ATPC
Briefing

No. 6

Economic Commission for Africa

African Trade Policy Centre

The Economic and Welfare Impacts of the EU-Africa Economic Partnership Agreements[1]

Introduction

The Cotonou Partnership Agreement (CPA) between the European Union (EU) and African, Caribbean and Pacific (ACP) countries is expected to succeed the expired Lomé Agreement. It envisages the signing of Economic Partnership Agreements (EPAs) by December 2007 between the EU and the ACP countries. The EPAs, which will be the new cooperative framework under the CPA, are expected to adopt an integrated approach based on partnership and promoting cooperation, trade and political dialogue between the EU and ACP countries. One of the essential characteristics of this multilateral partnership is that it hopes to combine responses to the challenge of globalization and the development aid essential to ACP countries; with a strengthened political dimension. The key CPA principles are reciprocity, differentiation, deeper regional integration, and coordination of trade and aid.

Any benefits that EPAs are expected to generate for ACP countries are unlikely to materialize spontaneously and instantaneously. Moreover, the implementation of EPAs will impose a number of severe challenges for ACP countries that include: how to manage the expected losses of fiscal revenue in some ACP countries; how to cope with more competition expected to be entailed under the EPAs principle of reciprocity; how to ascertain net benefits from the EPAs, especially in LDCs, that is, incentive compatibility between EPAs and the EBA provisions that do not require reciprocity; how to deal with limited negotiations capacity because EPAs negotiations will stretch the already limited resources available to the ACP countries; and how to ensure consistency between the negotiations under the EPAs and that under the Doha Work Programme (DWP), in particular, how to improve market access for agricultural and non-agricultural products that continue to impose difficulties in trade negotiations at the multilateral level.

Some questions arising from the trade related aspects of EPAs

The focus of this brief is to provide conclusions from an Economic Commission for Africa (ECA) study that quantifies the economic and social impacts of the trade liberalization aspects of the proposed EPAs. More precisely, the study seeks to provide a quantitative assessment of the likely implications of the implementation of the EPAs establishing Free Trade Areas (FTAs) between EU and the various Regional Economic Communities (RECs). The focus of the empirical analysis is on the trade liberalization component of the EPAs. In particular, the following questions are addressed. First, how are African countries likely to gain or lose as evidenced by the impacts on GDP, employment and other macroeconomic aggregates from a bilateral trade liberalization

between Africa and the EU as governed by the EPAs reciprocity principle? Second, what sectors in Africa are most likely to lose and what sectors gain in the EPA. And based on the empirical evidence on the industry structure likely to result under the EPAs, would application of the asymmetry principle in the EPAs provide sufficient lead-time for the nascent manufacturing sectors in African economies? Third, what are the welfare implications for the African countries from the EPAs? Fourth, how will the formation of EPAs affect trade expansion through trade creation and trade diversion effects? Fifth, what are the potential fiscal implications of the EPAs?

Methodological approaches to analysing the potential EPAs impacts

Trade policy analysis such as that required in the evaluation of the potential impacts of EPAs largely involves analysing implications of trade policy instruments on the production structure in economies at the national and global level. Trade policy instruments such as tariffs and quotas have direct and indirect effects on the relative prices of commodities produced in a given country. As the mix of goods and services produced change, the demands for factors of production also change. Consequently, in any given economy, it is difficult to conceive a situation where the change in trade policy would affect only one sector. Due to the forward and backward linkages and their related strengths existing in a particular economy, the result is always one in which the relative mix of sectoral outputs change. This by extension affects the relative mix of the different factors of production in the different sectors.

The country-level effects on output mix and demands for factors of production can in the context of international trade be extended to the global economy. Changes in relative prices of outputs and inputs resulting in a given country's change in trade policy are transmitted to the industries and input markets of other economies that the country trades with. Therefore, for trade policy analysis to be meaningful and for robust results to be produced, the interactions that prevail among different sectors as a result of a change in a given or group of countries trade policy instruments must be taken into account. Since, the EPAs will potentially have these kind of impacts, the general equilibrium methodology presented itself as the most appropriate analytical framework that would allow the inter- and intra-sectoral changes in output mix and by extension the demand for different factors of production to be captured. In this respect, this study utilises the Global Trade Analysis Project (GTAP) model and database to investigate the potential implications of the EPAs on sub-Saharan Africa. But, this model could only allow the assessment of the EPAs at the continental level through a hypothetical SSA-EU EPA due to data limitation with respect to representation of African countries in the GTAP database as stand-alone regions.

It was therefore necessary to look for an alternative methodology that would allow analysis at the country level and also at HS 6-digit level of products classification. It is in this light that the study found it necessary to consider a partial equilibrium methodology, in spite of its weakness of ignoring sectoral and regional feedbacks when trade policy instruments are changed either in a given sector or all sectors in a given country. However, given its capacity to allow analysis at high level of disaggregation, the partial equilibrium models become indispensable especially because of the interest to establish sensitive sectors either with regards to industrial or fiscal policies. The World Integrated Trade Solution (WITS/SMART) model was chosen as the applied partial equilibrium framework. The WITS/SMART model brings together various databases ranging from bilateral trade, commodity trade flows and various levels and types of protection. WITS also integrate analytical tools that support simulation analysis. The SMART simulation model is one of the analytical tools in WITS for simulation purposes. SMART contains in-built analytical modules that support trade policy analysis such as effects of multilateral tariff cuts, preferential trade liberalization and ad hoc tariff changes. The underlying theory behind this analytical tool is the standard partial equilibrium framework that considers dynamic effects constant. Like any partial equilibrium model, it has these strong assumptions allowing the trade policy analysis to be undertaken a country at a time. In spite of this weakness, WITS/SMART helped to estimate trade creation, diversion, welfare and revenue effects for those countries whose data is available.

The empirical scenarios

In the case of the general equilibrium results, it was necessary to reflect a realistic benchmark for the EPAs given that they are expected to come into force beginning 1 January 2008 when other events with implications to the international trade landscape will have taken place. The main events that will precede the launch of the EPAs and hence likely to affect how they impact on the economies and welfare of sub-Sahara Africa include the following: the enlargement of the European Union; the implementation of the Agreement on Textiles and Clothing as part of the MFA phase out; the implementation of the Uruguay Round Agreement on domestic support and export subsidies; the full accession of China into the WTO; and the conclusion of the Doha Development Round. It is currently not clear how the Doha Round outcomes will impact on EPAs. Therefore, it has not been built into the baseline of the EPAs as yet, but the other four events were built into the baseline.

With the baseline in place, three scenarios were designed to help unravel some of the impacts that the EPAs are likely to have on the sub-Saharan Africa economies. The first scenario looked at full reciprocity by the SSA countries to the EU preferences without addressing the sensitivities that currently exist on the part of the

EU for some of the sectors. Essentially, the tariffs faced by the EU in Africa were equated to the low tariffs that SSA products face in the EU market. In the second scenario, a benevolent stance of the EU was assumed that would accept EPAs that front-load in the first phase dismantlement of tariffs and other barriers within the SSA region in line with the principle of deepening regional integration in Africa as captured in the Cotonou Partnership Agreement. This scenario was further motivated by the desire to increase the market size within the SSA region that would support the development of competitive industries driven by economies of scale. The third scenario considered the ultimate goal of the EPAs, the establishment of free trade area between the EU and the SSA region. Essentially, full trade liberalization is undertaken between the EU and SSA and the sensitive markets in the EU are opened up for the SSA producers and exporters and vice-versa.

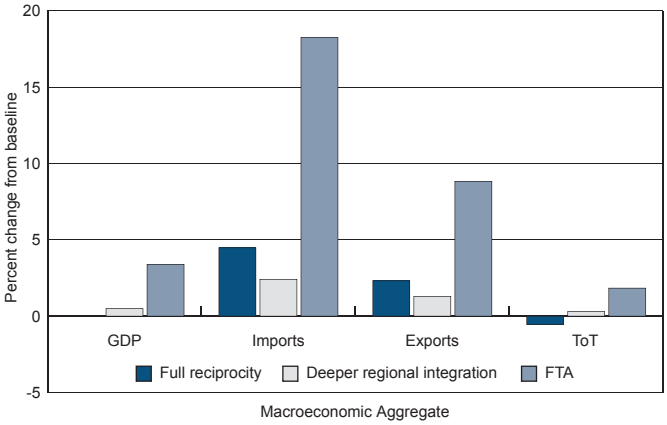
In the case of the partial equilibrium analysis, unlike the general equilibrium analysis where it was possible to look at several scenarios, only one simulation was undertaken for each country with the partial model. This scenario looks only at the reciprocity principal. Due to the weaknesses already pointed out especially the *ceteris paribus* assumption upon which this model operates; only one-way liberalization is possible. The scenario indicates the possible outcomes of reducing to zero the import duties that the SSA countries impose on EU goods. As already noted, one special advantage of the WITS/SMART model is that it allowed the analysis to be undertaken at the 6-digit level. There was therefore no aggregation problem such as the one with the GTAP database. The transmission mechanism for the trade effects in the partial equilibrium model is simple: the elimination of existing tariffs on EU imports reduces the prices that consumers in the importing African country face compared to domestic substitutes and the responsiveness of demand to the price change influences the amount of trade created or diverted. The substitutability of the EU goods for domestic goods is implicitly assumed. The Armington assumption at HS 6-digit level is that goods imported from different countries are imperfect substitutes. It is also assumed that the supply response to the price reduction will allow EU producers and exporters to meet any demand arising in the importing countries as a result of price reduction. That is, export supplies are perfectly elastic which means that world supplies of each variety of the goods by origin are given.

The main findings

The main conclusions that can be drawn from the results[2] and the discussion are that full reciprocity will be very costly for Africa irrespective of how the issue is looked at, in terms of revenue losses, adjustment costs associated with de-industrialization and its undermining effect of regional integration. Of major concern was this finding that even though the full reciprocity principle appears to be trade expanding globally (singularly in favour of EU), it will pose serious implications for deepening of regional integration in Africa.

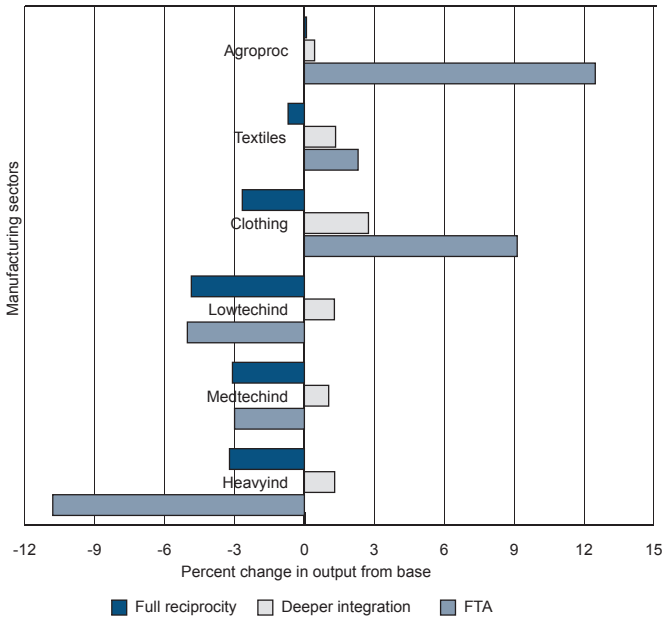
The benefits from regional integration efforts in Africa achieved so far are likely to be stymied by the EPAs since a significant portion of the trade gained by the EU will be due to trade diversion not only from the rest of the world but also from within the EPA groupings themselves that are configured around existing RECs. In deed, unless there are clear mitigating measures, the EPAs could seriously undermine the gains that have been achieved so far in the integration process of the continent. A focus on deepening integration with a view to enhancing intra-African trade would provide positive results. But it is the scenario for unrestricted market access for Africa, which deals effectively with barriers associated to sensitive European products, that portends the largest gain for the continent. Even with reciprocity, a free trade area that does not exclude sectors of export interest to Africa and one that deals with non-tariff barriers promises positive results for African countries.

Figure 1: Income and trade effects on sub-Saharan Africa



Based on the magnitudes and direction of impacts under the three scenarios, the overarching conclusion from the findings is that sequencing of policy reforms that Africa will need to undertake is critical to the success of the EPAs. To begin with, the EPAs should focus on deepening intra-African trade. This should be given sufficient lead-time to allow the African countries build the requisite competitiveness (see figure 2). This would have to be accompanied with significant developmental programmes to complement the larger markets with increased supply and diversified capacities. Eventually, any tariff dismantlement by African countries will need to be implemented in phases hand in hand with unrestricted market access for African exports into the EU market. Clearly, the 10-12 years period interpreted from Article XXIV of GATT is only sufficient for the deepening of the intra-African trade. The EPAs should look beyond the 12 years as the possible dates for introducing reciprocity. Before then, unrestricted market access and deeper African integration will have provided sufficient room for supply capacities and exports diversity to be built in the continent.

Figure 2: De-industrialization in SSA a realistic issue in EPAs



The adjustment costs at the country level and the dangers to the regional integration processes in the continent emerged also as potential challenges for the EPAs. Two consistent stories underpin these concerns. The first consistent outcome in each of the proposed EPA at the regional economic community (REC) level is that EU stands to gain significantly in terms of expanded trade into RECs markets. While part of this trade expansion will result from trade creation, which is welfare improving, significant proportions of the trade gain will also be due to trade diversion from the rest of the world and from within the REC EPA grouping itself. As a result, while the reciprocity principle appears to be trade expanding, it will pose serious implications for deepened regional integration in Africa. In deed, unless there are clear mitigating measures, the EPAs could seriously undermine the gains that have been achieved so far in the integration process of the continent. Africa must therefore hasten regional integration processes to build and consolidate supply capacity before opening up to EU.

Another consistent result at the country and regional level, are the potential adjustment costs that the African countries will have to bear as a result of revenue shortfalls (see Table 1). Given the prominence of the EU imports into these countries, the reliance of majority of the African countries on tariff revenues, the tariff dismantlement result in all cases in significant revenue shortfalls. It is only in the SACU countries where tariff losses appear limited and even then the revenues sharing formula within SACU is likely to ameliorate any shocks from the EPAs in those countries. The major challenge that these revenue shortfalls will pose is the adjustment costs associated with tax policy and administration reforms. The EPAs, if no appropriate measures are put in place to forestall the macroeconomic imbalances that are likely to result from the falling revenues, will have the possibility of undermining developmental objectives of the African countries.

(Footnotes)

[1] Stephen Karingi, Rémi Lang, Nassim Oulmane, Romain Perez, Mustapha Sadni Jallab and Hakim Ben Hammouda. This policy brief is based on on-going research currently being undertaken under the auspices of the African Trade Policy Centre in the Trade and Regional Integration Division of the ECA.

[2] A larger version of this study going by the same title (Karingi et al. 2005) can be downloaded from http://www.uneca.org/trid where all the empirical results are presented, both for the general and partial equilibrium analysis.

Revenue implications of a EPA (US thousands$)

ESA	Revenue Shortfall	ECOWAS	Revenue Shortfall	CEMAC	Revenue Shortfall	SADC	Revenue Shortfall
Burundi	-7 665	Ghana	-193 683	Cameroon	-149 256	Angola	-103 255
DRC	-24 692	Burkina Faso	-22 004	Congo	-75 104	Botswana	-5 233
Ethiopia	-55 126	Benin	-39 523	Gabon	-74 302	Lesotho	- 256
Eritrea	-7 385	Cote d'Ivoire	-112 237	Eq. Guinea	-33 914	Mozambique	-7 640
Djibouti	-37 523	Guinée-Bissau	-1 990	Cent. Af. Rep.	-5 845	Namibia	-3 832
Kenya	-107 281	Senegal	-80 203	Chad	-26 677	Swaziland	- 811
Madagascar	-7 712	Niger	-20 487			Tanzania	-32 491
Malawi	-7 090	Nigeria	-426 903				
Mauritius	-71 118	Mauritanie	-14 573				
Rwanda	-5 623	Mali	-33 142				
Seychelles	-24 897	Togo	-35 472				
Zimbabwe	-18 431						
Sudan	-73 197						
Uganda	-9 458						
Zambia	-15 844						

Source: WITS/SMART Simulations