP level in September of 2002. According to the Cotonou Agreement's timetable, the negotiations are to be completed by December 2007, and the EPAs are to become effective as of January 2008, although these deadlines could be modified by mutual agreement. Implementation is to take place gradually over the next 10 to 12 years, but this time limit could also be extended by mutual agreement.

Objectives of the EPA process

Development. The overarching objective of the EPAs is supposed to be to support the development of the SSA countries. Both the EU and the ACP

countries have repeatedly emphasised their 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 (FTAs) with them, by strengthening regional integration among them, and by increasing 'aid for trade' under the EU's technical and financial co-operation programmes.

Regional integration. The second central objective of the EPA process is to promote outward-oriented regional integration in the ACP countries. Intra-SSA trade is fairly limited, amounting to only about 12% of the average SSA country's merchandise exports and 7% of its merchandise imports. Intra-SSA and transit trade is, however, 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. Increasing the integration of their economies with their regional neighbours is a longstanding concern of African countries.

Traditionally, the 77 ACP countries have been divided into six 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 groupings, the precise composition which is to be determined by the ACP countries themselves. The Cotonou agreement envisages a model of outward-oriented parallel North–South–South integration, regionally within the EPA groups and bilaterally between each of them and the EU.

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 tends to benefit more 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. The 'hub and spoke' effect that a series of bilateral free trade agreements just between the EU and individual ACP countries could have would be miti-

gated by the regional integration aspects of the EPAs.

Four key features of EPAs

EPAs are intended to have four key features: (a) replacement of unilateral preferences with reciprocal free trade arrangements in order to make the EPAs WTO-compatible; (b) comprehensive coverage of trade and trade-related measures; (c) differentiation in the treatment of LDCs and non-LDCs; and (d) 'aid for trade'.

Reciprocal free trade 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. Under such reciprocal free trade, the EU would provide tariff-free access to its markets for ACP exports, and ACP countries would reciprocate by providing 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 Lomé 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 Lomé ones, are not part of the EU's general system of preferences (GSP) extended to all developing countries – and some of the ACP countries are not LDCs – these preferences do not conform with the WTO's 'enabling clause'. Hence, the EU needed to obtain waivers from the WTO, first for the Lomé Convention in 1994 and then for the Cotonou Agreement at the Doha ministerial conference in 2001. Even with the waivers, the EU's commodity protocols governing preferential trade in bananas and sugar with the ACP countries have already been successfully challenged in the WTO.

To bring the EU's trade relations with the ACP countries into line with WTO rules, the Cotonou Agreement provides for replacing the unilateral

trade preferences that the EU currently accords to the ACP with economic partnership agreements involving reciprocal obligations. The EPAs, like other free trade agreements between developed and developing countries would be governed by WTO's Article XXIV rather than by its enabling clause, which applies only to unilateral preferences granted to developing countries and to preferential trade agreements between developing countries. Article XXIV requires that the countries entering into a reciprocal free trade agreement liberalise 'substantially all trade' within a 'reasonable length of time', without distinguishing between developed and developing countries.²

WTO-compatibility is an important consideration for the EU and weighed heavily in launching of the EPA process. In contrast, because of their small size, many of these 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. Many SSA countries have argued that they should be exempted from Article XXIV or that it should be amended in the Doha round to permit less than full reciprocity by developing countries participating in an FTA with industrial countries.

Comprehensive coverage and the implicit reform model. EPAs are envisaged in the Cotonou agreement as including comprehensive coverage of trade in services, investment, competition, trade facilitation, and aid for trade as well as merchandise trade. The EU sees the EPAs as instruments for addressing many of the supply-side constraints that limited the expansion and diversification of SSA exports to the EU despite the trade preferences provided under the Lomé and Cotonou Agreements. The EPAs would thus be used to leverage and lock-in broad programmes of trade and investment climate reforms. The EU envisages the EPAs to be broadly similar in this respect to the accession agreements between the EU and Central and Eastern Europe, to the EU-Mexico FTA and NAFTA, and to Chile's FTAs with the EU and US. In contrast, despite having signed the Cotonou Agreement, many SSA countries are hostile to the inclusion of the 'Singapore

issues' (investment, competition, trade facilitation, and government procurement) in the EPAs, which they perceive as a 'divide and conquer' strategy for the EU to achieve through EPAs what it could not in the WTO.

Differentiation between LDCs and non-LDCs. In addition to reciprocity and comprehensive coverage, a third key feature of the Cotonou Agreement is intended to be differentiation between LDCs and non-LDCs. The last part of Article 2 of the Agreement states: 'differentiation and regionalisation: co-operation 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 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'. For example, the LDCs may not be required 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 long as the differential pace of market opening does not undermine the overriding development and regional integration objectives. As we will discuss below, the differentiation principle creates some complications with respect to regional integration within SSA, and differentiation between LDCs and non-LDCs could end up being a temporary feature of EPAs.

Aid for trade. A fourth intended feature of EPAs is to more effectively co-ordinate trade and aid. The EU is one of SSA's largest aid donors. Thus, its financial and technical co-operation programme could, in principle, provide substantial assistance for overcoming problems and taking advantage of opportunities created by the improved market access and trade liberalisation under EPAs. The opportunity for effectively co-ordinating 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.

Co-ordinating the programmes of the EC's two large general directorates for trade and aid, each of which have different constituencies and different perspectives, and the finance and trade ministries in SSA countries, which have similar differences, is essential for a pro-development outcome but will be a challenge for all concerned.

One issue with particularly important implications for the EPA negotiations is the amount of financial resources that will be provided to support the trade liberalisation process in SSA. The amount of development finance available from the EU until the end of 2007 under the 9th European Development Fund (EDF) has already been set, and its regional integration support programmes have been worked out with the various country groupings. However, the ACP group has argued that the financial resources currently available from the EU are insufficient to support trade liberalisation and expansion as well as the ACP countries' other development needs.

Any effects from the changes in market access and liberalisation under the EPAs will only be felt after 2007, potentially long thereafter, depending upon the liberalisations schedules under the EPAs. The financial envelopes for the 10th EDF and subsequent ones for the period after 2007, when the EPAs will be implemented, have not yet been determined; and their size and operational features presumably could still be designed to support the EPA process.

As discussed later, because of the limited scope that the EU has for offering additional trade preferences under the EPAs to SSA countries, particularly the LDCs, 'aid for trade' will have to play a central role in creating a favourable economic and political environment for the comprehensive reforms envisaged under them. As part of the G8 effort to mobilise increased funding for development in Africa, the EU has pledged to double its aid to Africa by 2012. Trade Commissioner Mandelson has recently indicated that a 'substantial portion' of this increase will go to aid for trade and that a mechanism will be put in place to strengthen co-ordination between the trade and aid directorates of the EC.

The EPA negotiations thus far

The Phase I Negotiations

Phase I of the EPA negotiations, during which ACP-wide issues were to be addressed by the group as a whole, ran for one year from September 2002 through October 2003. The ACP group and the EC then 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 group and the EU and even disagreement on some issues within the ACP group itself. Issues that were still under discussion at the end of Phase I included: WTO compatibility; the treatment of non-LDCs not entering into EPAs; rules of origin; technical barriers to trade (TBT) and sanitary and phytosanitary (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.

Establishment of the regional EPA groupings in SSA

In parallel with Phase I, the EU initiated discussions of regional EPA groupings with SSA countries. These countries subsequently formed into the following four regional groups for negotiating EPAs with the EU:

- The Economic Community of West African States (ECOWAS) plus Mauritania form the ECOWAS EPA group.
- The Central African Economic and Monetary Community (CEMAC) plus São Tomé and Príncipe comprise the CEMAC EPA group.
- Sixteen countries, including most of the members of the Community of Eastern and Southern African (COMESA), constitute the Eastern and Southern Africa (ESA) EPA group, for which COMESA is serving as the Secretariat.

- Four Southern African Customs Union (SACU) members (all but South Africa) and three neighbouring SADC countries (Angola, Mozambique and Tanzania) form the SADC EPA group.

The Phase II Negotiations

In October 2003, the Phase II negotiations were launched with two of the four SSA sub-regions – CEMAC and ECOWAS. EPA negotiations were subsequently initiated with ESA in February 2004 and with the SADC group in July 2004. Broad road maps setting out the organisational arrangements for the negotiations have been agreed with all groups. The first year of the negotiations was devoted to two tasks: (a) establishing the status of regional integration within the four negotiating blocks in order to address measures for integrating and strengthening regional markets, including their outward orientation, before considering steps to liberalise EU-SSA trade and (b) discussing questions of priority interest to individual EPA groups such as fisheries, SPS, and TBT issues.

General issues concerning EPA regional negotiating groups in SSA

As noted earlier, 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. Although the composition of the four regional EPA negotiating groups in SSA has now largely been determined, a number of important regional trade integration issues remain to be addressed.

Very different initial conditions

Determining the nature of the EPA groupings in SSA has been no simple matter because of the multiplicity and heterogeneity in SSA's regional trade agreements, which include a number of overlapping preferential trade areas, free trade areas, and customs unions (CUs) with different structures, operational rules, and implementation levels. 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 creates a useful dynamic impetus for rationalising this situation and an opportunity for removing intra-regional trade barriers.

The role of customs unions in EPAs

Of the four EPA negotiating groups in SSA, three (ECOWAS, ESA, and SADC) are FTAs that contain smaller CUs: UEMOA in ECOWAS, EAC in ESA, and SACU in SADC. The fourth negotiating group, CEMAC, is a CU. The member countries of each CU share a common external tariff. 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 prior to the entry into force of the EPAs and that it may be desirable to pursue EPA negotiations first with customs unions to see how much can be accomplished in this format and establish good precedents for addressing regional integration issues.

Customs unions with LDC and non-LDC members

A complication in negotiating EPAs with customs unions is the potential inconsistency between the Cotonou Agreement's 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 explained 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 now have little incentive in terms of improved access to the EU market to open their markets to the EU on a preferential basis under an EPA, although EPAs could provide other potentially important benefits for the LDCs (as discussed below).

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 trade preferences expire in 2007. 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. Hence, as noted earlier, given the importance of the regional integration objective to all concerned, differentiation could end up being a temporary feature of the EPA process.

The role of FTAs in EPAs

The situation is different in free trade areas where each country is free to maintain its own external trade policy. On the one hand, because of the different tariffs and other trade policies among 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; instead, separate (similar) EPAs will need to be negotiated by the FTA's member countries. 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. In particular, the tariffs of LDCs and non-LDCs on imports from the EU could differ. Since all four of the EPA groupings are various combinations of CUs, FTAs, and countries with independent trade policies, it may not be feasible to establish customs unions with CETs including all countries in each EPA group as the EU has envisaged. Rather, a flexible variable-geometry approach may be needed, at least in the near term until regional integration is further advanced in SSA.

Barriers to intra-regional trade 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. Intra-regional free trade, where it is has been effectively

implemented, is generally limited to a small group of selected products.

None of the three FTAs involved in the EPA negotiations (ECOWAS, COMESA, and SADC) yet has even relatively free internal trade among its members. The ECOWAS FTA has not yet been effectively implemented. Twelve of COMESA's members have only recently 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, except within SACU, is currently 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, both substantial obstacles to internal free trade and country deviations from the common external tariff remain. The EAC customs union just became operational and faces similar problems since its design is similar. Only SACU is a fully functioning customs union with relatively free internal 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, of course, 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 RoO, most of which are quite restrictive; and there are constant protectionist pressures to increase their restrictiveness. Liberalisation of internal 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 major obstacles that need to be addressed under the

rubric of intra-regional trade facilitation (Yang and Gupta, 2005).

In addition, some natural trading partners with substantial cross-border trade between themselves belong to different regional EPA groupings, and the trade between these countries is not covered by *intra*-regional liberalisation measures. For example, Nigeria belongs to ECOWAS, whereas Cameroon on its southern border belongs to CEMAC. Similarly, the Republic of Congo belongs to CEMAC whereas the bordering Democratic Republic of Congo belongs to the ESA group. The substantial cross-border trade between these countries thus does not benefit from measures designed to liberalise *intra*-regional trade within ECOWAS and CEMAC.

Measures to increase intra-SSA trade

Although the political support for regional integration is currently greater than for the liberalisation of external trade in goods and services, SSA countries will still need to overcome the political and administrative obstacles to liberalisation of intra-SSA trade, with which the EPAs may be able to help. To promote intra-SSA trade and minimise the hub-and-spoke effect of the EPAs, further intra-CU and intra-FTA liberalisation of trade in both goods and services are needed. There are several steps which could 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 and related trade facilitation measures could be implemented in all the EPA groups. Free movement of labour within CUs and FTAs also needs to be encouraged. These reforms are particularly important for the landlocked and poorer members of the regional groupings.
- Second, in addition to implementing internal free trade among their members, the regional EPA groups could implement free trade with each other at the same time as they do so with the EU to avoid distorting cross-border between members of different regional EPA groups and limit the potential hub-and-spoke effect of the EPAs that could result from the EU's establishing separate free trade areas with each regional EPA group in SSA.

- Third, SSA countries could take advantage of the EPA process to adopt simple, standardised, liberal RoO for the various FTAs and CUs in SSA and to address the other trade facilitation issues noted above.
- And, fourth, those member countries of customs unions that have not fully implemented their CU's common external tariff (CET) should do so when implementing other trade liberalisation measures under their EPAs..

In addition, as discussed below in the section on reciprocity, most-favoured nation (MFN) liberalisation would both increase outward orientation generally and facilitate expansion of intra-African trade since trading partners in other African EPA groups would benefit from it.

Implementation of the above reforms is, however, likely to be difficult. Some of these reforms have existed on paper for years in some regional trade areas in Africa, but little progress has been made in actually implementing them. Establishment of free trade with the EU could significantly reduce protectionist opposition both to effective implementation of free trade within Sub-Saharan Africa and to liberalisation of most-favoured-nation (MFN) trade. For, once a product can be freely imported from the EU, there will be much less incentive for protectionist interests to try to block similar imports from other SSA countries or the rest of the world.

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-organisational issue concerns the East African Community's (EAC) customs union, three of whose members (Kenya, Rwanda, and Uganda) are participating in the ESA group while the fourth (Tanzania) elected to join the SADC group. Since the four EAC countries are

implementing a common external trade policy, they will need to negotiate a common EPA as a group. Consequently, some geographic realignment of the ESA and SADC regional EPA groups may be required.

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 as they are known as a group) are participating in the EPA process and have joined the SADC regional EPA group along with Angola, Mozambique, and Tanzania. However, the fifth and by far the largest SACU member, South Africa, which plays a central role in determining SACU's trade policies, is eligible neither for the trade benefits of the Cotonou Agreement nor for an EPA. Furthermore, South Africa has already signed a separate FTA with the EU (the Trade Development and Cooperation Agreement, TDCA), many aspects of which apply *de facto* to the other four SACU countries. In addition, SACU is currently in the process of negotiating a free trade agreement with the US. More thought needs to be given to the roles of SACU and the EU–South Africa free trade agreement and to the membership in the SADC and ESA regional EPA groups in order to create a sound basis for the regional and global integration of the economies of the sub-region.

ECOWAS

The third issue concerns Nigeria's adoption of the planned ECOWAS common external tariff. The Economic Community of West African States (ECOWAS) is composed of the eight members of UEMOA and seven additional countries. An 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 three-rate CET similar to UEMOA's CET by 2008, when the EPAs are supposed to come into effect, and thus in principle may be able to negotiate a common EPA as CU. However, Nigeria's economy is larger than that of all of the other ECOWAS countries put together, and

its trade policy is currently much more restrictive than that of the UEMOA. It is an open question whether Nigeria will implement the ECOWAS CET any time in the near future or demand modifications in it. If full implementation of the ECOWAS customs union is substantially delayed, negotiation of the ECOWAS EPA could be more complicated than currently envisaged, involving variable geometry arrangements for some countries which have implemented the ECOWAS customs union arrangements and others which participate only in the ECOWAS FTA.

SSA's access to the EU market under EPAs and its 'Everything But Arms' (EBA) Initiative

In addition to giving 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 market access conditions 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 non-ACP LDCs 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. Implementation of full market access was 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 being phased out over eight years. 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 developing 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, as countries develop, they can graduate from LDC status, which is determined by UNCTAD/WTO, as Cape Verde is doing, and thus lose their eligibility for the EBA Initiative. The EBA Initiative has also eliminated the preference margin of ACP countries relative to non-ACP LDCs, although the Cotonou rules of origin for the ACP countries 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. Such benefits could, as discussed below, come from liberalisation of the EU's restrictive rules of origin and additional aid for trade to both deal with adjustment problems and support the growth and diversification of exports.

Market access for the non-LDCs in SSA

In contrast to the 33 LDCs in SSA which benefit from EBA and whose current access to the EU market would presumably not be greatly reduced (except possibly as result of the EBA Initiative's somewhat more restrictive rules of origin than the Cotonou Agreement's, as discussed below) 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 favourable preferential access than the Cotonou Agreement: narrower product coverage, smaller margins of preference, and more restrictive rules of origin. The EU has also recently adopted a

GSP+ scheme that provides additional preferences for non-LDCs that comply with a list of international conventions on human rights, the environment, etc; but the GSP+ preferences are not as attractive as the EBA preferences accorded to LDCs.

The value of Cotonou preferences, and hence the impact of reverting to the EU's less favourable GSP, varies considerably among the 13 non-LDCs in SSA. For three non-LDCs, in 2002 the value of the tariff savings under the Cotonou preferences exceeded that under the GSP preferences by 16% to 39% of the value of their total exports to the EU: Swaziland 39% (meat), Mauritius 20% (sugar and knitted garments), and Seychelles 16% (fish). In contrast, for the other 10 non-LDCs the value of the tariff savings under the Cotonou preferences for current exports is small relative to that under the GSP. For five non-LDCs (Namibia, Zimbabwe, Ivory Coast, Cameroon, and Kenya) the loss would be 3% to 6% of the value of their merchandise exports to the EU, and for the remaining five non-LDCs (Ghana, Botswana, Congo, Gabon, and Nigeria) the loss would be 2% or less. Thus, these 10 countries would not lose much by way of reduced market access 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 nine 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.

However, the above figures cover only 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. The 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 in SSA will, in any case, need to obtain improved market access through EPAs to create opportunities for diversifying and expanding exports in the long term. Discriminating under EPAs between the exports of the LDC and non-LDC members of the same customs union or free trade area could slow the growth of the regional group's exports and the development of the group as a whole. Hence, the most development-friendly option would be for the EU to provide EBA market access to all SSA countries – both LDCs and non-LDCs – signing EPAs.

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 more restrictive than those under the Cotonou Agreement. In fact, Brenton (2003) shows that SSA LDCs make little use of EBA preferences and continue to export to the EU under Cotonou preferences. The RoO that apply under Cotonou appear sufficiently less restrictive to make continuing to export under them more attractive for some SSA exporters of some products that face low tariffs under Cotonou than switching to EBA with its zero tariffs but more restrictive RoO.

Two examples that illustrate the potential benefits from liberalising restrictive RoO are: (a) the success of garment exports from SSA under the provision of the US Africa Growth and Opportunity Act's (AGOA) preferences which, as an exception to the US's standard RoO under FTAs, permit SSA garment exporters to use, for a temporary period, fabrics imported from third countries outside the region instead of having to source the fabrics from within the region or the US; and (b) Mauritius's exports of knitted products to the EU which get around the EU's two-stage processing RoO governing textiles and garments by producing knitted garments directly from imported yarn.

Unless the EU's RoO are liberalised and simplified under EPAs, the benefits of even full tariff-free,

quota-free market access will be limited. The liberalisation of the EU's RoO is particularly important for the diversification of SSA's exports to the EU as it is typically the development of simple non-traditional exports which is prevented by restrictive RoO as illustrated by the foregoing examples.

Thus, the Commission for Africa (the 'Blair Commission') has recommended that the EU's current complex RoO be replaced by a simple, uniform 10% value added requirement in the EPAs. An even less restrictive RoO would be to give SSA exporters the choice between meeting a 'change of tariff heading' rule or the uniform 10% value-added rule.³ The EU's trade standards and import defence measures should also be reviewed to see if more development-friendly provisions concerning these can be included in the EPAs.

Reciprocity: Reductions in tariffs on imports from the EU, parallel MFN liberalisation, and complementary domestic reforms in SSA

In return for secure preferential access to the EU market under EPAs, SSA countries are supposed to reciprocate by making preferential reductions in tariffs on SSA's merchandise imports from the EU. Designing the required liberalisation of SSA imports (the 'reciprocity' issue) in a pro-development fashion is one of the more complex and controversial aspects of the EPA process. Two important complementary reforms to the preferential reductions in African tariffs on imports from the EU will be required to achieve pro-development outcomes: MFN tariff reductions and the restructuring of indirect tax systems.

Likely preferential reductions in tariffs on imports from the EU

As noted earlier, WTO's Article XXIV governing all free trade agreements involving industrial countries requires that tariffs be completely eliminated on 'substantially all trade' by the participants in a free trade agreement within a 'reasonable length of time'. Although precise definitions of the two phrases in quotations have not been established, 'substantially all trade' has been interpreted in pre-

vious EU free trade agreements to mean 90% or more of trade. The 90% figure refers to the existing level of trade – which is constrained by existing tariffs and other trade restrictions — rather than to the potential trade level once trade liberalisation has taken place.

The EU–South Africa FTA provides for the EU to eliminate tariffs on about 95% of its imports from South Africa and for South Africa to eliminate tariffs on about 86% of its imports from the EU to reach an average coverage of about 90% of total EU–South Africa trade. If, as seems likely, a similar approach is followed in the EPAs, the EU would probably liberalise 100% of its imports from SSA (that is, grant full tariff-free, quota-free access to imports from SSA); and SSA would liberalise 80–90% of its imports from the EU to arrive at a target average liberalisation of 90% or more.

Ten years has been considered to be a 'reasonable length' of time for implementation in EU free trade agreements except in special cases. A 12-year implementation period was allowed in the TDCA between the EU and South Africa, and the Commission for Africa has suggested extending this period to 20 years in EPAs. Thus, the implementation period for EPAs is likely to fall in the 12–20 year range.

Problematic effects of preferential tariff reductions

Many SSA countries still have high and distorted MFN tariffs. Even in countries where peak tariffs themselves have been reduced to the 20–25% range, tariff exemptions and special protective measures are often problems. Preferential bilateral tariff reductions under EPAs could, in the presence of high MFN tariffs, lead both to some costly diversion of trade from low-cost non-EU to high-cost EU suppliers and to some monopoly pricing by EU exporters and implicit transfers of forgone tariff revenues from SSA governments to them.

Little empirical work has been done on the risk of trade diversion and monopoly pricing by EU suppliers in SSA. On the one hand, advocates of EPAs tend to assume that the EU economy is sufficiently large and competitive that trade diversion and

monopoly pricing are not likely to be serious problems. But, on the other hand, observers familiar with supply conditions in small, isolated African markets that are costly to serve and with historical patterns of market dominance in the region tend to be more sceptical about the existence of effective competition among EU suppliers.

As explained above, it is likely that the preferential elimination of SSA tariffs on imports from the EU will cover only 80–90% of current imports and completely exempt some sectors and products. 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 liberalisation 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 free trade agreement. Limiting liberalisation to 80% of SSA's current imports would probably allow most of the important import-competing sectors in SSA to be exempted because, with their relatively small import-competing manufacturing sectors and current high protective tariffs (and quantitative restrictions in a few cases), imports of products that compete with domestic productions are likely to be a small percentage of total imports (Stevens and Kennan, 2005).

A tariff structure resulting from selective, *ad hoc* preferential reductions in tariffs on imports from the EU would be problematic both for the sectors for which imports are liberalised and for those for which they are not. The sectors for which tariffs on EU imports are eliminated may experience trade diversion or monopoly pricing by EU suppliers, and the sectors for which current high tariff rates are maintained would continue to have little incentive to increase their efficiency or reduce monopolistic profits. In addition, the 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 further distort existing tariff regimes by increasing the already high effective pro-

tection rates for import-competing 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 these distortions.

Furthermore, the existing structure of tariffs within the various EPA groupings makes it likely that strong protectionist interests, including foreign firms producing behind high tariffs, will resist an efficient common external tariff. Stevens and Kennan (2005) find, somewhat surprisingly given the existence of three customs unions with CETs, that in the four African EPA groupings there is only a 1–12% overlap of the high tariff products that member countries may wish to exclude from liberalisation for protective reasons. This finding, if confirmed, would suggest that there will be hard negotiations over a common list of products to be excluded by all countries in EPA groups having a common external tariff, that very different lists of products may be excluded by each country in FTAs where there is no common external tariff, and that regional harmonisation of exclusions may be desirable to foster regional integration.

Need for parallel MFN tariff reductions

Because of the distortions that can result from *ad hoc*, selective preferential liberalisation, a number of pro-active developing countries (Chile and Mexico, for example) lowered their MFN tariffs to a uniform rate of 10% or so on a comprehensive basis before selectively eliminating tariffs on a preferential basis under free trade agreements with the EU and the US, and have followed up on these initial cuts with both further MFN liberalisation and adoption of free trade agreements with other large trading partners. The most successful regional trade agreements (the EU itself, NAFTA, AFTA) have also used low MFN tariffs to stimulate trade (World Bank, 2005).

Upfront MFN tariff reductions. Parallel preferential and MFN liberalisations are beneficial both because of the standard static benefits from increases in trade and the much larger dynamic gains from a more

open economy as well as because of the reductions in trade diversion and in monopoly pricing effects and the implicit transfer of forgone tariff revenues to foreign suppliers benefiting from preferential tariff reductions. MFN tariff reductions would need to be implemented by SSA countries before the preferential tariff reductions with the EU under EPAs take place so that trade diversion is minimised and EU suppliers do not have a chance to sell into highly protected domestic markets in SSA, and thus obtain large implicit transfers of forgone tariff revenues, before MFN tariffs are reduced. In order to increase competition and lower the prices of tradable goods in SSA, the tariff reductions would need to cover all sectors, including, in particular, the main domestic import-competing industries.

However desirable the adoption of a low uniform tariff of 10% or so may be economically, because of political and revenue constraints it may not be possible to lower the MFN tariff this much in all EPA groups before starting to implement preferential reductions in tariffs on imports from the EU under EPAs. In those EPA groups (ECOWAS and CEMAC) where the establishment of a common external tariff precedes the implementation of the EPA, adoption or lowering of the CET will offer an opportunity to start the necessary MFN tariff reductions in a co-ordinated way and to reduce the magnitude of the subsequent changes needed prior to implementing preferential liberalisation of imports from the EU under an EPA. For example, the ECOWAS/UEMOA CET with four rates of 0, 5, 10, and 20% is currently the most open tariff structure in SSA. Its implementation by the ECOWAS countries that have not already done so would put them in a good starting position for the subsequent MFN reductions needed for an EPA. ECOWAS's common external tariff with its maximum rate of 20% and simple four-rate structure is also a good model for other EPA groups to follow in adopting or liberalising their own common external tariffs prior to preferential reductions in tariffs on imports from the EU under EPAs.

In the case of any FTAs (ESA or SADC) where it turns out not to be feasible to adopt an efficient common external tariff prior to implementation of the EPA, a well-designed MFN liberalisation would

make it easier for the countries in the FTA to move towards a common external tariff and create a favourable environment for further liberalisation among themselves. On the other hand, as CETs are adopted by new countries, there will inevitably be protectionist pressures for high tariffs (as is possible, for instance, in the case of Nigeria's adopting the ECOWAS CET) that will need to be resisted.

Subsequent parallel MFN and preferential tariff reductions. The initial reductions in MFN tariffs in the regional EPA groups may not go as far as ultimately needed. However, the selective, phased nature of the likely preferential reductions in tariffs on imports from the EU, with 80–90% of EU imports becoming completely free with 0% tariffs over a 10–12 year period and the remaining 10–20% of EU imports continuing to face current tariffs, offers the possibility of a parallel two-track approach to MFN tariff reductions with different schedules of reform for these two groups of products.

In the case of the 80–90% of imports from the EU that will have no tariffs, the simplest approach for avoiding trade diversion and monopoly pricing resulting in implicit transfers of forgone tariff revenues to EU suppliers is for the SSA countries to lower their MFN tariffs on products that will be freely imported from the EU to no more than 5%. From a development perspective, the only rationale for maintaining even such a small preference margin (5% or less) for imports from the EU would be to use the availability of this margin as an incentive to encourage other countries to enter into similar free trade agreements, an unlikely prospect in current circumstances. A zero preference margin (that is, lowering the MFN tariff to the same level as the preferential EU tariff) would be the most development friendly outcome since it would minimise the risk of trade diversion or of monopoly pricing by EU suppliers. In addition, to limit revenue losses during the implementation period, instead of directly lowering to zero the tariffs on imports from the EU that are to be fully liberalised under EPAs, the preferential and MFN tariff reductions on these products could be carried out in steps, by first gradually lowering the preferential EU and MFN tariffs to a revenue tariff of 5% or so on these imports and then main-

taining the two tariffs at this level for as long as possible for revenue purposes.

In the case of the 10–20% imports on which there would be no preferential reductions in the tariffs facing the EU, EPAs by themselves would create no immediate urgency to reduce MFN tariffs except to offset the increases in effective protection that would result from eliminating the tariffs on many imported inputs. However, MFN liberalisations are often hard to engineer politically. Adoption of common external tariffs by some or all of the regional EPA groups will also complicate future liberalisations because their members will no longer be able to unilaterally reduce their tariffs and all (or a decisive majority) of an EPA group's members will need to support future liberalisations. Hence it would be desirable to take advantage of the reform dynamics of the EPA process to continue the trade liberalisation effort. In order to avoid increasing anti-export bias when tariffs on inputs imported from the EU are lowered and to put competitive pressure on import-competing sectors to operate more efficiently, the maximum tariff in the non-liberalised sectors should be lowered to 15% or less with the lower tariff bands being adjusted as necessary.⁴ In cases where such MFN reductions are likely to cause particularly difficult adjustment problems, it would be better to allow a longer time period for phasing in the tariff reductions and to provide more adjustment assistance under the aid-for-trade programme than to postpone indefinitely the required structural adjustment by exempting some industries from the liberalisation. The 15% maximum MFN tariff on the 10–20% of trade not subject to preferential liberalisation could subsequently be further reduced to 10% or so at an appropriate future date in accordance with the needs of individual customs unions and countries.

The MFN tariff reductions are essential if EPAs are to achieve their development objective. In the EPA process the EU needs, therefore, to support well-designed parallel MFN tariff reduction rather than just pushing for preferential reductions in tariffs on EU imports. If the MFN reductions cannot be formally included in the EPAs, the necessary MFN tariff reductions could be made by the SSA

customs unions and countries, unilaterally lowering their MFN tariffs at the same time as they lower their tariffs on imports from the EU under EPAs.

Potential revenue losses and the restructuring of indirect tax systems

Magnitude of the potential revenues losses. Import tariffs are still an important source of government revenue in many SSA countries, and preferential reductions in SSA tariffs on merchandise imports from the EU could have significant fiscal implications for some. Revenues from import tariffs amount to about 2% of GDP and 15% of government revenues in the median SSA country, and some countries depend even more heavily on tariff revenues. In the one-third of SSA countries which are most dependent on tariff revenues, import tariffs amount to 3–6% of GDP and account for 25% or more of government revenues, reaching as much as 40–50% of government revenues net of grants in a few extreme cases (Hinkle, Herrou-Aragon, and Kubota, 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 could 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 (7–10% of government revenues) from eliminating tariffs on all imports from the EU if the same average tariff is paid on imports from the EU as on those from the rest of the world.⁵ The revenues losses could be significantly greater in countries that are highly dependent on tariff revenues: countries in which tariffs account for 4% or more of GDP could lose revenues of 1.5% or more of GDP (15–20% of total 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) analyse the effects on the ECOWAS coun-

tries of preferential elimination of tariffs on all imports from the EU using a partial equilibrium model. They find that imports from the EU would increase by 5% (Guinea-Bissau) to 21% (Nigeria), rising 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. Mid-range countries such as Ghana and Senegal would experience revenue losses of 1.8–1.9% of GDP (10–11% of total revenues).

The above figures are, however, for the ultimate effect of a fully phased-in elimination of duty on all imports from the EU and thus are indicative of the upper limit of the magnitude of possible revenue losses. Excluding 10–20% of imports from the EU from preferential liberalisation could ease the fiscal shock, particularly if tariffs on imports that are important sources of revenue are not reduced. If, moreover, the tariff reductions are phased in gradually over a 10–20 year period as envisaged in the EPAs, the adjustment should be more manageable (0.05–0.3% of GDP per year), except possibly in a few extreme cases that may require special attention.

Nevertheless, there are still valid reasons for concern about the difficulty of replacing lost tariff revenues. Buansgaard and Keen (2005) find that, after trade liberalisations, ‘revenue recovery has been extremely weak in low-income countries (which are those most dependent on trade tax revenues): they have recovered, at best, no more than about 30 cents on each lost dollar. Nor is there much evidence that the presence of a value-added tax has in itself made it easier to cope with the revenue effects of trade liberalisation.’

Offsetting revenue measures. In view of the unmet expenditure needs for government spending on health, education, and infrastructure and the debt burden and structural constraints to increasing government revenues, many SSA countries will need to design the preferential reductions in tariffs on imports from the EU in a way that limits the loss of revenues. The products that SSA governments may need to exclude to maintain government revenues are likely to differ significantly from those that would need to be excluded to protect domestic

producers (Stevens and Kennan, 2005). Hence, in deciding on which products to exclude, a strategy of giving priority to protecting fiscal revenues, together with limiting the extent of the exclusions, could provide a healthy counterbalance to the demands of vested interests for continued protection. (For a discussion of additional measures for reducing the distortionary effects of preferential liberalisations see Schiff and Winters, 2003). In addition, as suggested above, the loss of revenues from completely eliminating tariffs on 80–90% of imports could be limited in the medium term by gradually lowering the preferential EU and MFN tariffs on these imports to a revenue tariff of 5% or so and maintaining the revenue tariff at this level for as long as possible while a restructuring of the domestic tax system is carried out and tax administration improved.

To protect their fiscal positions and maintain macroeconomic stability, SSA countries will also 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 or that have already successfully implemented a VAT scheme and have little scope for increasing the revenues from it may need to consider strengthening other components of their tax and revenue systems.

Restructuring indirect tax systems and strengthening tax administration are complex legal and administrative undertakings. They require some of the most demanding and time-consuming reforms facing SSA countries. Indirect taxes will also need to be harmonised within regional EPA groups, and variations in revenue impacts within the same EPA group will create additional complications. However, the restructuring of indirect tax systems is necessary in the long term to modernise revenues systems. All countries wishing to integrate into the world trading system will need to implement this reform sooner or later. (Some SSA countries, such as those in SACU and UEMOA, have already embarked on this process in the course of ongoing reform programmes.)

Detailed country-by-country analysis of the revenue implications of preferential tariff reductions and parallel MFN liberalisation will, therefore, be essential for planning complementary reforms in domestic tax reforms. The required strengthening of tax administrations and restructuring of the indirect tax system needs to be started before, the tariff reductions on EU imports are implemented. In addition to having enough time to plan and implement the required reforms, the SSA countries, particularly the least developed ones, may require substantial technical and financial assistance from the EU during the implementation period if elimination of tariffs on imports from the EU is not to undermine their fiscal positions. One particularly useful confidence-building measure would be to provide back-up grant-financing for tariff losses and related revenue shortfalls until the tax reform has been completed, tax administration has improved, and foregone tariff revenues have been securely replaced.

Harnessing EPAs for development: Broad design issues

We see the EPA as a means of unlocking the future, not imprisoning ... ACP countries in the past.

EU Trade Commissioner Mandelson⁶

Determinants of success or failure

The fundamental condition for realising the potential development benefits of the EPAs is to actually use 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 focus of the EPA process in the face of pressures from business and political interests, a difficult task for trade negotiators accustomed to thinking in terms of mercantilist commercial advantage and political deals, 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 be abandoned or end up causing 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 SSA countries, the key requirement is commitment to using EPAs to accelerate reforms that are necessary in the long term for integrating their economies globally and regionally. Implementing free trade with the EU will require a number of difficult policy and administrative steps by SSA countries, including undertaking parallel MFN tariff reductions to avoid costly trade diversion and monopoly pricing by EU suppliers, replacing foregone tariff revenues, and liberalising internal trade within and among SSA's regional EPA groups.

Moreover, there are many obstacles to expanding production of tradable goods in Africa in addition to the merchandise trade-related reforms discussed in this paper. The investment and supply response to the merchandise trade-related reforms will be much greater if these reforms are followed by additional reforms in the investment climate. Hence, the readiness of individual countries to use the EPA process to leverage a wide range of investment-climate reforms will be critical in determining the success of EPAs.

Broad EPA design issues

Four design issues are critical to the success of the EPA process: creating effective incentives to reform; allowing enough flexibility to deal with wide variations in regional and country conditions; appropriate phasing and sequencing of a long list of complex policy actions; and designing, if feasible, pro-development provisions concerning trade in services, investment, and competition.

Incentives to reform and aid for trade. Many African countries are reluctant to undertake necessary trade-related reforms, and it is unclear whether the incentives in the current EPA design are sufficient to induce them to do so. 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 EPAs have become quite

controversial; and the perception of the potential gains from EPAs currently appears to be negative in some African countries. 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. The EU will need to include generous treatment of SSA exports in the EPAs by liberalising its restrictive rules of origin, extending full tariff-free, quota-free market access to the non-LDCs in SSA, eliminating agricultural export subsidies and decoupling agricultural production support in products of particular interest to SSA in the Doha round, and in general facilitating exports from SSA in whatever way possible under EPAs. Furthermore, if EPAs are to be credible instruments for leveraging reforms, they will need to be enforced; and a development-friendly approach will thus need to be found for handling enforcement and dispute settlement problems.

Providing attractive levels of aid for trade to support the implementation of the EPAs is also likely to be a critical incentive, particularly for the LDCs. To reverse the current negative perception of EPAs, resources provided as aid for trade will need to be perceived as additional and substantial by the countries entering into EPAs. The additional aid for trade will need to be significantly greater in real terms than the amount needed to finance the transitional costs associated with the EPAs and related reforms and to cover both budgetary assistance and financing of new investment. If the EU were to offer an ambitious programme of additional aid for trade as well as the trade-related benefits noted above, it might tip the balance of political-economy incentives favourably. Careful thought therefore needs to be given to the design of the aid-for-trade package as the negotiations unfurl.

Flexibility in regional and country design. EPAs were originally envisaged as agreements between the EU and customs unions that have common external tariffs. However, 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 integra-

tion. Except for SACU, few, if any, are capable in the medium term of reducing internal border barriers or in co-ordinating their external trade regimes to the extent required in a full customs union with revenue pooling and no customs barriers at intra-regional borders. Hence, the EPAs will probably have to permit flexible combinations of customs unions and free trade agreements.

Country conditions within the regional groupings are also diverse. All four regional EPA groups include both LDCs and non-LDCs as well as small economies alongside one or two dominant large ones. Commitment to both external and intra-regional liberalisation differs similarly. The political obstacles to reform (such as civil unrest and strong vested interests) may be so great that some countries, or even sub-regions, may have 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. Progress in these diverse country circumstances is likely to require that EPAs allow for some differences in the trade regimes and the pace of reform in the same EPA group, at least in the initial phases.

Appropriate timing and sequencing of EPA-related reforms. The current EPA design envisages addressing a wide range of difficult development issues in multiple sectors in 44 countries in four diverse regional groups in a period of 12–20 years. The end-2007 deadline for completing the EPA negotiations is rapidly approaching. Even for countries with substantial institutional capacity, dynamic leadership, and strong political support for reforms, design and implementation of such comprehensive programmes will be a challenge. For countries with serious capacity constraints and lukewarm political support for reform, the list of reforms envisaged is daunting. Hence, a single mega-EPA agreement with a 12–20 year implementation period may prove too demanding to negotiate and implement even for the most committed regions. A series of agreements with careful attention to the timing and sequencing of reforms is probably a more realistic option than a single comprehensive EPA.

The reform process will have to be carefully steered to take advantage of the dynamism provided

by the EPA negotiations and their deadlines while allowing realistic amounts of time for policy design and implementation and avoiding initiatives that would not be sustainable institutionally or politically. With appropriate programme design, the envisaged 12–20 year implementation period appears generally reasonable. However, given the depth of some of the controversies and the need for more preparatory work on some key issues, the end-2007 deadline for completing negotiations may eventually need to be extended for some of them, particularly if trade in services, investment, and competition policy are to be included.

Designing development-friendly provisions concerning trade in services, investment, and competition policy. There are many obstacles to expanding production of goods and services in Africa in addition to the trade-related reforms discussed in this paper. The investment and supply responses to the merchandise-trade reforms will be much greater if these are followed by actions in other areas. It may be possible to address some supply-side and behind-the-border reforms by including trade facilitation, trade in services, investment, and competition policy in the EPA process. Despite the controversy surrounding these ‘Singapore issues’, this possibility merits serious examination. In-depth analytical work on how to design such measures in a development-friendly way needs to be undertaken with some urgency if they are to be included in the EPAs.

Conclusion: Rewards, risks, and alternatives

The impetus of the EPA process offers the African countries as a group an opportunity to address both internal and external obstacles to global and regional trade integration. This concluding section reviews the potential rewards and risks of EPAs and notes alternative approaches.

Potential rewards of EPAs

Likely situation without EPAs. In many SSA countries the political economy environment for trade liberalisation is difficult because of powerful, well-organised protectionist interests. Political enthusi-

asm for unilateral liberalisation is limited. SSA countries, hoping for a ‘round for free’, have not really engaged in the multi-lateral WTO discussions, and the Doha round by itself may not lead to any reductions in applied MFN tariff rates in SSA. The prospects for regional integration efforts in SSA are also uncertain. Thus, in the absence of EPAs, in the medium term progress with reforms is likely to be confined to a handful of countries.

Potential outcome with EPAs. EPAs and the current regional trade areas in SSA may not be optimal arrangements from an economic point of view, but there are strong political forces supporting their continuation. Although controversial, the EPA process has already gathered substantial momentum in both the EU and SSA and is catalysing an active debate over, and some actions on, trade reform and regional integration in SSA. Implementation of EPAs involving liberalisation of both intra-regional and external trade and investment climate reforms may be more feasible to engineer politically than unilateral or intra-regional trade liberalisation by themselves since a quid pro quo, in the form of improved access to the EU market and aid for trade, would be involved. EPAs could thus offer SSA an important opportunity to accelerate trade and growth.

The EPAs could be quite beneficial economically for SSA if they can be used to leverage important policy reforms. The EC hopes that the EPA process can reinforce current reform efforts by strengthening public and private sector reform advocates and deepening the regional integration process. The requirement for SSA countries to liberalise imports from the EU to improve their access to the EU market provides an opportunity for them to integrate into the global economy, strengthen regional integration in Africa, accelerate trade and related reforms under potentially favourable conditions, and lock in these reforms in a way that makes them credible to the rest of the world, investors, and aid donors alike. Moreover, the inclusion of trade in services, investment, competition, and trade facilitation, if feasible, could provide an opportunity to use the leverage of the EPA process and accompanying aid for trade to address a broad range of obstacles

to a strong supply response in trade related sectors. The EPA's 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.

Risks

The EPA process also entails some serious risks for Africa. 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. Initial negative reactions from the European Commission's trade directorate to liberalisation of the EU's rules of origin and to parallel MFN tariff reductions by African countries are not good omens. The management of a truly development-oriented EPA process effectively combining trade and aid could also prove too complex. Partial preferential liberalisation of imports from the EU under EPAs by itself could be disadvantageous on balance because of the distorted structure of protection and increased anti-export bias that it would create and the likelihood of significant costly revenue losses, trade diversion, monopoly pricing by EU suppliers, and continued inefficiency of import-competing industries. Some SSA countries may not be able to implement the necessary parallel MFN tariff reductions or the required accompanying domestic reforms as a result of lack of political support or limited institutional capacity. These countries may suffer from losses of fiscal revenue, trade diversion, and monopolistic pricing until they make the required reforms. The EPA process could also end up being abandoned, with the acrimony surrounding this outcome poisoning the environment for trade and investment-climate reforms, at least temporarily.

Alternative approaches

The Cotonou Agreement envisages a fairly uniform approach to EPAs with broadly similar agreements to be adopted by four African regions more or less

simultaneously. However, as discussed above, because of the diversity of initial conditions, considerable flexibility and selectivity is likely to be needed in the treatment of both the regional EPA groups and the countries within them. Moreover, in order to avoid being limited to the minimum level of progress that is possible in the most difficult sub-regions, it may be desirable to confine EPAs to those regions and countries that are most committed to the EPA process and can use it effectively to leverage their reform programmes, letting the others fall back on the GSP and EBA initiative for access to the EU market until they are ready to reform. Bilateral FTAs, or other temporary arrangements, with individual non-LDCs may also need to be considered for those that would be most adversely affected by dropping back from Cotonou preferences to GSP.

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