

# **ADJUSTING TO THE EFFECTS OF THE ACP-EU ECONOMIC PARTNERSHIP AGREEMENTS**

## **The Application of Special and Differential Treatment**



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## Abstract

The economic partnership agreements (EPAs), in order to meet their development objectives, will need to bring about higher benefits than costs. This paper's aim is twofold. Firstly, it tries to identify the effects EPAs will have on the African, Caribbean and Pacific (ACP) group of states. Secondly, this paper attempts to systematically discuss the various ways in which special and differential treatment (SDT) may be applied to minimize the adjustment costs of EPAs. The paper argues that the EPAs have the potential to bring about significant benefits but will also involve adjustment costs that will need to be addressed. It focuses its discussion of the effects on the Vinerian effects (trade creation and diversion) and fiscal effects; the latter is an important adjustment cost associated with EPAs.

With regards to the application of SDT in EPAs, this paper enters a subject area that so far has not been discussed in the literature. It argues that SDT provisions in the WTO may be related to the EPA provisions, but cannot simply be transposed. It explains how the WTO SDT provisions may influence the EPA SDT provisions and vice-versa. Also, it identifies and discusses additional forms of SDT that are unique to EPAs and other free trade agreements and addresses the difficulties related to the identification of SDT in EPAs. It concludes that the scope for SDT in EPAs is limited, but can be of value for the ACP in terms of exemptions of goods from trade liberalization and temporary safeguards in all trade-related areas.

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# 1. INTRODUCTION

The African, Caribbean and Pacific (ACP) group of countries, a formation that consists of 77 former colonies of the member states of the European Union (EU), have benefited for a long time from the trade preferences that were provided to them by the EU and which granted them better access to the European market than other developing countries. However, they are now engaged in the negotiations of the Economic Partnership Agreements (EPAs) that will transform their trade relationship with the EU from unilaterally determined preferences to a reciprocal trade regime.

Ever since the EU proposed this change of the trade relationship 10 years ago, its effects on the development of the ACP countries have been subject to debate. Although the EU has continuously argued that the EPAs will contribute to the development of the ACP countries and constitute an improvement in comparison to the regime which is about to expire, many observers have voiced their doubts about the development effects of EPAs. One of the big questions of the debate has thus been how it can be made certain that the EPAs will deliver on their development promises.

What do we know about the impact of EPAs, for which the negotiations have started in 2002 and will be concluded before 2008? What do critical surveys tell about the potential effects of EPAs and what are the main effects identified? What conclusions do they draw about the adjustment costs associated with EPAs?

Analyses seem to indicate that the EPAs have the potential to bring about significant benefits to the ACP countries, but also involve adjustment costs. However, only partial results are provided and no overall, comprehensive assessment is available. Since many results are still missing, it is difficult to draw any conclusions on the impact of EPAs; the estimated benefits may turn out to be larger but it is also possible that the benefits will

turn out smaller, possibly even smaller than the costs. Although it is certain that ACP countries will face adjustment costs, it is unclear how big they will be.

Keeping in mind the development dimension of EPAs, it may be worthwhile to see how these adjustment costs may be addressed through special and differential treatment (SDT). In this framework, the following question comes to mind: *What are the effects of EPAs and what can the role of SDT be when addressing the adjustment costs that are associated with EPAs?* This thesis will aim to answer this question. With regards to the latter part of the question, it must be noted that, rather surprisingly, the application of SDT in EPAs has not yet been discussed in the literature. Therefore, the thesis is the first attempt to systematically discuss SDT in the context of EPAs

This thesis will start with an introduction to the EPAs. The history of the ACP-EU trade relationship and the debate on the development effects of EPAs will be discussed in brief. Also, the importance of capacities and institutional quality for EPAs will be addressed. In chapter 3 the economic effects of EPAs will be discussed. Out of the myriad effects that are expected of EPAs, trade creation and trade diversion and the fiscal impact will be discussed in some detail. Chapter 4 will address the application of SDT in EPAs. The history of and rationale for SDT, as well as the special nature of SDT in EPAs and the ways in which it may be applied will be considered. Finally, the conclusion will provide a summary of the issues discussed and hence will answer the thesis question.

## **2. SHORT OVERVIEW OF THE ECONOMIC PARTNERSHIP AGREEMENTS**

Since the EU, or earlier communities that now together constitute the EU, has been established the development of the third world has always been one its objectives. In fact, the Schuman declaration of 9 May 1950, acknowledged as the first move towards European integration, already mentioned the development of Africa. The French Minister for Foreign Affairs Robert Schuman, trying to persuade his audience to support his plans for economically integrating the German and French –and possible other European- coal and steel industries, mentioned that with the increased resources arising from this integration “Europe will be able to pursue the achievement of one of its essential tasks, namely, the development of the African continent” (Schuman, 1950). Although Schuman in his speech referred to an African continent that was near fully colonized by European countries, Europe has continued to pursue the development of its former colonies.

### ***2.1 A short history of the ACP-EU relationship***

The first association between Europe and the former colonies was the Yaoundé agreement, signed in 1963 and renewed in 1969 (Yaoundé II). After the United Kingdom joined the EU in 1973, its anglophone ex-colonies ended the dominance of francophone countries in the Yaoundé agreements. The ACP group was formed and its members signed Lomé I with the EEC, one of the predecessors of the EU. Because the Lomé agreements combined predictable aid flows with trade preferences and consisted of several other new features it was long considered highly innovative. However, with the publication of the *Green Paper* on the ACP-EU relationship in 1996 the European Commission (EC) started a process of revolutionising the ACP-EU relationship. Lomé IV would expire in 2000 and several developments had convinced the Commission that important changes were needed. First of all, since the end of the Cold War North-South relationships had become politicised (ECDPM, 2001). The EU became more concerned with respect for human rights, democratic principles and the rule of law; issues that were not addressed within the Lomé framework. Secondly, and more relevant to the scope of this paper, the EC advocated a re-evaluation of the system of trade preferences in the

ACP-EU relationship. The non-reciprocal trade preferences granted to the ACP were increasingly perceived by other non-ACP developing countries as discriminatory and hence incompatible with the international rules agreed through the WTO, which stated that, generally speaking, countries cannot discriminate between their trading partners, the so-called most-favoured nation principle (MFN). Moreover, Lomé preferences had not brought about the development of the ACP and most ACP countries were not well integrated in the world economy. Its share in the EU market had declined from 6.7% in 1976 to 3% in 1998 and the income-gap between the ACP and the EU had only increased.

The Cotonou Partnership Agreement (CPA), which was signed on 23 June 2000, set out to address these concerns by introducing the new Economic Partnership Agreements (EPAs) and presented the signatory parties with a time-line for the negotiations: talks started in 2002 and the EPAs “shall enter into force by 1 January 2008’ (CPA 37.1). It anticipated “the gradual removing of barriers to trade” (CPA 37.7) between the EU and the ACP, the latter divided into regions. Ever since the EPA negotiations begun on 27 September 2002, its contribution to the development of the ACP countries, the overall goal of the CPA and hence of the EPAs, has been subject to much debate.

## ***2.2 Introducing the EPAs***

The EPAs which are currently being negotiated are essentially free trade agreements (FTAs) between the European Union on one side and six regional ACP groupings<sup>1</sup> on the other. The EPAs will cover a wide scope of issues: in addition to trade in goods and agricultural products, they will also cover trade in services and will address non-tariff and technical barriers to trade. Depending on the region’s preparedness and/or willingness, EPAs may also include one or more of the so-called ‘Singapore-issues’ (investment, competition, trade facilitation and transparency in government procurement).

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<sup>1</sup> West Africa (ECOWAS+), Central Africa (CEMAC+), East and Southern Africa (ESA), Southern Africa (SADC-), the Caribbean (CARIFORUM) and the Pacific ACP. Annex A contains a diagram depicting all the African regional groupings. Annex B contains a table with the regional groupings the ACP countries belong to.

The CPA has set out four principles that constitute the building blocks of the EPAs. The first principle is that EPAs must fit and reinforce the overall development objectives of the CPA (Bilal and van Hove, 2002). To be of benefit to the ACP, EPAs must be ‘economically meaningful, politically sustainable, and socially acceptable’. The second and arguably most revolutionary principle of the EPAs is reciprocity. FTAs will be established between the EU and the regions and for the first time ACP countries will have to open up their economies to a much more developed partner. The third principle is regionalism. EPAs are intended to become a FTA between two regions. The last principle is differentiation. The CPA attaches considerable importance to differentiation and special treatment in EPAs, affirming the North-South character of the relationship, by stating that the EPAs will take into account the different levels of development of the contracting parties (CPA 35.3). The least developed countries (LDCs), small and vulnerable economies (SVEs), land-locked LDCs (LLDCs) and small islands developing states (SIDSs) are mentioned specifically in this regard.

The merits of EPAs for development have been intensely debated; although criticism of the EPAs started as early as 1996 when the EC only suggested EPAs in their embryonic form as an option, the approaching deadline and the fact that the EPAs are entering more substantive phases have only heightened the controversy. The most outspoken supporter of the EPAs is the EC itself, while critics can be found in civil society<sup>2</sup>, academic circles and both ACP countries and EU member states. The EU has been arguing that EPAs, which will widen markets after they have taken effect, will help ACP companies and economies to become more efficient. These larger markets will be more attractive for local and foreign investors. Also, by building on existing regional integration initiatives, EPAs will consolidate and strengthen these initiatives and hence will help to make regional integration more effective (EC, 2002). The EC also aims to include many trade-related issues in the EPAs through which procedures related to trade can be harmonised and simplified in the ACP regions. Finally, the EC claims that the EU-EPA groupings,

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<sup>2</sup> Several civil society organizations that are critical of the EPAs have united their efforts in the “StopEPA” campaign ([www.stopepa.org](http://www.stopepa.org))

rather than the various and overlapping South-South regional groupings<sup>3</sup>, will constitute more credible regional integration initiatives and can hence be used to lock-in reforms, making them effectively irreversible. The EC is adamant that because of these benefits and because of the parallel development cooperation which will accompany the EPAs<sup>4</sup> the agreements are ‘above all about development’ (EC, 2005).

Criticasters of the EPAs tend to disagree with one or more of the interpretations of the EC. Although many different reasons are provided as explanation of the critical stance towards EPAs, the ‘forced’ opening of ACP markets for more competitive EU products is considered by many to bring about much higher costs than benefits (StopEPA, 2004). Many civil society organisations consider the EPAs, at least in their current form, to be anti-developmental. Also, it has been argued that the EC’s claim that EPAs will bring about the strengthening of regional integration in the ACP is uncertain at best. By discriminating between LDCs and non-LDCs in the application of another trading scheme, the ‘Everything but Arms’ initiative, regional integration may even be weakened by creating conflicts of interests within the ACP regions (Stevens, forthcoming).

However, the impact the EPAs will have on the ACP countries and regions, and hence its contribution to the development of these countries, does not depend on the principles laid out in the CPA but on the content of the agreements when they will be signed at the end of 2007 (if the deadline will be respected). Since the text of the EPAs is still unknown it is impossible to draw definite conclusions about the impact the EPAs will have, many impacts take years to materialise and cannot be measured for years after the EPAs have taken effect.

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<sup>3</sup> The diagram in annex A also serves as an intuitive illustration of the myriad regional groupings on the African continent.

<sup>4</sup> The mandate that the EC received from the Council does not include the negotiation of development cooperation. A copy of the mandate is available at <http://server2.matematici.com/epawatch/index.jsp?id=137>. The resulting inability of the Commission to discuss additional development support is leading to mounting frustration with its ACP regional counterparts.

### **2.3 EPAs and development**

Yet, before discussing the various impacts the EPA will have, it is worthwhile to discuss the several linkages between trade and development. Firmly embedded within the CPA and since then repeatedly stressed by the EU and the ACP is the notion that EPAs are development agreements and not just trade agreements. Bilal and Rampa (2005) shed some light on this issue by suggesting that for EPAs to deliver on its development dimension, three categories of measures need to be covered in these agreements.

- 1) *Trade (-related) regulations*: The trade and trade-related provisions of the agreement, which will regulate the trade relations between the regions, will need to take account of the specific needs and vulnerabilities of the ACP countries and regions. If the rules and measures in the EPAs do not reflect these specificities, the ACP will probably not benefit from the free trade agreements, despite the merits associated with trade liberalisation. It may be suggested that the Uruguay Round negotiations are a good example of the effects of liberalising trade without sufficiently, effectively and meaningfully addressing asymmetries between countries. It has been estimated that the Uruguay Round's benefits accrued mostly to the industrialised world and competitive DCs like Brazil, but not to majority of the ACP countries (Osakwe, 2006). Examples of the necessary measures are asymmetric trade liberalisation, allowing ACP countries to postpone and/or exclude sensitive products from trade liberalisation in the EPAs, while the EU would liberalise all imports from ACP much sooner. Also, special and differential treatment, which may include provisions on asymmetric liberalisation, and will be discussed at length in chapter 4, falls under this category.
  
- 2) *Accompanying measures and policies*: Accompanying and adjustment measures and policies will facilitate the preparation, negotiation and implementation of trade and trade-related measures and are necessary for ACP countries to reap the benefits and meet the challenges of trade liberalisation with the EU. Measures to address supply-side constraints and improve the competitiveness of the ACP

economies are included in this category. Also, fiscal adjustment programmes, which will be discussed in section 3.2, fall within this category.

- 3) *Effective processes for support delivery*: In addition to trade (-related) measures and accompanying measures, it is pivotal that the development support mechanisms to finance and implement them lead to an effective and efficient delivery of assistance. Currently, the non-utilisation of EDF funds<sup>5</sup> and the slow delivery of disbursements in many ACP countries suggest that better provisions should lead to more effective and efficient delivery.

## **2.4 EPAs and capacity constraints**

Another constraint facing the ACP countries in the EPA negotiations, and closely related to the development dimension of EPAs, is gathering all the various kinds of capacities that are needed to effectively take part in the EPA process. Firstly, ACP countries need to have the capacity to formulate a trade policy that supports their development strategy and need to be able to engage in the EPA negotiations and defend their formulated trade policy effectively. Arguably, it is especially difficult to meet these capacity needs because most ACP countries are involved in parallel trade negotiations that also may have far-reaching implications for their economies. For example, most Caribbean ACP countries are currently also negotiating the Free Trade Agreement of the Americas (FTAA) and the WTO Doha Round. Meeting all the capacity needs of the myriad negotiations poses (too) great challenges for the ACP countries. In most ACP countries, trade policy capacity is very limited at most and delegations in Brussels and Geneva often lack policy analysis all together<sup>6</sup>. The regional nature of the EPA negotiations may alleviate the capacity constraints since it allows for a regional pooling of capacity but it may also aggravate the capacity constraints since trade policy needs to be negotiated on an extra (regional) level.

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<sup>5</sup> The ninth EDF, signed at the same time as the CPA and covering the period 2000-2007, consisted for 9.8 billion euros or 42% of the total EDF fund of EDF funds which had remained unspent during previous periods (EU, 2005).

<sup>6</sup> Stiglitz (1999) noted that 19 of the 42 African WTO members have no trade representative at the WTO headquarters in Geneva.

Another type of capacity that is needed in the ACP is the capacity to implement and enforce the EPAs once they have taken effect. If provisions on trade and trade-related measures are not implemented or enforced in a meaningful way, the ACP country concerned will not be able to reap the benefits. Landmark recognition of this capacity constraint was achieved in the WTO, when its members launched the negotiations on trade facilitation in July 2004. As part of the ‘July Package’, the mandate explicitly stated that the negotiations “shall take fully into account the principle of special and differential treatment for developing and least-developed countries” (WTO, 2004a, annex D, paragraph 2). Arguably even more importantly, members understood the limits of developing country capacity in this respect: “In particular, the extent and the timing of entering into commitments shall be related to the implementation capacities of developing and least-developed Members” (ibid). Also, WTO members agreed that there may be a limit to the capacity of countries: “It is further agreed that those Members would not be obliged to undertake investments in infrastructure projects beyond their means” (ibid). Although such recognition now only applies to trade facilitation, it may possibly be expected that similar understanding will develop in other trade and trade-related negotiations.

Lastly, in addition to negotiating and implementation capacity, ACP countries also face constraints in their effort to take advantage of the EPAs in terms of taking accompanying measures. As mentioned above, ACP countries will need to address supply-side constraints and take measures that improve the competitiveness of ACP economies. Milner (forthcoming) divided these accompanying measures in four broad and possibly non-exhaustive categories: fiscal adjustment, trade facilitation/export development support, production and employment adjustment assistance and skills and productivity enhancement support. Using the method of extrapolation, he estimated that the total costs to be 9 billion euros for the whole ACP<sup>7</sup>.

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<sup>7</sup> Milner did attempt to provide an insight into the costs of these programmes by looking at the costs of past fiscal reform programmes and using this information to estimate the costs of programmes in all countries. In order to do this, he categorised countries by size and by current level of trade restrictiveness and asserted that the larger the country and the more restrictive the trade regime (higher average tariffs), the higher the

## ***2.5 EPAs and institutional quality***

Lastly, in addition to the capacities to negotiate, implement and take accompanying measures, another factor that will influence the extent to which the ACP countries will benefit from EPAs is the quality of institutions<sup>8</sup>. Institutions, which were long neglected as a factor of importance, have recently received a lot of attention and are now considered one of the most important determinants of economic growth. Rodrik et al. (2002) even found that institutional quality is the best explanation for the international differences in prosperity.

Regarding institutional development, Szepesi (2004) offers four non-exhaustive and mutually reinforcing conditions which support or strengthen the much-needed institutional development in the ACP. Firstly, institutional development is a long-term and evolutionary process. Successful institutional development builds on local conditions. Case studies suggest that replacing existing institutions and building up institutions from scratch does not work; incremental changes are more likely to yield results. Also, institutional development is dependent on support from the political leadership, a sense of ownership by both government and non-state actors and a high degree of inclusiveness involving all stakeholders.

Busse, Borrmann and Neuhaus (2006) have compared the levels of institutional quality with economic growth and trade openness and conclude that many (not all) ACP countries<sup>9</sup> score very low for the indicators of institutional quality. In fact, the scores are so low that these countries are unlikely to benefit from increased trade, regardless of the origin of this increased trade (WTO, EPA, etc.). As long as the institutional quality does not improve the majority of (West African) countries are currently unlikely to reap

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costs would be. Using the information on the costs of past programmes with this ranking of countries in a table, he has come to rough estimates of the costs of such programmes for all ACP countries.

<sup>8</sup> The term ‘institutions’ is referred to here as the set of formal and informal rules that shape the behaviour of actors in society.

<sup>9</sup> Busse et al. focus on ECOWAS, but their observations are valid across the African ACP

benefits from trade liberalisation. Institutional development is therefore a prerequisite for the EPAs to succeed in their objectives.

### **3. ECONOMIC IMPACT OF THE EPAs**

Since the EPAs are agreements in progress and no details have been released yet about their contents, it is impossible to evaluate the development dimension of EPAs, and because estimating the capacity constraint and quantifying this constraint in an impact assessment is very difficult and has not yet been carried out, at least not for the ACP countries, the available assessments of the economic impact do not take these two aspects into account. Instead, EPAs are treated as free trade agreements and the impact of the trade liberalisation on the ACP economies is assessed under the assumption of elimination of all trade barriers to imports from the EU.

In 1998, when the European Commission proposed to sign (Regional) Economic Partnership Agreements with ACP regions, thereby replacing the non-reciprocal trade preferences, concerns were raised about the impact of these envisioned free trade agreements (FTAs) on the ACP. The EC responded to these concerns by contracting six studies for the six regions. These studies have not been made public, a summary is provided by McQueen (1999) and Bilal (2002). Since the launch of the negotiations official impact studies have been carried out on the ACP country or regional level. These studies have been financed by the European Development Fund (EDF) EU through the EPA Programme Management Unit facility of 20 million Euros and, unfortunately, have generally not been made publicly available either. Lastly, researchers and other observers of the EPAs have published their own impact assessments, which generally are publicly available and hence will be used in this section.

The economic effects of FTAs that are conceptualised, which are generally recognised are trade creation and diversion, fiscal effect, competition and scale effects, agglomeration effect, technology effect and the investment effect. In addition, because EPAs claim to be more than FTAs, one may also want to assess the poverty effect and the

‘deep’ integration effect. However, the majority of these effects cannot (yet) be assessed and will therefore only be discussed briefly in this paper<sup>10</sup>.

In section 3.1 trade creation and trade diversion will be addressed firstly because these concepts are central to the appraisal of FTAs and because several estimates are available. In section 3.2 the fiscal impact will be discussed most extensively, because the impact is of immediate concern to the ACP countries. Methodological issues and weaknesses of the impact assessment will be discussed in section 3.3. This chapter will be concluded in section 3.4

### ***3.1 Trade creation and trade diversion***

The classic Ricardian analysis of trade, which allows countries to exploit their comparative advantages through trade and reap the benefits from increased production and hence improve welfare, seems to imply that any liberalisation of trade is necessarily beneficial. It could therefore be expected that FTAs are welfare-enhancing as well. FTAs, however, have been subject to a lot of research and discussion in the second half of the 20<sup>th</sup> century and no consensus has yet emerged on the desirability of FTAs<sup>11</sup>. Roughly speaking, it can be argued that those economists who take complete multilateral trade liberalisation as their benchmark tend to think of FTAs as a protectionist deviation from world-wide free trade, while those who take as their starting point a highly protectionist, isolationist world trading system tend to view FTAs as positive steps in the right direction.

#### **3.1.1. Theory**

The framework most often used in the debate has been introduced by Jacob Viner in 1950 and focuses on the concepts of trade creation and trade diversion. Viner used these concepts to demonstrate that FTAs or customs unions, by discriminating against non-members, may not bring about welfare gains in spite of the fact that trade is liberalised.

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<sup>10</sup> Comprehensive reviews of the several effects are provided by Szepesi (2004), Tekere and Ndlela (2002) and Bilal (2002).

<sup>11</sup> Good overviews are provided by Krugman (1993), Winters (1993) and Bhagwati and Panagariya (1996).

The ambiguity of the effect on welfare concerns not solely the third countries that may not reap the benefits of trade liberalisation, the welfare may fall in participating economies as well.

In Viner's framework, two countries, the home (H) and the partner (P) country form a customs union and thus eliminate all barriers to trade between them, while the barriers to trade with third countries (ROW) remain intact. Trade diversion is the substitution of low-cost imports from ROW with less efficient imports from P. This is possible because tariffs on imports from P will be eliminated while tariffs on imports from ROW are maintained. This discrepancy may lead to lower prices for the less efficient imports from P, because the decrease in tariffs can more than offset the higher price due to lower efficiency<sup>12</sup>. However, the combined welfare of H+P is negatively affected because the consumer surplus as a result of lower prices due to the elimination of tariffs is less than the revenue that would be collected on imports from ROW but is now lost since the products is imported from P. Trade creation, on the other hand, is generally considered to be the replacement of producers from H with imports from P that are more efficient. By bringing down the barriers to trade between H and P the imports from P become cheaper than the domestically produced good, which in turn brings about a welfare gain due to consumer and producer surplus; consumers end up paying less for the same good. In Viner's framework, the sign of the welfare change depends on whether trade creation is bigger than trade diversion. If so, the FTA is welfare-enhancing; if not, the FTA is welfare decreasing.

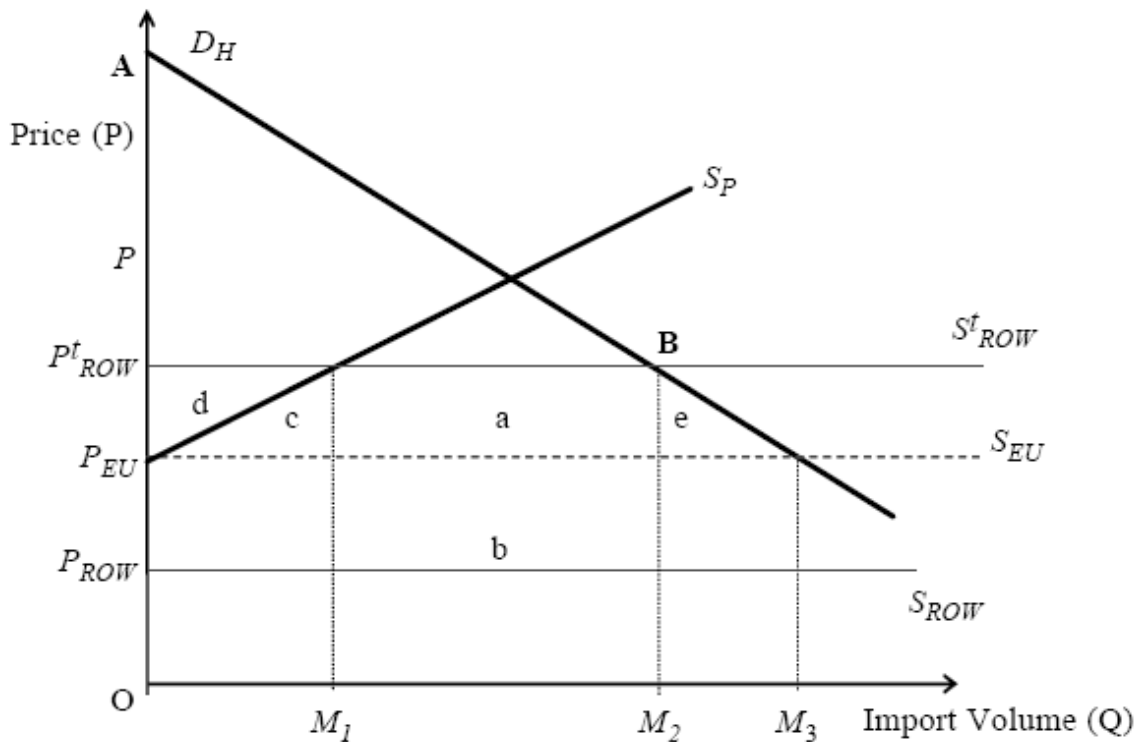
Milner et al. (2005) have adapted Viner's model to the context of the EPAs; a graphical representation can be seen in Figure 1. The adaptations are mostly about the fact that the EPAs are essentially of a bi-regional nature. Therefore it is assumed that the ACP countries, H and P, have already formed a preferential trade agreement (PTA). This PTA then concludes a FTA with the EU, which leaves out the rest of the world (ROW). In the figure,  $D_H$  is the home country's demand for imports,  $S_P$  the ACP regional partner's

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<sup>12</sup> In Viner's framework, markets are assumed to be perfectly competitive and perfect substitutability is assumed between domestically produced goods and imports.

supply of exports.  $P_{ROW}$  is the supply curve of the ROW,  $P_{EU}$  the supply curve of the EU and  $P^t_{ROW}$  the supply curve of the ROW that takes account of a non-discriminatory (ad valorem) tariff imposed on imports from ROW ( $P^t_{ROW} = P_{ROW} * (1+t)$ ). Both EU and ROW supply at constant cost, which reflects the assumption that the ACP PTA is small compared to these external suppliers. Lastly  $P^t_{EU}$ , which is higher than  $P^t_{ROW}$ , is not shown since the EPA renders that line obsolete by eliminating tariffs on imports from the EU.

**Figure 1: Effects of EPAs**



Before the EPA takes effect, H imports  $OM_1$  from the ACP regional partner P and  $M_1M_2$  from ROW. For reasons of simplicity, domestic production is ruled out and hence total welfare can be defined as the triangle  $ABP^t_{ROW}$  plus the tariff revenue on imports from ROW ( $a+b$ ). Once the EPA takes effect, imports from the EU are cheaper than imports from ROW since they enjoy duty-free access to H. Both P and ROW are replaced as exporters by the EU, which now supplies  $OM_3$  to H. Milner et al. (2005) point out that in addition to the trade creation effect (EU replaces less efficient P in  $OM_1$ ) and the trade

diversion effect (EU replaces more efficient ROW is  $M_1M_2$ ), there is also a consumption expansion effect of  $M_2M_3$  (since  $P_{EU}$  is lower than  $P_{ROW}^t$  a higher volume is imported). The trade creation effect for the PTA can be seen as area  $c + d$ , and the consumption expansion effect is illustrated by  $e$ . The trade diversion effect for the PTA is illustrated by  $b$ , representing the amount of tariff revenue lost that would have been raised if the most efficient producer had been chosen. From Figure 1 it can be deduced that the total welfare effect of EPAs can be summarised as  $(c + d + e) - b$ .

Generally three factors have been identified as positively influencing the welfare effects of EPAs. Firstly, the more efficient the EU is as a supplier, the lower trade diversion (area  $b$ ) will be. As  $P_{EU}$  approaches  $P_{ROW}$ , the EPA will tend towards the multilateral trade liberalisation outcome. It can be argued that the intensity of trade prior to the EPAs taking effect is a good proxy for this factor. The more the EU and the ACP region traded with each other before the EPA was signed, the more likely it is that the EPA will be welfare enhancing. Secondly, the lower the external tariffs vis-à-vis ROW are, the more likely it is that EPAs will bring about more trade creation than trade diversion. Lower tariffs imply smaller price advantages for EU suppliers and hence lower incentives to shift imports away from ROW, thus lower incentives for trade diversion. If the tariffs are even smaller, smaller than the difference between  $P_{ROW}$  and  $P_{EU}$ , trade diversion will be ruled out completely as  $P_{ROW}^t$  will be lower than  $P_{EU}$ . Lastly, total welfare is more likely to increase when the demand and supply are elastic. As  $D_H$  (supply curves of EU and ROW are already perfectly elastic) becomes more elastic (hence more horizontal)  $c$ ,  $d$  and  $e$  become larger while  $b$  remains fixed.

### 3.1.2 Overview of estimates

As has been noted in the beginning of chapter 3, since the EPA negotiations have commenced many different impact assessments have been published by various actors and stakeholders. Although the studies have used different methodologies for their estimates, a concern which will be elaborated upon in section 3.3, and hence often came to very different conclusions, it may be cautiously argued that some general conclusions

can be drawn about the size of trade creation and trade diversion in the various ACP regions.

**Table 1: Central Africa, CEMAC-EU EPA (mil. USD)**

	<b>Trade Creation</b>	<b>Trade Diversion</b>
<b>Cameroon</b>	255.4	-26.6
<b>Congo Rep</b>	123.7	-20.5
<b>DRC</b>	n/a	n/a
<b>Gabon</b>	126.5	-27.7
<b>Eq. Guinea</b>	53.3	-5.4
<b>CAR</b>	8.2	-1.3
<b>Chad</b>	40.7	-5.9
<b>CEMAC-Total</b>	<b>607.9</b>	<b>-87.3</b>

Source: UNECA, 2005

The CEMAC region, highly dependent on mineral and oil exports, is expected to experience trade creation far in excess of trade diversion as can be seen in Table 1. This is arguably due to the fact that the EU is already the most important trading partner of this region. The UNECA impact assessment still considered the Democratic Republic of Congo (DRC) as part of the ESA-EU EPA; the country switched allegiance in December 2005. Therefore no estimates are available for this country, the largest of the region. Since the region is one of the least integrated, UNECA (2005) expects intraregional trade, more so than in other African regions in which it is already very low, to be undermined by the uniform treatment of EU imports. Therefore, even more in this region than in others, mechanisms that ensure maximization of gains for individual and groups of countries should be prioritized.

**Table 2: Western Africa, ECOWAS-EU EPA (mil. USD)**

	Trade Creation		Trade Diversion	
	<i>UNECA<sup>a</sup></i>	<i>Busse<sup>b</sup></i>	<i>UNECA<sup>a</sup></i>	<i>Busse<sup>b</sup></i>
<b>Ghana</b>	267.8	45.8	-101.9	-40.2
<b>Burkina-Faso</b>	40.5	14.1	-9.2	-9.8
<b>Benin</b>	61.1	20.4	-14.1	-10.7
<b>Cote d'Ivoire</b>	188.8	69.3	-26.4	-25.3
<b>Guinea-Bissau</b>	2.8	1.6	-0.3	-0.3
<b>Senegal</b>	144.6	71.2	-16.3	-31.4
<b>Niger</b>	39.5	4.6	-4.3	-3.5
<b>Nigeria</b>	617.7	348.3	-172.9	-229.1
<b>Mauritania</b>	28.5	9.8	-5.3	-5.4
<b>Mali</b>	54.7	13.3	-4.5	-8.3
<b>Togo</b>	58.3	10.1	-6.5	-6.5
<b>Gambia</b>		8.2		-5.8
<b>Cape Verde</b>		16.9		-4.5
<b>Guinea</b>		14.3		-10.0
<b>ECOWAS-Total</b>	<b>1,504.4</b>	<b>608.5<sup>c</sup></b>	<b>-361.6</b>	<b>-370.5<sup>c</sup></b>

Sources: a) UNECA, 2005

b) Busse and Grossmann, 2004

c) Not including Gambia, Cape Verde and Guinea

Although all sources report more trade creation than trade diversion, the ECOWAS region will experience significant trade diversion, as is illustrated in Table 2. Busse and Grossmann (2004) estimate<sup>13</sup> the net trade created to be very small for countries as Ghana and Niger while in absolute terms Nigeria will experience a lot of trade diversion as well. Although varying estimates are also here due to different sets of data and varying methodologies, Busse and Grossmann have not estimated the effects at each stage, or have calculated one total effect; instead they have focused on the final stage of trade barrier elimination. This, and the fact that Busse and Grossmann took collection efficiencies ratios -which will be discussed later- into consideration, may explain their lower estimates.

<sup>13</sup> Busse and Grossmann give estimates using three scenarios. In this paper only the estimates in the 'medium' scenario are reported. However, even the values for the 'high' scenario are well below those reported by UNECA (2005).

**Table 3: Eastern and Southern Africa, ESA-EU EPA (mil. USD)**

	Trade Creation		Trade Diversion	
	<i>UNECA<sup>a</sup></i>	<i>Tekere<sup>b</sup></i>	<i>UNECA<sup>a</sup></i>	<i>Tekere<sup>b</sup></i>
<b>Burundi</b>	12.4		-1.6	
<b>Ethiopia</b>	120.7		-31.2	
<b>Eritrea</b>	13.1		-1.4	
<b>Djibouti</b>	56.5		-9.6	
<b>Kenya</b>	211.3		-60.5	
<b>Madagascar</b>	16.6		-4.1	
<b>Malawi</b>	15.1	18.4	-6.5	-14.1
<b>Mauritius</b>	166.9	136.5	-44.7	-87.5
<b>Rwanda</b>	10.6		-3.1	
<b>Seychelles</b>	25.3		-2.7	
<b>Zimbabwe</b>	45.6	82.9	-17.6	-21.5
<b>Sudan</b>	119.6		-33.5	
<b>Uganda</b>	19.2		-9.0	
<b>Zambia</b>	31.7		-10.4	
<b>ESA-Total</b>	<b>909.9</b>		<b>-242.7</b>	

Sources: a) UNECA, 2005

b) Tekere and Ndlela, 2002

As no known studies have been conducted to estimate the quantitative trade effects of an ESA-EU EPA, with the exception of a few individual country estimates by Tekere (2002), UNECA is the sole source of estimates; as can be seen in Table 3. Kenya, Mauritius, Sudan and Ethiopia are expected to experience the largest absolute trade effects. In Kenya and Mauritius, the reason for the large effects is a combination of large volumes in trade and the significance of the reduction in tariffs while in Ethiopia the large effects are primarily for the latter reason.

**Table 4: Southern Africa, SADC-EU EPA (mil. USD)**

	Trade Creation		Trade Diversion	
	<i>UNECA<sup>a</sup></i>	<i>Tekere<sup>b</sup></i>	<i>UNECA<sup>a</sup></i>	<i>Tekere<sup>b</sup></i>
<b>Angola</b>	174.5		-39.0	
<b>Botswana</b>	9.3	25.7	-4.1	-0.6
<b>Lesotho</b>	0.5		0.0	
<b>Mozambique</b>	16.5	21.0	-5.9	-6.5
<b>Namibia</b>	7.0		-3.8	
<b>Swaziland</b>	1.0		-0.5	
<b>Tanzania</b>	63.5	103.0	-25.1	-78.8
<b>SADC-Total</b>	<b>272.3</b>		<b>-78.4</b>	

Sources: a) UNECA, 2005

b) Tekere and Ndlela, 2002

Publicly available estimates about trade creation and trade diversion are also scarce in the SADC region, which can be seen in Table 4. Still, in all countries trade creation is larger than trade diversion. It must be noted that the picture in the SADC region is quite complicated as Botswana, Lesotho, Namibia and Swaziland are all in the South African Customs Union (SACU) with South Africa and hence are de-facto part of the Trade and Development Cooperation Agreement (TDCA), a FTA between South Africa and the EU that is already in place.

Unlike the African regions, which are all relatively close to the EU and therefore are more likely to have the EU as their most important trading partner, the Caribbean region is much closer to the US (and NAFTA) and the emerging economies of South America. Therefore the EU is not such a dominant trading partner of the CARIFORUM as it is in Africa, increasing the possibility of trade diversion exceeding trade creation. Cali and te Velde (2006) report that it has been estimated that trade creation will only exceed trade diversion if the EPAs are accompanied by tariff cuts towards third countries in excess of 50%.

The most remote ACP region, seen from a Eurocentric perspective, is the Pacific ACP. There are no quantitative estimates publicly available for the Pacific, but it has been argued that trade creation will surpass trade diversion, although there is some risk that in some countries the latter will end up as the largest effect (Roza and Szepesi, 2003). Fiji

and Papua New Guinea, the two larger countries of this region with mostly micro-states are expected to experience the largest trade creation over diversion ratio.

**Table 5: Intra-regional trade creation and trade diversion**

	<b>Trade Creation (mil. USD)</b>	<b>Trade Diversion (mil. USD)</b>	<b>Intra-regional diversion (mil. USD)</b>	<b>Trade diverted per unit of trade created</b>
<b>SADC</b>	272.3	-78.4	-0.7	0.29
<b>ECOWAS</b>	1504.4	-361.6	-31.1	0.24
<b>COMESA</b>	909.9	-242.7	-14.1	0.27
<b>CEMAC</b>	607.9	-87.3	-1.6	0.14

Source: UNECA, 2005

Lastly, UNECA has also provided an intra-regional overview of trade creation and trade diversion, which is shown in Table 5. Again, such estimates are not available for the two other regions. The most striking aspect of this table is the column that shows that intra-regional diversion, relatively to total trade diversion, is, with the exception of ECOWAS, insignificant. This seems to support the assumption in Milner et al.' model (2005), which was discussed earlier, that treated trade diversion solely in terms of EU suppliers replacing ROW suppliers.

Trade creation and diversion are arguably two powerful concepts to appraise the effects of EPAs. Although it is generally estimated that trade creation exceeds trade diversion, the latter remains significant in all regions and may even be larger in the more remote regions. Maximising trade creation and minimising trade diversion is hence one of the big challenges the ACP countries will have to face in order to maximise the positive welfare change as a result of the EPAs.

### **3.2 Fiscal Impact of EPAs**

However, trade creation and diversion are by no means the only effects of the EPAs. A non-exhaustive list has been provided in the beginning of this chapter. In this section one of the other effects will be discussed. There are two reasons why the fiscal impact is discussed rather than the other effects. Firstly, due to the poor quality and availability of data in the ACP countries, it is very difficult to provide estimates for most other

(dynamic) effects. This issue will be elaborated upon in section 3.3. Relative to the other effects, it is relatively straightforward to estimate the fiscal impact and the data necessary for this calculation are more likely to be available than the data needed for estimating the other effects. As a result, there are quite a few estimates available of the fiscal impact on ACP countries, while many other effects have not been quantified at all. Secondly, the fiscal impact, by affecting the revenues of ACP governments, poses a significant challenge to these countries that will need to be addressed quickly. Together, these two reasons validate a discussion of the fiscal impact as an example of the many effects that will arise from EPAs.

In section 3.2.1 the dependence on trade taxes in ACP countries will be considered. Section 3.2.2 will elaborate on the effect of EPAs on fiscal revenues. In section 3.2.3 possible strategies will be discussed.

### **3.2.1 The dependence on trade taxes in the ACP**

For most developing countries, customs duties remain a major source of fiscal revenues, constituting on average 25% of government revenues in Africa and 15% in Asia and the Pacific. The continued reliance on customs duties as a source of revenue in the ACP can clearly be seen in Table 6. Although only two out of six EPA regions are covered, similar dependencies exist in the other two African regions and the reliance on trade taxes is also high in the Caribbean and the Pacific. Table 7 provides an overview of some ACP countries' level of reliance on trade taxes. Across the ACP, the reliance on trade taxes as a source of revenue is much greater than for countries of the EMU zone, where it does not even constitute one-thousandth of total revenues (World Bank, 2006).

**Table 6: ESA and SADC reliance on trade taxes**

	Maximum Tariff	Simple Average Tariff	Trade Tax Revenue as % of GDP	Trade Tax Revenue as % of Total Revenue
<b>ESA-EU EPA</b>				
Burundi	40	23.5	3.4	18.6
Comoros	200	37.9	2.8	31
Congo, Dem. Rep. of	20	13	...	...
Djibouti	0	0	0	0
Eritrea	25	9	...	...
Ethiopia	35	17.5	2.6	18.4
Kenya	35	17.2	3.6	17.6
Malawi	25	13.6	2.5	12.4
Mauritius	80	19.9	5.4	31.5
Madagascar	25	16.2	2.8	25.6
Rwanda	30	9.3	1.4	14.2
Seychelles	200	25	...	26.9
Sudan	45	22.6	...	...
Uganda	15	9	1.7	11.3
Zambia	20	11.5	5.9	30.9
Zimbabwe	100	19.7	2.6	10.4
<b>SADC-EU EPA</b>				
Angola	35	19	...	...
Mozambique	25	11.1	2.2	18.9
Tanzania	25	12.5	1.3	11.6
<b>SACU</b>				
Botswana	...	...	7.7	18.1
Lesotho	...	...	18	58
Namibia	...	...	12.1	38
Swaziland	...	...	15.3	55.2

Source: Adapted from Khandelwal, 2004

The continued reliance on customs duties can in part be explained by the relative ease with which they are collected compared to more complex kinds of taxes such as income tax or value-added tax (VAT), which require different methods because they are, at least in part, collected inland instead of at the border. As a result, the reliance on trade taxes as a source of revenue seems to be larger in agricultural economies with low urbanisation, many micro-businesses, a large informal sector and a weak and/or corrupt (tax) administration.<sup>14</sup>

<sup>14</sup> See for instance Khattry and Rao (2002), Kowalski (2005), and Tanzi and Zee (2002).

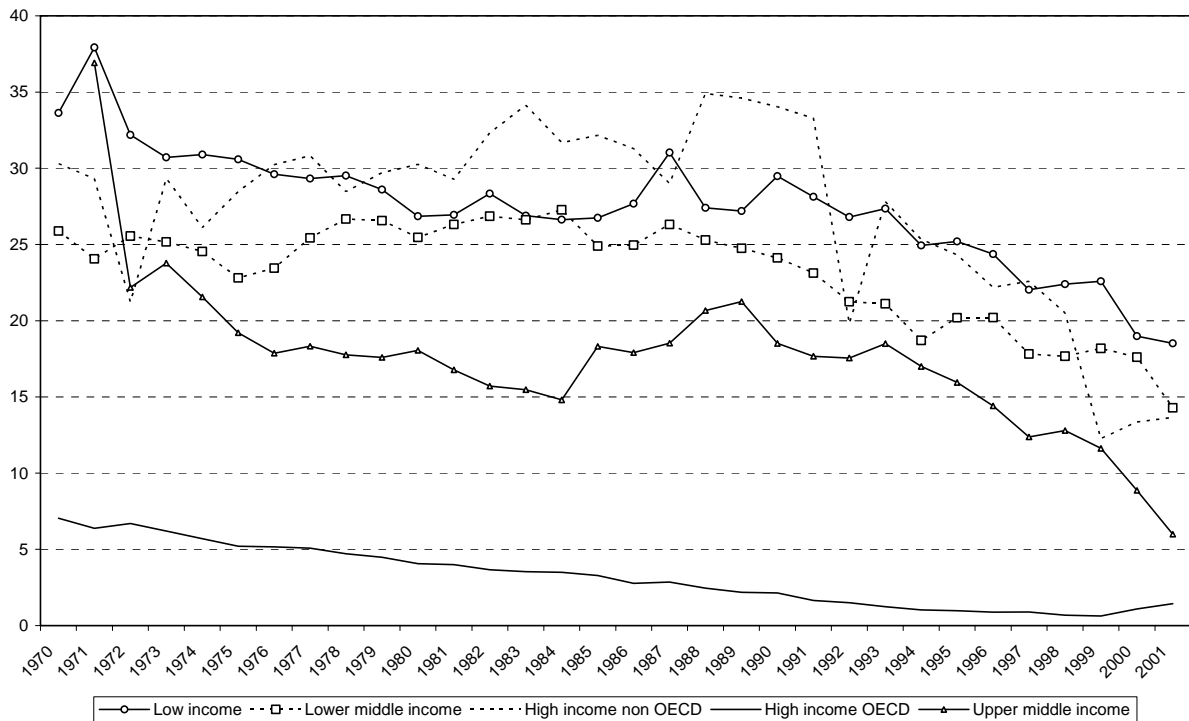
Although trade taxes are significant in most developing countries, there are great differences between countries and over time. In Table 6 it can be seen that the importance of trade taxes varies widely between regions and within regions. Also, Figure 2 shows that regardless of income group, there has been a strong trend towards decreasing trade barriers, a finding which is widely acknowledged (Clarke, 2005).

**Table 7: Trade taxes as percentage of total revenue for selected ACP countries**

Country	most recent year of recording	%	<i>continued</i>		
<b>Pacific</b>			<b>Eastern and Southern Africa (ESA)</b>		
Fiji	1996	21	Sudan	1999	29
Vanuatu	1999	34	Uganda	2002	19
Papua New Guinea	2002	26	Zambia	1999	13
<b>Caribbean</b>			Zimbabwe	1997	20
Dominican Republic	2002	32	Mauritius	2003	20
Jamaica	2003	9	Seychelles	2002	24
Barbados	2003	8	Burundi	1999	17
Belize	1997	28	Ethiopia	1999	25
Bahamas, The	2003	59	Kenya	2000	17
<b>West Africa (ECOWAS)</b>			Madagascar	2002	36
Cote d'Ivoire	2001	41	<b>Southern Africa (SADC)</b>		
Senegal	2001	33	Botswana	1996	12
Sierra Leone	1999	28	Namibia	2002	25
<b>Central Africa (CEMAC)</b>			Swaziland	2000	50
Congo, Dem. Rep.	2002	27	Lesotho	2003	39
Congo, Rep.	2002	6			

Source: World Bank, 2006

**Figure 2: Reliance on trade taxes by income group, percentage of total revenue, 1970-2001**



Source: Kowalski, 2005

However, the liberalisation carried out so far<sup>15</sup> is smaller in extent than the liberalisation envisaged in EPAs. First of all, when a country starts to liberalise its trade, it may not necessarily bring about a great loss of fiscal revenue. In fact, lower administrative costs as a result of the simplification of customs procedures and elastic import demand may actually even increase the revenue from customs duties (Ebrill et al., 1999). Secondly, since the revenues from trade taxes are zero when trade taxes are set at zero, there must be a point after which a lowering of tariffs would always cause revenues to fall. Naturally, since EPAs will ultimately lead to the elimination of tariffs on trade, revenue must fall as a result of EPAs.

Note that the data should be interpreted with caution, however, since the reporting mechanisms vary and the quality of data may be poor. Also, the loss of customs duties is

<sup>15</sup> This liberalisation has generally taken place through multilateral negotiations as well as through lending-agreements with international financial institutions.

not the only source of revenue that will be decreasing as a result of lower tariffs. Trade diversion may replace third country taxed imports with duty-free imports from European producers under an EPA, implying a further loss of tariff revenue. Also, the income from VAT on imports, levied on the total value of the imports plus the tariff, will be lower when tariffs are abolished. Lastly, income and corporate taxes may yield lower revenues when companies go bankrupt and workers lose employment as a result of the more rigid competition from European producers (Mihretu, 2006).

If one takes into account the fact that the earlier trade liberalisation already caused fiscal difficulties for several ACP countries, it is understandable that there is great concern about the potential fiscal impacts the EPAs. The EPAs will bring about FTAs between the ACP regions and the EU, and could thus eliminate most of the revenues so far generated by taxing imports from Europe. The fact that the EU is the most important trading partner of many of the ACP countries only increases the fiscal impact. The question thus is whether these countries are able to compensate the losses from trade taxes due to trade liberalization with revenues from other sources. Recent empirical evidence suggests that tax revenues have continued to increase after trade liberalization in rich countries and have only been modestly affected in middle-income countries. However, Baunsgaard and Keen (2005) come to a very unsettling conclusion about the low-income countries: the poorer countries have only managed to recover 30 per cent of the trade tax revenue lost as a result of trade liberalization through other taxes.

### **3.2.2 Estimates of the Fiscal impact of EPAs**

It may thus be clear that the loss of tariff revenues as a result of the EPAs taking effect poses big challenges to the ACP countries. However, before the estimates of the fiscal impact are discussed, it is worth discussing some factors that may alleviate the impact of EPAs.

First of all, the trade liberalisation will not happen overnight. Although there are varying opinions about the length of the transition period, it may be assumed that ACP countries will be offered at least 10 years to implement the trade liberalisation. Of course,

ultimately the tariff revenues from imports of the EU will be lost. However, during this transition period countries may still levy (continuously decreasing) tariffs on EU imports. This may temporarily increase revenues, as discussed before, but most importantly, the transition period offers the country a period of time during which a country can use the possibly higher revenues to prepare for and/or smoothen the adjustment by taking specific domestic reforms. Also, trade liberalisation will expose ACP companies to a more competitive environment and hence could generate positive competition and production effects which both may lead to higher economic growth. Economic growth broadens the tax base and could thus partly or even more than offset the trade tax revenues lost. Finally, the pressure on fiscal revenues due to the reduction of import duties may trigger ACP governments to undertake generally much-needed substantive administrative and fiscal reforms, so as to improve the efficiency of tax collection and administration, which are often deficient in many developing countries. These reforms could, if completed successfully, generate higher tax revenues. Whether these three factors will offset the loss of trade taxes cannot be established a priori; the fiscal impact hence remains a matter of empirical assessment.

**Table 8: Fiscal impact assessments of EPAs on some ACP countries and regions (in percentages)**

	% fiscal revenue loss	% customs revenue loss	continued		
<b>ACP<sup>a</sup></b>	5.8	27.9	Gabon	6.5	51
<b>ACP LDC<sup>a</sup></b>	7.5	37.7	Chad	18.2	76.7
<b>SADC-EU EPA<sup>a</sup></b>	5	19.4	<b>Pacific EPA<sup>a</sup></b>	0.9	2.4
Angola	3.7	n.a.	Papua New Guinea	0.6	2.8
Botswana	1	6	Fiji	0.3	1.4
Lesotho	0.4	0.8	Salomon Islands	1.4	2.5
Mozambique	5.2	23	Vanuatu	1.4	2.7
Namibia	0.8	2.5	<b>CARIFORUM-EU EPA</b>	2.8	13.8
Swaziland	0.4	0.8	Antigua and Barbuda	9.5	14
Tanzania <sup>c</sup>	8.2 / 20	30 / 73	Bahamas	n.a.	n.a.
<b>ESA-EU EPA<sup>a</sup></b>	10.5	42.2	Barbados	0.6	17
Malawi	1.4	6.3	Belize	1	16
Mauritius	9.3	27.9	Dominica	1.4	6
Zambia	2	22	Dominican Republic	1.9	19
Zimbabwe	3.1	18	Grenada	2.1	13
Kenya	12	82	Guyana	2.6	12
Seychelles	29.7	70	Jamaica	0.9	11
Uganda	16	69	Montserrat	4.6	10
<b>EAC<sup>b</sup></b>	14	63.5	St Kitts and Nevis	2	10
<b>CEMAC-EU EPA<sup>a</sup></b>	12.4	72	St Lucia	2.5	15
Cameroon	8.2	81.9	St Vincent and the Grenadines	7.1	17
Central African Republic	14.9	79.2	Suriname	n.a.	17
Rep. Congo	14.1	71.3	Trinidad and Tobago	0.4	16

Notes: (a) Unweighted averages; (b) at the time EAC was considered one of the regional groupings; (c) the first figure was the estimate for Tanzania as part of SADC, the second for EAC  
*Source:* Studies commissioned by the EC in 1998, as reported by Bilal (2002).

The earliest estimates of the fiscal impact already appeared in the first EPA impact assessments that were commissioned by the EC. These estimates, presented in table 8, reveal that the fiscal effect varies within and in between the various regions. In Annex C an overview is provided of the available fiscal impact assessments of African ACP countries. As in section 3.1, methodological concerns regarding these estimates demand a very cautious interpretation of these results.

Instead of interpreting the estimates quantitatively, it may be more appropriate to use them to acquire a sense of the relative magnitude of the expected effects. By comparing the estimates of fiscal effects between countries and regions some general trends appear

that seem to explain why some countries tend to lose relatively more revenue than others. For instance, it may be expected that the more restrictive a trade regime is the bigger the drop in fiscal revenue will be. Thus, Seychelles and Tanzania, relative restrictive countries, as shown in Table 9, are expected to face larger fiscal revenue drops than Uganda and Zambia, for instance. Other factors also seem to be critical: the fiscal revenue losses of trade liberalisation tend to be proportionally larger for small, landlocked and least-developed countries. Baunsgaard and Keen (2005) also observed that the ability to recover revenue after trade liberalisation and the level of national income are inversely related.

**Table 9: Restrictiveness ratings in ESA and SADC, 2003**

	Tariff Rating (1-5)	NTB rating (1-3)	Overall TRI rating (1-10)	continued			
<b>ESA</b>				Sudan	4	1	4
Angola	3	1	3	Swaziland	2	2	5
Burundi	5	2	8	Uganda	2	1	2
Comoros	5	2	8	Zambia	2	1	2
DRC	2	1	2	Zimbabwe	3	2	6
Djibouti	1	1	1	<b>SADC</b>			
Egypt	4	2	7	Angola	3	1	3
Eritrea	1	2	4	Malawi	2	1	2
Ethiopia	3	2	6	Mauritius	3	2	6
Kenya	3	2	6	Mozambique	2	1	2
Malawi	2	1	2	SACU	2	2	5
Mauritius	3	2	6	Tanzania	2	2	5
Madagascar	3	1	3	Zambia	2	1	2
Rwanda	2	1	2	Zimbabwe	3	2	6
Seychelles	5	3	10				

Note: All ratings come from the Trade Policy Information Database of the IMF. The higher the rating, the more a country restricts trade by levying high tariffs (left column) or imposing restrictive non-trade barriers (middle column). The right-hand column aggregates the first two columns.

Source: Khandelwal, 2004

Although the extent of the trade tax revenue losses differ between countries and regions, the relative size of revenue shortfalls is significant for most countries concerned. In any case, it is clear that, for EPAs to be politically acceptable and economically sustainable, a strategy to deal with the expected revenue losses is certainly necessary.

### **3.2.3 Possible strategies to deal with fiscal revenue loss**

With the real prospect of significant fiscal revenue losses as a result of EPAs, several strategies have surfaced in the debate that may be put into practise to deal with this impact. Three will be discussed in some detail<sup>16</sup>.

#### Fiscal reform

The first strategy is also the strategy that has received the most attention in relation to trade liberalisation; a more elaborate discussion of this strategy can be found in Annex D. The rationale is very simple: developing country governments need to find new sources of revenue to replace the revenue lost as a result of trade liberalisation. The fiscal instrument preferred by policy advisors and by international finance institutions as the IMF and the World Bank is the introduction or reform of the value-added tax (VAT)<sup>17</sup>. Since VAT is levied on both imports and domestic production, in theory it has a wider tax base than import duties and could thus raise more revenue than import duties do.

The biggest drawback to VAT is the administrative challenges that need to be overcome in order to make a VAT system work. Currently, many developing countries already have a VAT system, but the receipts from the system are not nearly as important as they are in developed countries. Ebrill et al. (2002) have made several recommendations that may improve the VAT systems. These recommendations are a single VAT rate instead of multiple rates, as little exemptions from VAT as possible and a sufficiently high threshold value to be eligible for VAT. The last recommendation helps to decrease the administrative burden and increases the VAT system's profitability.

#### Minimising fiscal losses

Stevens and Kennan (2005) have developed a strategy that uses the provisions in GATT article XXIV, which relate to scope for differential treatment within an FTA, to exclude as many sensitive products as possible and backload the remaining sensitive products.

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<sup>16</sup> A more elaborate discussion is provided in Bilal and Roza (2006, forthcoming)

<sup>17</sup> The VAT option is advocated for only for developing countries and is motivated also by the fact that developing countries have generally been unsuccessful in their attempts to raise revenues by direct taxes, most notably income taxes (Ebrill et al, 2002).

Although it is beyond the scope of this paper to discuss the strategy in great detail, it is worth noting that if countries can exclude all the 20% most sensitive products<sup>18</sup> and backload the remaining sensitive products they could significantly decrease the revenue loss. For example, Uganda could retain approximately three-quarters of its revenue, while Ethiopia would be able to retain half of the current customs proceeds (Bilal and Roza, forthcoming). The more liberal a trade regime is the higher the share of fiscal revenue is that can be retained.

However, this strategy has several serious shortcomings. Firstly, the bi-regional nature of the EPA negotiations implies that the ACP countries would need to harmonise their national lists of sensitive products to be excluded into a regional list. Stevens and Kennan (2005) have already tested the overlap and concluded there is hardly any. The more compromises are needed, the lower the benefits of the strategy. Another shortcoming is the fact that the lists are necessarily compiled on the basis of past trade flows. However, trade patterns may change and are expected to change drastically as a result of EPAs; it is therefore difficult to determine which products are most sensitive and will generate the highest revenues. Yet, the biggest shortcoming is that this strategy negates any strategic thinking about trade and leaves out any trade and/or industrial policy considerations.

The distinction between permanently and temporarily excluding (backloading) products is quite important with regards to exclusion possibilities the WTO recognises. Except for the exclusion of products in a FTA, which only needs to cover ‘substantially all trade’, permanently excluding products is generally not accepted in the GATT. However, the WTO does recognise the possibility that a country may temporarily exclude certain products from liberalisation; in other words, restrict the import of certain goods. Generally, two reasons are considered valid: Firstly, a country may restrict the imports temporarily because the industry concerned is causing serious injury to the domestic industry concerned (GATT XIX). In the Doha round, the concept of agricultural ‘Special

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<sup>18</sup> GATT XXIV stipulates that within a FTA, “substantially all trade” (SAT) must be liberalised with a “reasonable amount of time”. Although no FTA has ever been challenged under XXIV, there is some consensus that SAT means about 90% of trade. If the EU would liberalise 100% of their imports, the ACP countries would need to liberalise roughly 80% of their imports to comply.

Products’ that may be excluded<sup>19</sup> to preserve rural development and food and livelihood security can be considered an example in this respect (Bernal, 2004). Secondly, safeguard measures could be introduced when a surge of imports inflict grave balance of payments problems by draining the monetary reserves. In the context of the Doha round, the WTO has proposed to introduce a ‘Special Safeguard Mechanism’ that would apply to agricultural goods and could be put into force after imports surge or a drop in the world market price (Bernal, 2004). This possibility is discussed further below. Such clauses, if adapted for and included in EPAs, may be considered examples of SDT if the EPAs anticipate individual countries within the ACP regions to temporarily restrict the imports of a certain goods.

#### Balance of Payment support

The last ‘strategy’ to deal with the fiscal impact is balance of payment support by the donor community. By setting up a compensation mechanism ACP countries could engage in far-reaching trade liberalisation without possibly compromising the vital government programmes. Although the fiscal losses are permanent, many envisaged benefits of EPAs, such as economic growth and hence a wider tax base, will take time to materialise. In the period preceding these longer-term benefits, temporary balance of payment support can be a valuable relief to ACP countries during this adjustment period. Also, many (African) ACP countries are already very dependent on sector and budget support by donors; the support needed as a result of the fiscal impact is generally small compared to existing aid flows.

Nevertheless, there are also several shortcomings to this strategy. Firstly, it would be very difficult to come up with an acceptable and accurate compensation mechanism. The larger, more developed ACP countries would also get much higher compensation than the poorer countries; a result which is unlikely to be favoured by the donor countries. Lastly, it will also be difficult to estimate beforehand the period it will take for the longer-term

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<sup>19</sup> Since the concept of ‘Special Products’ has not yet been concretised in the WTO, it is not yet clear whether such an exclusion may be temporary or permanently.

benefits to materialise or to establish the moment these benefits outweigh the fiscal losses.

Like the temporary restriction of imports using the safeguard clause, the WTO also recognises the possibility to restrict the import of certain goods when the balance-of-payment situation is very negatively affected as a result of liberalisation and the ensuing surge in imports (GATT XII). It may be argued that elements of SDT would be introduced in EPAs if these agreements, recognising the divergences between countries within the ACP regions, would give ACP countries the possibility to restrict imports and hence differentiate their trade regime from the region's regime as a result of balance-of-payment problems. Such clauses would make it easier for ACP countries to commit themselves to liberalisation schedules.

In conclusion, it can be argued that it has been demonstrated that the fiscal effect of EPAs is justifiably an issue of great concern to the ACP countries. ACP governments stand to lose a significant portion of their revenues as a result of EPAs, which may compromise their socio-economic objectives and programmes. Although several strategies have been developed and elaborated upon to meet the fiscal challenges of trade liberalisation, the conclusion by Baunsgaard and Keen (2005), that only 30% of lost trade tax revenues if recovered serves as a very persuasive argument that ACP countries still have a long way to go if they are expected to successfully address these costs.

Nevertheless, the fiscal effect is only one of the many effects that the EPAs will have and the fiscal loss is only one of the many other adjustment costs. Since the fiscal impact will be different for each country, affecting countries between and within regions to varying degrees, it may be argued that SDT may be one way to address the country-specific circumstances during the period when the liberalisation schedules are pursued. Mirroring the GATT, countries could, for example, be offered the chance to temporarily restrict imports because of safeguard or balance-of-payment considerations. More generally, using the fiscal impact as an example, SDT may be considered as a way to assist ACP countries to face the short-term adjustment costs helping them bridge the gap between the

EPAs taking effect and their longer-term benefits and allowing them to take measures to face the longer-term impacts (e.g. increase competitiveness of domestic industry).

### **3.3 Methodological concerns**

On several places in sections 3.1 and 3.2 estimates of trade creation, trade diversion and fiscal impact were provided with the warning to interpret such estimates with caution due to methodological issues. Although it should now be clear that the Vinerian concepts of trade creation and diversion are very different from fiscal effects, the methodological approach to estimating these effects is similar, which explains why the methodology is discussed in a separate section. Different methodologies explain in part the differing estimates provided by impact assessments, such as the differing results in Tables 1, 2, 3, 4 and in Annex C, but these differing results also serve as a warning that too much importance may be attached to the numbers in quantitative impact assessments that are based on trade models. For example, the Doha Development Round, which is now dormant after another stalemate in July 2006, was first expected to bring about a raise in global income by USD 250 – 520 billion. However, since then the World Bank had to cut back these estimates to a ‘mere’ USD 95 billion (Hertel and Winters, 2006; Polaski, 2006).

#### Static versus dynamic; partial versus general

The estimates for trade creation, trade diversion and fiscal effects are based on static analysis in a partial equilibrium model. Comparative static analysis is concerned only with determining the difference between the initial and the final equilibrium and does not concern itself with the transition required to move from the initial to the final equilibrium (Piermartini and Teh, 2005). By not considering the transition, important costs that may accompany the transition between the two equilibria (e.g. retraining of workers) are not taken into consideration. Also, other dynamic effects, most notably technological change and capital accumulation are also left out of the static analysis, which thus fails to capture two of the most important sources of economic growth. It is therefore not surprising that dynamic analyses usually estimate higher gains from trade liberalisation. However, the

reason why static analysis still dominates in trade models is the fact that dynamic analysis is more difficult to solve and requires more sophisticated data.

Partial equilibrium models differ from their counterpart, general equilibrium models, in the scope of their focus. General equilibrium analyses explicitly accounts for all the links between sectors of an economy. It will explain how a change in one market affects all the other sectors of the economy. Partial equilibrium analyses only take one specific sector (or even one industry) into account, assuming that the effects of the changes in the sector have little or no effect on other sectors. However, general equilibrium analysis needs a lot of consistent and comparable data which is generally unavailable in the ACP. The poor availability and quality of data is the main reason why most EPA impact assessments rely on partial equilibrium analysis.

#### Role of data

It may thus be argued that without improved data collection facilities in the ACP there will be little chance that the models will take account of dynamic effects and will consider the effects in other sectors of the economy. Also, the estimates may vary significantly depending on which period the data refer to. Many important variables in the models, like exchange rates and trade volumes, are subject to great volatility (Bilal and Rampa, 2006). Depending on the reference period of the data the impact assessments, even when using the exact same model, may end up with very large differences in estimates. The poor quality of the data and the fact that in some countries data is only erratically supplied further decrease the reliability of the estimates since modellers are forced to 'fill' these gaps in the dataset.

Also, the choice of variables has a great impact on the outcome of the models. The extent to which these estimates can fluctuate as a result of using different variables is demonstrated persuasively by the different estimates for Tanzania (see Table 10). This might be partly explained by the use of different periods and the volatility of fiscal revenues over time. In large, the differences in estimates for the same countries are largely due to differences in the methodologies adopted by the various studies.

Firstly, one of the variables used to calculate the expected revenue loss are the tariff lines. The models seem to have used two different kinds of tariffs, the bound and the applied tariff. The bound tariff is the maximum tariff rate a country can levy on a particular product under commitments made at the WTO. By contrast, the applied tariff is the level of tariff actually levied at the boarder by the country. In developing countries, these are often significantly lower than the bound tariffs. The effect the choice between these two measures of tariffs can have on the estimates may explain in part the different estimates, which are presented in Table 10. UNECA (2005) used applied tariffs while Tekere and Ndlela (2002) used bound tariffs; the higher bound tariffs arguably have led Tekere and Ndlela (2002) to provide much higher estimates for the revenue loss than if they had use applied tariffs. The choice of tariff lines has also caused Tekere and Ndlela to provide much higher estimates for trade creation and trade diversion, as is shown in Table 4.

**Table 10: Comparison of estimates on the fiscal impact of EPAs**

	in mio. USD		% GDP*		% customs revenue		% fiscal revenue	
	A	B	A	B	A	C	A	C
Mozambique	-7.6	-29.2	-0.2	-0.7	-9.5	-23	-1.5	-5.2
Tanzania	-32.5	-146.6	-0.3	-1.5	-25.9	-30 / -73**	-2.3	-8.2 / -20**

Notes: \* Computations, GDP data are from World Bank (2005); \*\* first figure relates to losses if Tanzania would join an SADC-EU EPA, second figure was the estimate if Tanzania were to join an EAC-EU EPA  
Sources: (A) UNECA (2005); (B) Tekere and Ndlela (2002); (C) studies commissioned by the EC in 1998, as reported by Bilal (2002).

Another aspect that is important when the fiscal revenue loss is estimated is the collection efficiency of trade taxes, since there are several factors that could cause trade taxes not to be levied on certain imports. First of all, governments may decide to grant certain companies a tax holiday, exempting them from the obligation to pay import duties for a certain period. Various other trade tax breaks and exemptions may also be granted, such as in export-processing zones. Red tape, corruption and smuggling can also cause the revenue collection to be lower than expected. Busse and Grossmann (2004) attempted to determine the collection efficiencies for West African countries and found collection efficiencies to range from less than 30% for Ghana to 90% for Senegal, as indicated in Table 11. The discrepancies between the estimates for revenue loss by UNECA (2005)

and Busse and Grossmann (2004), as reported in Table C2 in Annex C, are partly explained by the fact that UNECA did not take collection efficiencies into account, leading to higher estimates of revenue losses.

**Table 11: Collection efficiencies and their impact on revenue losses**

Country	Collection efficiency <sup>a</sup> in 2001	Revenue Loss (mio. USD)	
		Busse <sup>a</sup>	UNECA <sup>b</sup>
Benin	77%	-27.6	-39.5
Burkina-Faso	61%	-17.5	-22
Cote d'Ivoire	69%	-82.9	-112.2
Ghana	29%*	-90.8	-193.7
Guinee-Bissau	38%	-2.2	-2
Mali	44%	-16.6	-33.1
Mauritania	73%	-11.8	-14.6
Niger	53%	-6.6	-20.5
Nigeria	80%*	-487.8	-426.9
Senegal	90%	-87.9	-80.2
Togo	77%	-12.9	-35.5

Notes: \* 2000.

Sources: (a) Busse and Grossmann (2004); (b) UNECA (2005).

### EPAs as black boxes

A very important shortcoming common to all quantitative assessments of trade creation, diversion and fiscal loss is that they are based on 'blind' assumptions on the scope and speed of trade liberalization. With the EPA negotiations still underway and no precise shape of an agreement in sight, notably with regard to the products coverage and schedule for liberalisation, econometric modelling rests on bold scenarios, generally assuming full liberalisation by the ACP. However, the exclusion of sensitive products from liberalisation and longer transition periods could significantly mitigate the loss of custom revenues from an EPA, as discussed in section 3.2. Most empirical studies also ignore the broader trade policy context under which an EPA should take place. Notably, regional integration process and multilateral liberalisation will often accompany an EPA-related liberalisation. Obviously, the choice of scenarios for liberalisation has a major impact on the estimates of the size of the customs revenue effects.

In particular, by assuming overnight liberalisation, most studies fail to take account of the gradual phasing down of trade barriers over time, which will affect the magnitude of

revenue losses and their impact on government finances. The EPA schedule for tariff liberalisation and transition period have not yet been determined for any region. It might be reasonably expected though that substantive liberalisation will not take place for five to ten years (and perhaps even longer for some products), when revenue effects will start to kick in. Using much the same reasoning, estimating the impact of EPAs is further hampered by the fact that it is still unknown what measures and development support will accompany the EPAs

The above discussion of methodological concerns has arguably pointed out that there are several shortcomings to the quantitative impact assessments. The kind of model, the relative poverty and scarcity of the data and the unfinished EPA process (and hence the impossibility to address all effects) necessitate a very cautious interpretation of the estimates and the models that deliver them. Also, it is worth noting that most factors discussed above tend to overestimate the static effects of trade creation, trade diversion and fiscal impact. However, while the estimates as such may not be as accurate as is often suggested, they do provide a valuable and useful sense of magnitude of the various effects and, perhaps most importantly, allow for a comparison of the relative sizes of the effects between countries and regions.

### ***3.4 Concluding remarks***

It is arguably fair to say that the EPAs have the potential to bring about huge economic benefits for the ACP. According to most estimates, and all estimates presented in this study, trade creation will outweigh trade diversion for all ACP countries. Also, the effects discussed here are all static, and no dynamic effects of EPAs have yet been quantified which suggests that the benefits from EPAs may turn out to be even bigger. Also, the EU's eagerness to address the Singapore issues, and thus address a lot of regulatory issues in the ACP only increases the potential of the EPAs as a spreader of economic development.

On the other hand, this chapter has also demonstrated that there are significant costs associated with EPAs as well. There are costs associated with the EPAs materialising and

costs are incurred when ACP countries adjust to EPAs<sup>20</sup>, both which need to be addressed comprehensively by the ACP if the EPAs are to be accepted by the EU and the regions.

However, as has been stressed earlier, many factors determining the outcome of the EPAs are not known yet, since the EPAs are still being negotiated and their content and even their scope is still not known. Also, more capacities and better institutional quality are also necessary conditions for the ACP countries to take advantage of the possibilities that EPAs offer.

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<sup>20</sup> This paper focuses on the adjustment costs of EPAs. Bacchetta and Jansen (2003) provide an excellent overview of the adjustment costs to trade liberalisation in general.

## 4 SPECIAL AND DIFFERENTIAL TREATMENT

Having established that EPAs have both significant benefits and costs, it seems reasonable to expect parties to only conclude an EPA if the benefits are perceived to outweigh the costs. This is especially important for the ACP group of states, since many of these countries are small and vulnerable economies for which the adjustment costs can prove particularly high in relation to the benefits. In this context, the reason for special and differential treatment in the context of EPAs is that SDT can decrease the (temporary) adjustment costs and hence positively affect the EPA's net benefits<sup>21</sup>.

Since both the content and the scope of EPAs are still unknown, it must be noted that it is very difficult to address SDT in EPAs. Also, the scope for SDT relates directly to the scope of the EPAs themselves. Only if EPAs will cover the Singapore issues can SDT in these four areas be introduced in the agreement. This lack of information limits the scope of this chapter to providing general recommendations and outlining some options for SDT. More concrete and detailed discussions of SDT in EPAs can only be provided when the negotiations have reached a more advanced stage and more is known about both the content and the scope of the agreements.

In the first section of this chapter, SDT will be introduced. Section 4.2 will address the economic rationale for SDT. Section 4.3 will discuss the additional forms of SDT that are specific to EPAs and other FTAs. Section 4.4 will outline the ways in which SDT may be introduced in the EPAs. Section 4.5 will conclude this chapter.

### **4.1 History of SDT**

The history of SDT, which ultimately comes down to the discrimination between countries in multilateral or bilateral trade agreements, already started in the late fifties. As Keck and Low (2004) state, “the battle to establish the principle that a set of uniform

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<sup>21</sup> Although this arguably constitutes a strong case for SDT, and is arguably the most relevant in the context of EPAs, it must be noted that it is not the only justification for SDT that has been discussed in the literature. Page and Kleen (2005) provided an overview of the other reasons for SDT.

multilateral rights and obligations among a deeply diverse set of nations could not serve the best interests of all parties was won a long time ago” (page 3). Arguably, an important landmark was in 1957, during the twelfth session of the GATT. During the Ministerial of that session, it was identified that agricultural protectionism, fluctuating commodity prices and the failure of export earnings to keep up with import demand in developing countries were undesirable features of the international trading system (Keck and Low, 2004). Since then, the concept of SDT has changed considerably. Initially, SDT was considered a means to increase the benefits of the international trading system. The introduction of the Enabling Clause in 1979, which provides the WTO legal basis for both the Generalised System of Preferences (GSP), which allows developed countries to provide preferential treatment to developing countries, and the increased flexibility that developing countries get when they form regional trade agreements among themselves, is an important example of such an ‘increased benefit’. However, during the Uruguay Round SDT was increasingly considered as a means to address the potential costs of new trade-related rules. Developing countries were concerned with both the implementation costs of the new agreements and the costs that are related to the permanent loss of policy space, since binding commitments were made in more trade-related areas (Fukusaku, 2000). Reflecting this evolution, SDT can take three different forms: improved access to developed country markets, modulation of commitments (e.g. allowing delays or only partial compliance) and the preservation of policy space that would normally be against the rules.

Since the Uruguay Round, the debate on SDT has gradually intensified. Developing countries felt increasingly frustrated about their peripheral role in these negotiations and have assumed a much more active role in the Doha Round. Also, developing countries were concerned that the implementation of the obligation agreed in the Uruguay Round may not be consistent with national economic interests and their own development priorities. The Doha declaration addressed this latter concern in paragraph 44, in which a review is requested for SDT provisions “with a view to strengthening them and making them more precise, effective and operational.” Unfortunately, the negotiations on SDT were anything but easy and many issues remained unresolved (Keck and Low, 2004).

Since the Doha round has officially been suspended in July 2006 the concretisation of SDT provisions, which appear in most WTO agreements, seems even further away.

## **4.2 Rationale for SDT**

As mentioned in the beginning of this chapter, the rationale for SDT in this paper is the fact that SDT can address the significant adjustment costs and hence improve the net benefits of EPAs. However, this is by no means the only reason for SDT. This section will first explain the perceived incompatibility of SDT with economic theory and will then discuss some economic and political justifications for SDT.

The three forms of SDT that have evolved over the years can all be interpreted as derogations of the international trading system. Whether it is improved market access, modulation of commitments or allowing countries to conduct policies that are against WTO rules, all forms of SDT discriminate between countries that are eligible for SDT and those that are not. Since the WTO rules largely reflect the economic consensus that trade liberalisation and integration in the world economy constitute the best way to achieve economic development, it may seem understandable that some have argued that SDT is undesirable because it hinders economic development (Singh, 2003). The relationship between economic growth on the one hand and trade liberalisation and integration in the world economy on the other is usually demonstrated by referring to the established positive relationship between economic growth and trade openness (Sachs and Warner, 1995). It must be noted that controversy remains on the relationship between openness and growth<sup>22</sup>.

However, several nuances have been introduced with regards to the benefits of trade liberalisation. Already in the 1950s, it was argued that developing countries needed to transform their economies first before they could benefit from trade (Page and Kleen,

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<sup>22</sup> Rodriguez and Rodrik (2000) have criticized Sachs and Warner (1995) and argued instead that the relationship between trade openness and economic growth is still an open question; however, Lee et al. (2004) have reviewed the matter once more and argue that one of the main difficulties is the endogeneity of the relation. While controlling for the effect of growth on openness, they argue that openness has a small, positive effect on growth.

2005). Developing countries were considered different from developed countries and would need to transform their economies first before they could engage in trade liberalisation<sup>23</sup>. Such a transformation, it is argued, may require government intervention and could involve conducting policies that would go against WTO rules. Also, utilising the notion that developing countries are different from the developed world, it has been argued that these countries lack institutional quality and as a result experience relatively higher costs to trade liberalisation and may not benefit at all (Hoekman et al, 2003; Busse, forthcoming). SDT is therefore needed to increase the benefits.

Another rationale for SDT may be that a country is permanently different from other countries in the international trading system and therefore needs SDT provisions to make sure it benefits from trade liberalisation. In contrast to the previous concepts of being different, which justify SDT on the grounds that these countries need to change in certain ways first before they can engage to the full extent in the international trading system, this notion of ‘being different’ is permanent. Examples of such permanent differences could apply to small and vulnerable economies like island states that will never be able to diversify their economy to a high degree. Such economies, usually with a high concentration of exports and high import dependence face a permanent increased risk of income volatility (Jansen, 2004). This argument may be used to justify greater policy freedom.

There are also some arguments for SDT that are of a more political nature. Such justifications are usually derived from the argument that the WTO, or rather GATT, is by design biased towards the developed countries, because developed countries have dominated the GATT for the majority of the second half of the 20<sup>th</sup> century (Singh, 2003). This dominance has arguably led to distortions in the WTO regulations that favour developed countries over developing countries. An example could be the approval of agricultural subsidies, which are more difficult to be used by developing countries, because they have insufficient resources to grant subsidies to their agricultural sector.

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<sup>23</sup> Singh (2003) refers to the South Korea and Japan, two countries that managed to achieve very high growth rates in the second half of the 20<sup>th</sup> century, as two examples of countries that first transformed their economy before they liberalized their trade regime.

This bias can thus be interpreted as implicit SDT for developed countries and thus developing countries, it is argued, are eligible for SDT to be at 'parity' with the developed countries.

The reasons for SDT outlined above are not meant to be exhaustive, but do demonstrate that there is a strong case for SDT. Developing countries are different from developed countries and trade agreements ought to take these differences into account to ensure that the benefits of trade are disseminated to all parties. However, there is a trade-off between the use of SDT and the benefits that are associated with trade liberalisation. SDT is in essence also a second-best solution. In this framework, the best solution is simply to remove the distortions (which constitute the differences) through reforms. However, if these reforms are not feasible for political or economic reasons, one could create an extra distortion (the application of SDT) to address the initial market imperfection (which can have an economic, political or institutional nature). Hoekman et al. (2003) recognise that especially for the poorest countries with little resources and institutional capacity constraints SDT may offer a good second-best option since implementation of WTO rules would prove too resource intensive. Also, when differences are permanent (e.g. the small size of eastern Caribbean islands) SDT may also be a good second-best option, since reforms will not take away the distortions (e.g. higher vulnerability to price volatilities due to export concentration). Still, by introducing an extra distortion, the outcome will be sub-optimal (Paugam and Novel, 2005) and no Pareto-efficient outcome will be reached. In other words, SDT will benefit some at the expense of others. Arguably, this is even more the case for SDT in EPAs, since bilateral trade agreements are already a sub-optimal alternative to multilateral trade liberalisation. It is therefore not surprising that SDT not only may allow countries to minimise the adjustment costs and follow their development strategies, it may also decrease the potential benefits that are expected of EPAs. Effects that are related to the widening of markets, such as the agglomeration effect, the competition and scale effects and the increased investment effect may be compromised as the 'widened' market becomes smaller when ACP countries exclude more sectors from liberalisation.

### **4.3 Additional forms of SDT in EPAs and FTAs**

So far the discussion of SDT has focused exclusively on SDT in the WTO and not on SDT in the EPAs. Although the rationale for SDT in EPAs, minimising the adjustment costs, is also valid in the WTO framework it should be mentioned that there is an important difference in analysing SDT at the multilateral level and at the level of EPAs. In the WTO, SDT can only be considered in areas that are actually covered in the WTO agreements. In this framework, provisions that explicitly allow developing countries to derogate from the agreement, regardless of whether it is through delayed, partial or non-compliance can be considered as SDT. However, in the EPAs an extra form of SDT could be applied through the mere exclusion of certain trade-related areas from the EPAs. Naturally, whether or not the exclusion of certain areas from the EPAs will constitute SDT would be difficult to define; it is unlikely that the EPA would explicitly mention the exclusion of certain areas as SDT. Only when all six EPAs have been concluded, the differences in coverage between them and possibly in relation to other EU FTA can be studied and would it maybe be possible to identify ‘exclusion SDT’ in some EPAs.

In addition to the possibility of ‘exclusion SDT’, there are two reasons why SDT in EPAs can have a special nature. Firstly, the EPAs will be agreements between two parties and will be a so-called North-South FTA, involving a developed partner, the EU, and a developing country partner, the ACP region. North-South FTAs (N-S FTAs) are relatively new to the international trading system; examples include the Trade, Development and Cooperation Agreement (TDCA) between the EU and South Africa, signed in 1999, and the EU-Chile Association Agreement, signed in 2002. In such N-S FTAs, an asymmetrical sharing of obligation may constitute a form of SDT. For example, as discussed in section 3.2, FTAs, in order to be compatible with GATT XXIV, need to cover “substantially all trade”, commonly interpreted as 90% (by the EU). In the TDCA, the EU committed itself to liberalise 95% of its imports while South Africa agreed to liberalise 86% of its imports (Grant, 2006). Such an agreement, where the developed party takes on more commitments than the developing party, can arguably be understood as a form of SDT. In the TDCA this SDT is implicit, since the asymmetry is not referred to as SDT. With regards to the asymmetric liberalisation of trade in the context of EPAs,

it should be mentioned here that the popular expectation is that the EU will liberalise 98-100% of its trade allowing the ACP countries to only liberalise 80-82% of their imports (Bilal and Rampa, 2006).

The second reason for the specificity of SDT in N-S FTAs is again illustrated by the TDCA and relates to transitional safeguard measures. In addition to the 'regular' safeguard provisions, which are largely similar to the WTO rules (TDCA Article 24) and can be invoked by both the EU and South Africa, during the initial stages of trade liberalisation South Africa may invoke 'transitional safeguard measures' (TDCA Article 25) and temporarily reintroduce the pre-TDCA customs duties on any product in its liberalisation schedule (Art. 25.1). The transitional safeguard provision can only be invoked on specific grounds (infant industry protection or major social problems) and can last no longer than 4 years, but allows South Africa to shield any sector from a surge of EU imports during the initial stages of trade liberalisation. The EU cannot invoke the transitional safeguard provision and this can thus arguably be considered another form of implicit SDT (there is, again, no reference to SDT in Article 25). Such a transitional safeguard mechanism could also help preserve the rural development and livelihood security in the ACP countries if such a mechanism is included in the EPAs.

The two extra forms of SDT essentially arise from the possible interpretation (as in the case of the EU) of Article XXIV of GATT 1994, which permits preferential trade agreements when it covers 'substantially all trade' (SAT) and completes the liberalisation process within a 'reasonable length of time'. These two conditions are then used to introduce FTA-specific forms of SDT. The first form of SDT, the asymmetric liberalisation, constitutes permanent SDT since developing party imports are excluded from the agreement. As stated before, SAT is generally considered to be 90%. If a lower percentage is used, the potential of SDT, in terms of permanent lowering adjustment costs, becomes larger. The latter form of SDT, the transitional safeguard mechanism, is a temporary form of SDT since such a mechanism expires at the end of the 'reasonable length of time.' This period of time is commonly understood to be no longer than 10 years, but may be longer in 'exceptional circumstances'. Longer implementation periods

have been adopted in some FTAs, stretching up to 20 years (Scollay, 2005). Naturally, when longer transition periods are agreed upon in the context of EPAs, the longer such a temporary adjustment mechanism can be utilised by the ACP regions. However, as both conditions are interpreted more freely, the greater the risk that the EPAs will be challenged; it may thus be argued that interpretations of the two conditions will not diverge very much from the common understandings since the EU considers WTO compatibility a corner-stone of the EPAs<sup>24</sup>. Also, as has been discussed in section 4.2, there is a trade-off between SDT and the benefits of EPAs. The higher the percentage of trade to be excluded and the longer the transition period, the more the potential benefits of EPAs may be compromised.

#### ***4.4 Outlining SDT options in EPAs***

The concept of utilising asymmetry in FTAs, thus addressing development concerns through SDT has not yet been discussed in the literature. Besides, as mentioned above, since the EPAs will be the first bi-regional N-S FTAs and are thus completely new to the international trading system this means that the possible SDT options in EPAs have not yet been discussed in much detail. However, the EPAs are not only trade agreements between two regions with very different development levels; the ACP regions themselves are also very heterogeneous in terms of development and vulnerability: all regions have LDC as well as non-LDC members. Arguably, that means that there is, in addition to differentiation between the EU and the ACP regions, also ample reason to differentiate within the regions. These two different levels of SDT make the EPAs truly revolutionary. It also implies that this section addresses new issues not yet tackled in the literature; as a result it will only outline possible options for SDT in EPAs and will necessarily refrain from discussing the options in great detail.

First, section 4.4.1 will address the different levels of SDT in the EPA negotiations. This will be an overview of the advantages and drawbacks of the various levels of SDT. In section 4.4.2 a possible framework will be provided for how SDT provisions in the WTO

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<sup>24</sup> For a thorough discussion of these two conditions and their relation to WTO compatibility see Onguglo and Ito (2003)

may or may not be extended to the EPAs and vice versa. Section 4.4.3 will provide an overview of some selected issues within the WTO framework.

#### **4.4.1 SDT for all countries and SDT within the ACP regions**

The unique nature of the EPAs implies that SDT options need to be divided into SDT that will apply to all countries within a particular ACP region and SDT that will be applied on a country-level, effectively differentiating within the ACP region. Furthermore, as discussed in section 4.2, another dimension in which SDT can differ is whether SDT is permanent or temporary.

Temporary SDT that applies to all countries in the region would arguably reflect the more traditional forms of SDT. Improved market access, one of these three forms of SDT, is arguably not relevant in the context of EPA since the EU will already liberalise its trade fully in the EPAs. It may be expected that the negotiations will give most attention to the concretisation of SDT provisions that have the form of modulation of commitments. Especially, as the scope of the EPAs expands, so will the implementation of the EPAs pose significant challenges to the ACP countries; it is therefore in the interest of the region to negotiate SDT provisions that allow the ACP states to implement the negotiation outcome with a delay. Together with development support programmes, such temporary SDT could then contribute significantly to minimising the adjustment costs. It should be noted that this is the kind of SDT that is usually called for in statements by the ACP negotiators, like Dame B. Miller (2006), the lead spokesperson for the ACP Group, who stressed that “a development-oriented EPA implies special and differential treatment for the ACP [...through] greater flexibility in the application of trade rules [...]” (page 3).

Permanent SDT on a regional level could take the form of is either the asymmetric liberalisation of goods in the EPAs or the ‘exclusion SDT’, as discussed in section 4.2. The big advantage of agreeing on a regional list of products to be excluded from liberalisation is that excluding products on a regional level does not compromise the regional integration process since coherence is maintained (Stevens, forthcoming). However, as stated earlier, this process will be very difficult because of the heterogeneity

of the regions; there is very little regional overlap in sensitive products. When the exclusion of certain areas from the EPAs is concerned, it is important to note that the exclusion of certain trade related areas does not necessarily need to mean that implicit SDT has been applied. If, for example, fisheries is not included in the ESA-EU EPA, this exclusion can also reflect a normal negotiation outcome. In other words, it is always possible that rather than agreeing to exclude fisheries in order to grant the ACP region implicit SDT the parties simply agreed not to include fisheries in the EPA. Such an outcome can simply be a display of the ACP region's successful negotiating tactics rather than an application of SDT. Since it may be argued that SDT is often interpreted as a 'favour' that is granted by the developed party, focusing on negotiating a good outcome rather than asking for SDT is much more favourable (Stevens, 2002). If the SDT option would be chosen instead, the chance that the EU would ask something 'in return', effectively decreasing the ACP bargaining power, would then be increased.

The high level of heterogeneity of the ACP region serves as an important rationale for differentiating on the country-level as well. It is highly unlikely that one, regional, set of SDT provisions meet the needs of all ACP countries in the region concerned. It must be noted that this level of SDT does not need to be restricted to one country; it can also address a group of countries within the region that are more homogenous than the region as a whole. However, a major complication in applying country-specific SDT provisions is the fact that it may threaten the regional coherence and hence the regional integration process as such; whose advancement is an important goal of the EPAs (European Commission, 2002, 2005; Stevens, forthcoming). Basically, if a country were to exclude a sector from liberalisation which is included in the liberalisation schedules of its regional partners, it would need to reinstall border controls and subject the trade flows from the region to customs inspection (i.e. de facto re-introducing specific rules of origin) in order to enforce the country-specific exclusion meaningfully. It is not difficult to imagine that such practises may eventually reduce the EPAs to de facto bilateral agreements between the EU and each individual country; the EPAs would then undermine the regional coherence and hence the regional integration process. An exception is the exclusion of a good that is solely traded by the country concerned; in that case the regional coherence

would not be compromised. Fortunately, not every trade-related issue will have such an undermining impact on regional coherence if SDT is applied on a country level as market access does. In trade related areas such as competition and investment, the effects of country-specific SDT may not significantly threaten the regional coherence, because in such trade-related areas the application of SDT within the ACP region does not hurt other countries' interests as much and hence may not significantly jeopardise regional coherence. Also, with regards to the level of regional integration, a surprising conclusion is the fact that the threat to regional coherence is smaller for less-integrated regions (i.e. FTAs) than for more integrated regions (i.e. customs unions). Member states of FTAs maintain a higher level of sovereignty when trade policy is concerned than for customs unions or common markets (e.g. they do not have to agree on a common external tariff), so SDT provisions for individual countries in a FTA are less likely to cause differentiation from regionally harmonised systems. Lastly, permanent differentiation between countries will tend to pose a greater threat to regional coherence than a temporary one. Therefore, transitional safeguard mechanisms are more likely to be used to differentiate within the ACP regions, although the disruptive measures like border controls would still be needed to invoke the transitional safeguards meaningfully.

It may be concluded that despite the various levels and forms that SDT can have in the context of EPAs, the country-specific differentiation has a major drawback because of its negative effect on the regional coherence. This disadvantage hampers the scope for its application, because regional integration is essential to ensure the positive development effects of EPAs. However, if only invoked for short (i.e. transitional) periods and/or for issues that are not so dependent on regional coherence, SDT within the ACP region may to a certain extent address the differences in adjustment between the countries. Naturally, regardless of the type or form of SDT, there is always a trade-off between minimising the adjustment costs and reaping the benefits from EPAs.

#### **4.4.2 Extending WTO provisions on SDT to EPAs and vice-versa**

Having discussed the implications of the different levels at which SDT may be applied in the EPAs, the way the WTO provisions on SDT may interact with the SDT provisions in the EPA, which are still unknown, is discussed here.

Perhaps the most intuitive way in which SDT provisions in the WTO can interact with the SDT provisions in the EPAs is by simply extending all provisions in the WTO to all ACP countries in the EPAs. The WTO provisions could similarly be considered as the benchmark scenario for the SDT provisions in EPAs. However, as EPAs may include more areas than are currently covered in the WTO, simply adopting the WTO SDT provisions may not be sufficient. Also, given the dissatisfaction of developing countries with the lack of concretisation of SDT provisions in the WTO (Keck and Low, 2004), it could be argued that the WTO SDT provisions are sub-optimal.

Another way in which the recent progress in the WTO could be extended to the EPAs is in the WTO's differentiation between countries. In the WTO, a distinction is made between developed, developing, least developed and, in the context of agriculture, net-food importing developing countries (NFIDCs) (Page and Kleen, 2005). This list is by no means exhaustive; depending on the trade area the WTO may differentiate countries with regards to that issue. Having established the country heterogeneity within the ACP regions, such a differentiation between ACP countries may also improve the effectiveness of SDT provisions. Arguably, the CPA already anticipates such a differentiation, by stating that special treatment will be maintained for ACP LDCs and that the vulnerability of small, landlocked and island countries will be taken into account (Article 35.3).

One of the reasons for the slow progress on SDT in the Doha Round has been the unwillingness of Northern countries to concretise the SDT provisions out of fear to grant unwarranted preferences and differentiated treatment to emerging developing countries (in particular large countries such China, India and Brazil). It may be suggested that developed countries were afraid that any concretisation of SDT would only aggravate the competitive pressure from these countries. No ACP country is large or competitive

enough to cause a similar fear, so it is possible that SDT provisions in EPA will be more favourable to the ACP if they are kept distinct from the provisions in the WTO.

However, such an argumentation could also create obstacles for the SDT provisions in the WTO. The EU may be unwilling to grant generous SDT provisions in EPAs because they fear setting a precedent for future FTAs with stronger developing countries (e.g. Brazil in the context of the EU-Mercosur FTA negotiations, or likely future EU negotiations with India) or setting a precedent in the context of the WTO negotiations on SDT, much like the SDT provisions in the WTO may serve as a precedent for SDT in EPAs.

#### **4.4.3 Overview of developments in selected areas.**

Regardless of whether the SDT provisions in the WTO will be used as a starting point for the SDT provisions in EPAs, they provide an important yardstick against which the effectiveness of the SDT in EPAs will be measured. Therefore, it is worthwhile to use recent developments in the WTO with regards to SDT provisions for the purpose of outlining possible options for SDT provisions in EPAs. However, there are too many provisions of SDT in WTO agreements to all be discussed in detail, this sub-section will therefore focus on one sector that is arguably the most vital the ACP Group's economies, agriculture, and will then discuss how SDT may be applied in EPAs as trade remedies, simplifications of rules and capacity building. Before this discussion, Table 12 provides a non-exhaustive and very brief overview of the several forms of SDT for LDCs in the WTO agreements and how SDT may be included in the EPAs in these sectors or trade-related areas and issues.

**Table 12: SDT for LDCs in WTO Agreements**

WTO Agreement	SDT provisions for LDCs	Possible SDT provisions in EPAs, if applicable
Agreement on Agriculture	LDCs are exempt from undertaking reduction commitments.	The concept of 'special products' and 'special safeguard mechanism' could be utilised as well in EPAs, using the EU interpretation of Article XXIV of GATT 1994. See below.
Application of Sanitary and Phytosanitary Measures	LDCs had the possibility of delaying for up to five years, the implementation of the provisions of the Agreement with respect to their sanitary and phytosanitary measures affecting imports.	ACP would benefit from the simplification of the complex EU rules for SPS. Also scope for capacity building to help ACP exporters to meet the SPS standards of EU.
Agreement on Textiles and Clothing	LDCs are accorded significantly more favourable treatment than other groups in the application of the transitional safeguard.	
Agreement on Technical Barriers to Trade	Particular account to be taken of LDCs in the provision of technical assistance and in the preparation of technical regulations.	Possibility to include provisions on capacity building for ACP in this regard.
Trade-related Investment Measures (TRIMS)	LDCs had a seven-year transitional period to eliminate TRIMS that are inconsistent with the Agreement.	EPAs may have wider scope (Singapore issues) with regards to investment. Delayed compliance may be introduced.
General Agreement on Trade in Services (GATS)	Special priority given to LDCs in implementing Article IV of GATS (Increasing Participation of Developing Countries) and particular account to be taken of the difficulties encountered by LDCs in accepting negotiated commitments, owing to their particular needs. Special consideration is given to LDCs with regard to encouraging foreign suppliers to assist in technology transfers, training and other activities for developing telecommunications.	Scope for SDT for trade remedies for ACP to protect them a surge in imports through temporary safeguards. Also protection against unfair competition.
Agreement on Trade-related Aspects of Intellectual Property Rights (TRIPS)	Delay for up to 10 years in implementing most of TRIPS obligations. Possibility of extension following duly motivated request. Members to provide incentives for encouraging the transfer of technology to LDCs.	EPAs may allow ACP countries delayed compliance; unlikely that ACP will be allowed exemptions from TRIPS for development concerns (e.g. cheap medicines)
Understanding on Rules and Procedures Governing the Settlement of Disputes (DSU)	Particular consideration should be given to the special situation of LDCs in all stages of a dispute involving an LDC. Members to exercise due restraint in raising matters involving an LDC. LDCs may request use of the good offices of the Director-General or the Chairman of the DSB.	EPAs may include provisions on simplification of DSU for ACP; avoiding cumbersome procedures.

Source: Adapted from WTO, 2004b

## Agriculture

Perhaps not surprisingly, most discussions on improving the SDT provisions in agriculture have focused on improved market access for the DCs (WTO, 2006). Since it is expected that the EU will liberalise at least most, and more likely all trade vis-à-vis the ACP country as part of the EPAs, this is not really an issue in the EPA negotiations. Regarding market access to ACP markets, developing countries have become increasingly concerned about the impact of liberalization on rural livelihood and have argued, in the context of the WTO, for flexibility in the reduction of tariffs for ‘Special Products’ (SP). Although ‘Special Products’ have not yet been concretised, Bernal (2004) has argued that the fact that in July 2004 the WTO officially endorsed food and livelihood security and rural development needs as the basis for operationalising SDT, already is “a positive step forward in the multilateral system in recognising the particular circumstances and concerns of developing countries in relation to trade liberalisation in agriculture” (page 7). There is also scope for ‘Special Products’ in the EPAs through the asymmetric liberalisation.

The July Decision has been useful in advancing the negotiations on SP in three ways:

- First, by guaranteeing that developing countries will have access to this flexibility in a revised agreement on agriculture, which at many instances of the long negotiation process looked unlikely.
- Second, by clarifying the basic parameters that should guide the designation of SP, being these. The endorsement of these concepts by WTO members is, indeed, an important departure from the Uruguay Round.
- Third, through the Decision, WTO members have acknowledged the “fundamental importance of SP for developing countries” (Annex A, paragraph 41 of July Decision).

The progress on the concretisation of the Special Safeguard Mechanism (SSM) has been much less promising, with the exception that it was agreed that the SSM will only be available to developing countries (Bernal, 2004). As was discussed before, the EPAs may

also provide in such a mechanism through the transitional safeguard mechanism during the initial stages of trade liberalisation.

Developing countries have argued for substantial reductions in the level of domestic support and elimination export subsidies; however, developed countries made very few commitments in these two respects. Although both parameters could prove important to ACP countries, respectively improving market access by becoming more competitive in relation to EU producers and by protecting agricultural sectors in ACP countries from EU subsidized imports, it seems unlikely that the EU will commit itself on these two issues in the EPAs.

#### Trade remedies (safeguards, antidumping and anti-subsidies)

Arguably one of the most important means to use SDT to ensure positive development outcomes of EPAs could be achieved through agreeing on provisions on trade remedies that fully take the development dimension of EPAs into account. Safeguards, one kind of trade remedy, can arguably facilitate ACP countries to protect their economies from (temporary) undesirable effects of the EPAs. Examples could include a temporary surge of imports due to trade liberalisation which threatens the balance of payments or a specific sector, but safeguards may also be applied when a sector is threatened by unfair EU competition pressures.

So far, safeguards have generally been provided for in agreements on the grounds that countries need to ascertain eligibility by demonstrating that a certain economic phenomenon is undesirable (deteriorating balance of payments) and generally may only invoke a safeguard measure for a limited and short period of time. It can be argued that extending both the eligibility for and the length of a safeguard measure would be considered by the critics of EPAs to be an important step towards ensuring that the EPAs will deliver on their development dimension. Another option would be to replace the time limit on safeguards with a development benchmark; in other words, to make a safeguard last until a certain development objective has been reached. It must be noted that extending the eligibility of safeguards to such degrees would probably also make

these provision incompatible with WTO rules. Another drawback is that extending the eligibility of safeguards also increases the risk that this trade remedy will not be used to remedy the negative effects of trade, but will instead really be applied to resist trade liberalisation all together and maintain a protectionist regime. Therefore, while extending safeguards may help to guarantee developmental outcomes of EPAs, it can also compromise the benefits of trade liberalisation.

Lastly, it must be noted that ACP countries should try to limit the scope for trade remedies by the EU as much as possible. This is especially important for anti-dumping and anti-subsidies. It may be argued that an asymmetric distribution of trade remedies between the ACP region and the EU, providing the Southern party with relatively more provisions for trade remedies, would be an application of SDT that may increase the development gains of EPAs.

#### Simplification of rules

Another way in which SDT could address the development dimension of EPAs is through the simplification of rules in trade-related areas. Many of the rules used by the EU in trade-related areas are very complicated and with procedures that are difficult to manage; addressing these issues through simplification could significantly improve the market access of ACP exporters to the EU market.

If the EPAs are intended to bring about simplification of rules, customs procedures are an important area where simplification would greatly assist ACP exporters. Other areas where simplification of rules would enhance the prospects of ACP exporters are trade facilitation, where simplification of rules could speed up the process of exports becoming imports, and sanitary and phytosanitary measures. It may be argued that in the latter area, simplification must balance the health concerns for EU customers with the need to make rules transparent and controllable. The simplification of rules may prove to be of specific benefit to the smaller companies of the ACP, since these companies, lacking the resources to address the cumbersome rules in these areas due to their smaller scale, find it too difficult and costly to enter the European market.

A last area in which simplification of rules may turn out to be valuable application of SDT is dispute settlement. If rules can be sufficiently simplified to make the procedures less cumbersome and taxing on ACP capacity, dispute settlement procedures may provide more equitable outcomes and hence become more ‘development-friendly’.

### Capacity building

Capacity building programmes are often regarded as important elements of SDT; however, only if the successful accumulation of capacity is a condition for the provisions concerned to take effect may capacity building be considered an element of SDT. Also, another concern is the fact that capacity building does not really differentiate between parties in terms of rules; it simply helps the less developed party to implement the agreement.

Having mentioned these shortcomings of capacity building as a possible application of SDT, capacity building can nevertheless be of great value to the EPAs. Especially in the areas of SPS and trade facilitation can capacity bring about significant development benefits, by helping ACP countries to address these issues more efficiently and effectively. Furthermore, capacity building can also be an important element of provision that concern other trade-related areas such as competition policy, investment regime and government procurement.

## **4.5 Concluding remarks**

Having discussed the various ways in which SDT may be applied in EPAs, it is important to note that the development dimension of EPAs cannot be addressed only through SDT. SDT can arguably play its part in addressing the development dimension, but accompanying and additional measures and policies, as well as effective support delivery, are needed to ensure a development-oriented outcome of the EPA.

Also, it has been demonstrated that SDT in EPAs (and FTAs) is not the same as SDT in the WTO. SDT provisions cannot simply be transposed to the EPAs: The EPAs may

cover a wider range of issues than the WTO which would require new concepts of SDT and the FTAs offer new concepts of SDT through GATT Article XXIV.

However, the exact scope of SDT is and will be difficult to define as it will remain difficult to determine whether certain exclusions or temporary safeguards will constitute SDT or not. Temporary safeguards are relatively much more valuable for the ACP parties than for the EU (EU is very important trading partner for the ACP countries, but for the EU the trade with the ACP countries is not very significant) and the inclusion of temporary safeguards do not necessarily need to be justified on grounds of SDT. Also, the exclusion of certain trade-related areas may constitute an exemption as SDT, but, like temporary safeguards, can also be the result of a bargaining process in which parties exclude or include trade-related areas or provisions on a *quid pro quo* basis.

Having said that, there is scope for SDT in EPAs; exemptions, delayed compliance and asymmetry in the obligation of commitments can bring about lower adjustment costs for the ACP regions and countries. Successful application of SDT in EPAs is conditional on each ACP country and region determining what provisions of the agreements it will pursue as SDT and which provisions it will pursue through bargaining.

## **5 CONCLUSION**

Whether or not the EPAs, which are meant to take effect in 2008 but are currently still being negotiated, will bring about development is still an open-ended question. No detailed information about the content of EPAs has become available to date and hence impact assessments rely on assumptions instead. However, it may be argued that the 'development-friendliness' of EPAs is dependent on its content, which should take development considerations into account through trade (-related) rules, by including sufficient accompanying measures and policies and ensuring effective processes for support delivery. In addition, the parties must acknowledge that the ACP capacity needs must be fulfilled for the EPAs to have the desired outcome. Lastly, an important factor that will influence the outcome of EPAs is the institutional capacity of the ACP countries.

Impact assessments have focused on trade creation and diversion and the fiscal impact of EPAs. Regarding trade creation and diversion, it may be argued that the net trade creation, which is also the net welfare effect in this framework, is positively related to the importance of trade between countries before they entered a FTA, the openness of FTA members vis-à-vis third parties and the elasticity of supply and demand. The estimates of trade creation in Africa all agree that trade creation will outweigh diversion, but this may not be the case for the other two regions.

The fiscal effect of EPAs is studied in more detail as an example of other effects of EPAs, because there are a fair amount of estimates available and it is of significant importance to ACP governments in the short term, since it arises from the fact that as a result of the elimination of tariffs on European imports ACP government lose trade tax revenues. Fiscal effects are estimated to constitute significant adjustment costs of EPAs and will require a response by ACP governments. Possible strategies may include a mix of fiscal reform, balance of payments support and excluding sensitive products, which may be facilitated through SDT provisions on (temporary) exemptions.

The estimates of the abovementioned two effects, however, cannot be interpreted without considering the methodological framework in which they were calculated. Important issues to be taken into account are the use of partial or general equilibrium, the inclusion of static and/or dynamic effects and the role and quality of the data. A very important shortcoming to all assessments is the fact that they cannot determine what exactly they assess; the EPAs contents, as well as the speed with which the liberalisation will take place, are unknown and hence the estimates are only as good as the scenario adopted. It can therefore be argued that impact assessment tend to overestimate the effects of EPAs. Nevertheless, it may be concluded that it has been demonstrated that EPAs will involve significant adjustment costs.

Having discussed some of the effects of EPAs and concluded that there will be adjustment costs, it can be argued that SDT may be applied in the agreements to

minimise the adjustment costs. SDT has had a long history and is roughly identified in three forms: improved market access, modulation of commitments and the preservation of policy space. The economic rationale for SDT is found in the acknowledgement that developing countries are different from developed countries and, as a result, a uniform set of rules may not be in the interest of developing countries.

SDT in EPAs has a specific nature in two ways. Because of the flexibility which is allowed in the WTO with regards to coverage of trade and transition period of FTAs, SDT in EPAs (and FTAs) can be applied through the exemption of certain products from liberalisation and through the possibility to introduce transitional safeguards during the initial phases. Also, the extent of the coverage of the FTAs may constitute SDT, by excluding certain areas from the agreement out of development considerations.

Furthermore, the heterogeneity of the EPAs regions serves as an important rationale for SDT at two levels: between the ACP and the EU and between countries within the ACP region. However, differentiation within the region, especially in market access SDT, may undermine the regional coherence and may be considered a very undesirable effect of EPAs. Also, paradoxically, regional coherence is threatened more by SDT in well-integrated regions than in less integrated regions. For example, it will be easier to provide SDT to the Dominican Republic than to Saint Lucia; both are part of the CARIFORUM-EU EPA but the former is not part of the Caribbean Community (CARICOM) or the Caribbean Single Market and Economy (CSME). Therefore SDT for the Dominican Republic would disrupt the regional coherence less, because, for example, transitional safeguards would not affect the wider region as much.

SDT provisions in the WTO cannot simply be transposed to the EPAs. Yet, they may provide an important benchmark for the differential treatment which may be agreed upon in the EPA negotiations. Much will depend on the willingness of the EU to address SDT and how the Commission will value the effect the SDT provisions in the EPAs will have on other bi- and multilateral negotiations. Also, the scope of SDT is also determined by the negotiating process; in FTAs it is often difficult to identify what provisions are

applications of SDT and which provisions are simply an outcome of the bargaining process that characterises every negotiation.

It may be argued that the most important forms of (implicit) SDT in the EPAs will be the exemption of products from the EPAs and the provisions on transitional safeguards; these two applications of SDT are very relevant to the most important sector of the ACP economies, agriculture, and, if applied with care, could bring about smaller adjustment costs of the EPAs by remedying the undesirable outcomes of trade liberalisation. Another relevant application of SDT is the simplification of rules in trade-related areas.

In spite of the benefits SDT may have, there is an important shortcoming. It has been demonstrated that SDT reduces the adjustment costs, but as the scope and coverage of SDT expands, it may also decrease the potential benefits that are expected of EPAs. Effects that are related to the widening of markets, such as the agglomeration effect, the competition and scale effects and the increased investment effect may be compromised as the 'widened' market becomes smaller when ACP countries exclude more sectors from liberalisation. These drawbacks are in addition to the threat to regional coherence that may be associated with SDT.

In light of this trade-off between adjustment and development, it may be argued that long-term SDT, with the exception of excluding some goods from the EPAs using the 'substantially all trade' clause of GATT 1994, may compromise the benefits of liberalisation too much. Also, since these kinds of SDT would probably be incompatible with WTO rules, it can be expected that the EU would be unwilling to discuss long-term SDT. There is more scope for temporary SDT during the transition period, which is not incompatible with WTO rules and may be more beneficial to the ACP economic development. Knowing these concerns, it is recommended that the ACP, rather using the customary strategy of trying to maximise SDT regardless of the context, should instead target the provisions of temporary SDT they deem most relevant. Not only is this strategy expected to face less difficulty in persuading the EU to agree, it also makes sense from an economic point of view.

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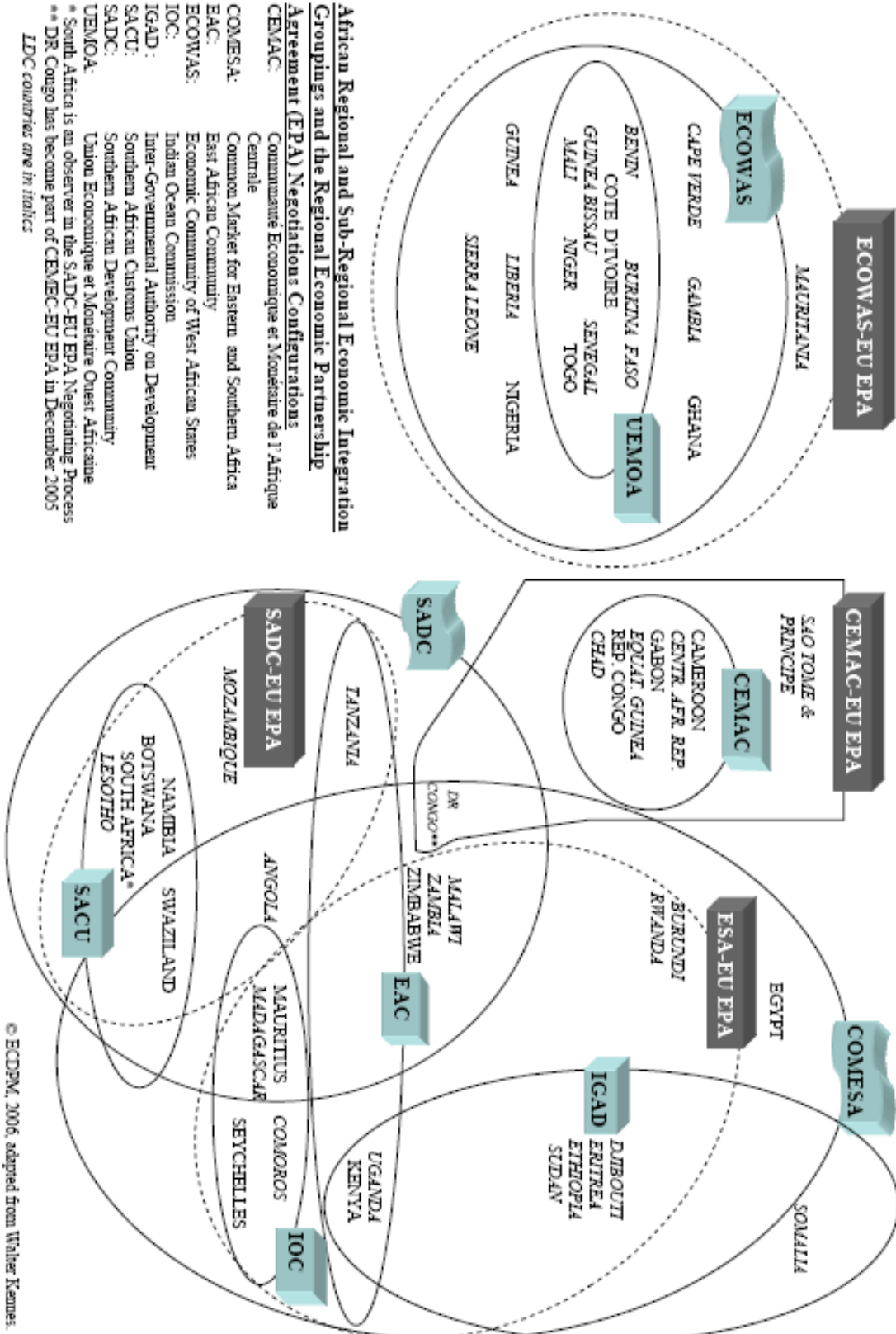
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## Annex A: Overview of various regional integration groupings in Africa



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## Annex B: EPA Regions

ECOWAS EPA	CEMAC EPA	ESA EPA	SADC EPA	CARIFORUM EPA	PACIFIC EPA
Benin	Cameroon	Burundi	Angola	Antigua and Barbuda	Cook Islands
Burkina Faso	Central African Republic	Comoros	Botswana	Bahamas	Fiji
Cape Verde	Chad	Djibouti	Lesotho	Belize	Kiribati
Côte d'Ivoire	Democratic Republic of Congo*	Eritrea	Mozambique	Dominica	Marshall Islands
Gambia	Republic of the Congo	Ethiopia	Namibia	Dominican Republic	Federal States of Micronesia
Ghana	Gabon	Kenya	South Africa**	Grenada	Nauru
Guinea	Equatorial Guinea	Madagascar	Swaziland	Guyana	Niue
Guinea-Bissau	São Tomé and Príncipe	Malawi	Tanzania	Haiti	Palau
Liberia		Mauritius		Jamaica	Papua New Guinea
Mali		Uganda		St. Kitts and Nevis	Samoa
Mauritania		Rwanda		St. Lucia	Solomon Islands
Niger		Seychelles		St. Vincent and the Grenadines	Tonga
Nigeria		Sudan		Suriname	Tuvalu
Senegal		Zambia		Trinidad and Tobago	Vanuatu
Sierra Leone		Zimbabwe			
Togo					

Notes: \* The Democratic Republic of Congo switched from ESA to CEMAC in December 2005; \*\* South Africa has an observer status to the EPA negotiations; it already signed the Trade and Development Cooperation Agreement with the EU

## Annex C: Fiscal impact of EPAs and African ACP countries

**Table C1: Central Africa, CEMAC-EU EPA (mil. USD)**

	Revenue Loss	
	<i>UNECA<sup>a</sup></i>	<i>CRETES<sup>b</sup></i>
<b>Cameroon</b>	-149.3	-99.1
<b>Congo Rep</b>	-75.1	
<b>Gabon</b>	-74.3	-92.1
<b>Eq. Guinea</b>	-33.9	
<b>CAR</b>	-5.8	-11.0
<b>Chad</b>	-26.7	

Sources: a) UNECA, 2005  
b) computed from CRETES, 2003

**Table C2: West Africa, ECOWAS-EU EPA (mil. USD)**

	Revenue Loss		
	<i>UNECA<sup>a</sup></i>	<i>CAPE<sup>b</sup></i>	<i>Busse<sup>c</sup></i>
<b>Ghana</b>	-193.7		-90.8
<b>Burkina-Faso</b>	-22.0	-126.6	-17.5
<b>Benin</b>	-39.5	-167.9	-27.6
<b>Cote d'Ivoire</b>	-112.2	-723.5	-82.9
<b>Guinea-Bissau</b>	-2.0	-15.3	-2.2
<b>Senegal</b>	-80.2	-609.7	-87.9
<b>Niger</b>	-20.5	-72.4	-6.6
<b>Nigeria</b>	-426.9		-487.8
<b>Mauritania</b>	-14.6		-11.8
<b>Mali</b>	-33.1	-212.5	-16.6
<b>Togo</b>	-35.5	-78.4	-12.9
<b>Gambia</b>			-13.8
<b>Cape Verde</b>			-24.0
<b>Guinea</b>			-16.7

Sources: a) UNECA, 2005  
b) Computed from CAPE, 2003  
c) Busse et al., 2004

**Table C3: Eastern and Southern Africa, ESA-EU EPA (mil. USD)**

	Revenue Loss	
	<i>UNECA<sup>a</sup></i>	<i>Tekere<sup>b</sup></i>
<b>Burundi</b>	-7.7	
<b>DRC</b>	-24.7	
<b>Ethiopia</b>	-55.1	
<b>Eritrea</b>	-7.4	
<b>Djibouti</b>	-37.5	
<b>Kenya</b>	-107.3	
<b>Madagascar</b>	-7.7	
<b>Malawi</b>	-7.1	-24.6
<b>Mauritius</b>	-71.1	-209.9
<b>Rwanda</b>	-5.6	
<b>Seychelles</b>	-24.9	
<b>Zimbabwe</b>	-18.4	-118.3
<b>Sudan</b>	-73.2	
<b>Uganda</b>	-9.5	
<b>Zambia</b>	-15.8	

Sources: a) UNECA, 2005

b) Tekere and Ndlela, 2002

**Table C4: Southern Africa, SADC-EU EPA (mil. USD)**

	Revenue Loss	
	<i>UNECA<sup>a</sup></i>	<i>Tekere<sup>b</sup></i>
<b>Angola</b>	-103.3	
<b>Botswana</b>	-5.2	-32.4
<b>Lesotho</b>	-0.3	
<b>Mozambique</b>	-7.6	-29.2
<b>Namibia</b>	-3.8	-285.3
<b>Swaziland</b>	-0.8	-5.6
<b>Tanzania</b>	-32.5	-146.6

Sources: a) UNECA, 2005

b) Tekere and Ndlela, 2002

## **Annex D: Fiscal reform**

The loss of customs duties from an EPA will require that revenue be raised from other sources. The need for fiscal adjustment as a result of trade liberalization in general, and the coming into effect of EPAs in particular, is obvious. The most favoured option is the introduction of a value-added tax (VAT), arguably the least distortionary tax available<sup>25</sup>, to compensate for the lowering of tariffs.

Since VAT is levied on both domestically produced and imported goods, unlike customs duties which are levied on imports only, it is possible in principle to generate more VAT-income than the revenue lost as a result of the elimination of tariffs. This increase in revenues does not come at the cost of lower efficiency gains since domestic producers are no longer protected behind tariff walls. If the VAT is set at a rate identical to the one of the import duty, total welfare will not decrease either since consumers still face the same prices.<sup>26</sup> The potential higher VAT revenues could allow a government to take accompanying measures to alleviate the transition costs on those sectors or segments of the population that stand to lose most from liberalisation<sup>27</sup>.

A major concern that many observers have is the perceived administrative challenges countries will need to overcome if they are to implement a successful VAT system. Of course, regardless of the choice of tax system a government will need to overcome these challenges but, as mentioned earlier, trade taxes do require less administrative capacity than other taxes. However, it is important to note that a lot of the VAT is collected at the

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<sup>25</sup> The distortions create efficiency losses, which affect the economy negatively. VAT, an indirect tax, is favoured over direct taxes because they distort people's or companies' decisions to work, produce or consume. VAT is considered to incur lower efficiency losses. VAT is also the most favoured of the indirect taxes because, by taxing the value added at each production stage, it is more transparent than other indirect taxes, which usually only tax at one stage.

<sup>26</sup> Stability of prices is theoretically possible, by replacing a tariff on a product with a VAT of the same rate. However, most countries currently have only VAT rate and, because many different VAT rates make its administration more complicated, less effective and more costly, it seems unlikely that many more VAT rates will be introduced. In practice, therefore, consumers will face different prices.

<sup>27</sup> Despite these advantages, critics of the VAT have pointed out that the VAT is not a progressive tax, unlike income tax whose rates usually increase as taxed income goes up, and would therefore fail to serve redistributive ends, which may be an important policy objective in countries with large income disparities, as is often the case in developing countries. Yet, as Ebrill *et al.* (2002) have pointed out, redistribution or fairness are determined by the tax system as a whole and not by one tax.

border. Although the tariffs will be eliminated, the customs officials that used to collect tariffs have always also collected the VAT on imports and the customs department will continue to collect VAT on the border. Many developing countries collect more than 50% of their VAT income from imports (IMF, 2005). Nevertheless, many countries, which have already implemented a VAT system, only have the option of increasing their administrative capacity if they are to collect more revenue from VAT; as VAT rates are already quite high a further increase seems unlikely (see Table D1 for an overview of VAT introduction dates and rates of randomly selected countries).

**Table D1: Introduction and rates of VAT**

Country	Date	Rate (%)
Central African Republic	January 2001	18
Ethiopia	January 2003	15
Fiji	July 1992	12.5
Mali	January 1991	18
Mozambique	June 1999	17
Papua New Guinea	July 1999	10
Suriname	April 1999	10
Tanzania	July 1998	20
Uganda	July 1996	17
Zambia	July 1995	17.5

Source: International Tax Dialogue, 2005.

Most countries do not manage to collect their VAT in an efficient manner, leading to lower than expected amount of VAT income.<sup>28</sup> For instance, UNECA (2004, p.203) notes that, in Zambia, VAT “non-compliance is estimated as high as 50% because of the failure by businesses to register as taxpayers [...] and as a result of under-reporting of sales for tax purposes”<sup>29</sup>.

The question therefore is in what ways VAT systems need to be transformed or designed in order to minimise the administrative burden and discretionary effects and maximising

<sup>28</sup> In European countries, with similar VAT rates, the proceeds constitute a much larger percentage of total revenues than they do in most ACP countries. Although the VAT regime in most ACP countries can be considered young by European standards, very new VAT regimes like the Ethiopian, which is young even by ACP standards, may face even bigger challenges in raising VAT revenues.

<sup>29</sup> Several factors may explain this situation. For instance, reviewing the VAT collection efficiency differences across countries, Ebrill *et al.* (2002) find that a high ratio of trade to GDP, high literacy rates and the age of the VAT are all positively correlated to a better collection efficiency of VAT.

revenue. The IMF made several recommendations to that end (Ebrill *et al.*, 2002). First, a single tariff is generally preferable to multiple tariffs. In this way the administrative burden is the lightest and there is no incentive for tax evasion. Second, the VAT system should have as few exemptions as possible. Exemptions, excluding certain products from VAT, bring about a larger administrative burden and incentives for fraud<sup>30</sup>. One extra factor that determines the success of the VAT is the threshold-value of annual turnover a company must reach to ‘qualify’ under the VAT system. Low thresholds will bring about a large administrative burden for the tax administrations, having to collect smaller VAT proceeds at high costs<sup>31</sup>. The inherent distortion that arises from such a threshold, since the economy is divided in a VAT and a non-VAT economy, is offset by the revenue gains.

It is very difficult to estimate the costs of the tax administration reform programmes that will need to be carried by the ACP governments in order to strengthen their tax revenue collection systems. Milner (forthcoming), as discussed in chapter 2, did attempt to provide an insight into the costs of these programmes by looking at the costs of past fiscal reform programmes and using this information to estimate the costs of programmes in all countries. In order to do this, he categorised country by size and by current level of trade restrictiveness and asserted that the larger the country and the more restrictive the trade regime (higher average tariffs), the higher the costs would be. Using the information on the costs of past programmes with this ranking of countries in a table, he has come to rough estimates of the costs of such programmes for countries, depending on their size and trade restrictiveness. His estimates for the some selected countries are reported in table D2.

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<sup>30</sup> Still, for reasons of poverty alleviation many countries exclude basic life necessities (staple foods, basic clothing, etc.) from VAT to keep prices down.

<sup>31</sup> In Uganda and Ghana, VAT systems initially failed (Ghana) or almost failed (Uganda) because the threshold was too low. Since Ghana increased the threshold from an annual turnover of USD 20000 to USD 75000 and Uganda from USD 20000 to USD 50000, the VAT system has functioned much better.

**Table D2: Estimates of Tax Administration Reform programme costs**

Country	Costs (mil. Euro)
Ethiopia	70
Guyana	15
Mali	70
Mozambique	60
Namibia	40
Tanzania	70
Uganda	90
Zambia	50
Total ACP	3000

Source: Milner (forthcoming)

More worrisome is the conclusion by Baunsgaard and Keen (2005) that, looking at past experience, low-income countries, irrespective of whether they had a VAT or not, did not manage to replace the revenue lost from trade taxes by taxing other sources.<sup>32</sup> They concluded that low-income countries with a VAT system recovered 40% of the revenue lost as a result of trade liberalisation, which shows that although VAT improves the recovery rate, it is still not nearly enough<sup>33</sup>. To be sure, fiscal reform is a difficult challenge that most developing countries will have to face. The conclusion of EPAs will provide an additional incentive, as well as an additional burden, to transform the tax system. To facilitate this reform process, accompanying measures will be required. These may take the form of technical assistance and temporary budget support, among others.

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<sup>32</sup> It seems likely that the relation between income and revenue recovery is not direct but rather due to other characteristics, such as level of governance, which are in turn positively related to level of income.

<sup>33</sup> Baunsgaard and Keen (2005) put their findings in perspective by arguing that behind the 40% result of the econometric generalisations, are many diverse country experiences. Without testing their hypothesis, the authors suggest that countries which adhere to the 'orthodox desiderata of single base, minimal exceptions and a reasonable threshold' have better recovery capacities than countries which do not follow these guidelines. As examples they mention Uganda, which managed to more than offset revenue losses by using the 'orthodox' VAT and Egypt, which has a very unorthodox VAT system and experienced falling revenues even in excess of the trade tax revenue losses.