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The WTO Compatibility of the Economic Partnership Agreements between the EU and the ACP Countries

The economic partnership agreements (EPAs) to be negotiated between the European Union and six different ACP regions under the Cotonou Agreement are intended to be in conformity with WTO rules, i.e. satisfy GATT Article XXIV and GATS Article V. To what extent is this realistic? What would be the effects on the ACP countries?

WTO conformity requires that barriers to trade be dismantled on both sides, introducing an element of reciprocity into trade relations between the EU and the ACP states for the first time. There is concern that extensive opening of the markets in these countries to the EU could create strong adjustment pressures, while European suppliers would presumably be only marginally affected by free market access for ACP products.

The WTO provides a range of mechanisms for dealing with possible asymmetries in trade liberalisation in the form of Special and Differential Treatment (SDT) for developing countries and specific groups of developing countries. In addition to these country-related exceptions to the most-favoured-nation principle, there are also functional exceptions, prominent among them the regional exception for free trade areas and customs unions for goods (GATT Article XXIV), and integration agreements for trade in services (GATS Article V). However, a link between the two categories of exceptions, introducing a development dimension into the regional exception, is only explicit in the service sector, and not for trade in goods. The question arises whether a similar link should be established in the goods sector. In other words, should special and differential treatment, concerning the breadth and depth of trade liberalisation between developing and developed countries, as well as its timing, be explicitly incorporated into Article XXIV, in order to enhance the development impact of North-South agreements such as the ACP-EU EPAs and ensure their compatibility with the multilateral trading system?¹

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Adjustment Costs

The first issue to be addressed in this context concerns the adjustment costs of trade liberalisation. A point requiring particular consideration here is the conditions which must be present in the developing countries and the economic policy measures which must be taken to deal with the adjustment problems.

The impact of trade liberalisation has been the subject of numerous theoretical and empirical studies. The simple basic models of trade theory largely emphasise the benefits to be expected from trade liberalisation, while largely neglecting the fact that opening domestic markets also involves adjustment costs. For example, the gains from specialisation in traditional trade theory are based on the assumption that factors of production displaced from import-competing industries can be readily employed in other domestic industries. In fact, however, it is more likely that most factors of production have limited mobility. If such imperfections are present in the domestic factor markets, trade liberalisation can easily reduce the total welfare of a nation. This suggests the need for complementary measures aimed at enhancing the mobility of factors of production and the flexibility of factor prices. However, it must be remembered that such measures also involve costs.

The endogenous growth models show that free trade does not necessarily support developing countries in their bid to catch up economically if there are product market imperfections in the form of increasing returns to scale.² It is, for example, possible that trade liberalisation drives developing countries to special-

¹ In this context, it is held that the European Union must truly treat EPAs as instruments of development, subordinating its commercial interests to Africa's development needs and effectively coordinating trade and development assistance, in order to realise their potential development benefits. Cf. Lawrence E. Hinkle, Richard S. Newfarmer: Risks and Rewards of Regional Trading Arrangements in Africa: Economic Partnership Agreements between the European Union and Sub-Saharan Africa, Washington DC 2006 (mimeo).

ise in economic activities which do not contribute to higher economic growth. The danger that free trade will constrain economic growth in developing countries is particularly great where trade does not involve international diffusion of existing knowledge. It may accordingly be necessary to take economic policy measures which reduce the competitive disadvantages of developing countries in sectors with a higher growth potential.

There also exists a large empirical literature examining the impact of international trade or trade liberalisation from the point of view of developing countries. A number of *ex ante* studies deal specifically with the impact of market opening in the ACP countries under the EPAs.³ Several studies note that the agricultural sector in the ACP countries would suffer from increasing competition, but give no indication of the size of the associated adjustment costs. Other studies completely ignore the adjustment costs, justifying this by claiming that goods imported from the EU would not compete with goods manufactured in the region. However, even without quantifying the adjustment costs, most of the *ex ante* studies conclude that extensive market opening to the EU involves a high risk to many of the ACP countries simply because of the loss of customs revenue.

There are considerable differences apparent in the impact of the EPAs on trade flows and customs revenue both among the ACP regions and within the individual regions. For example, the trade effects on the Caribbean and Pacific ACP states are relatively minor. The loss of customs revenue is correspondingly small in these countries (with a few exceptions). By contrast, a sharp rise in EU imports can be expected in the African countries, accompanied in many cases by a sharp drop in customs revenue. This is primarily due to the fact that the EU is already their most important trading partner. In several studies, the amount of trade creation is remarkably small, particularly in comparison with trade diversion. Other studies, however, show the trade diverting effects as much smaller than the trade creating effects.

Empirical Studies

More information on the possible size of adjustment costs is provided by a number of *ex post* studies which look at the impact of trade liberalisation

on employment over specific periods. Particularly important here is a 1991 World Bank study covering 19 countries.⁴ The results of this study show that the developing countries do not have to fear serious adjustment problems in the form of unemployment if they open up their domestic markets. Other country studies seem to confirm the assessment that international trade causes only minor adjustment costs. However, it is also noted that the level of adjustment costs due to trade liberalisation depends on the institutional characteristics of the labour market.⁵

Various empirical studies examine the impact of openness on economic growth by using cross-country regressions. David Dollar estimates a growth equation with data for 95 developing countries between 1976 and 1985.⁶ He shows that countries in which prices of traded goods were higher or less stable grew more slowly, and concludes that developing countries could increase their economic growth through greater outward orientation. Sachs and Warner arrange individual countries into two groups, one of which has an "open" trade regime and the other of which is classified as "closed".⁷ According to their estimates, countries that were open grew faster than countries that were closed. They conclude that the opening of domestic markets is the decisive element in the economic reform process of developing countries. Frankel and Romer find that international trade (share of imports and exports in GDP) has a positive effect on per capita income.⁸

Rodriguez and Rodrik express doubt about the value of the three studies cited (and several others).⁹ In their view, the indices used by Dollar are inappropriate for measuring the openness of markets or the extent of trade liberalisation. They criticise the Sachs-Warner

² For a brief review of this literature see Robert C. Feenstra: *Advanced International Trade: Theory and Evidence*, Princeton 2004, pp. 348-358.

³ References can be found in A. Borrmann et al., op. cit., pp. 20-22. Cf. also the review article by Matthew McQueen: *The Impact Studies on the Effects of REPAs between the ACP and the EU*, ECDPM Discussion Paper 3, Maastricht 1999.

⁴ Michael Michaelly et al. (eds.): *Liberalizing Foreign Trade*, New York 1991, Basil Blackwell.

⁵ Ana Revenga: *Employment and Wage Effects of Trade Liberalization: The Case of Mexican Manufacturing*, in: *Journal of Labor Economics*, Vol. 15, No. 3, 1997, pp. 20-43; Janet Currie, Ann Harrison: *Sharing the Costs: The Impact of Trade Reform on Capital and Labor in Morocco*, in: *Journal of Labor Economics*, Vol. 15, No. 3, 1997, pp. 44-71; Alejandra Cox Edwards, Sebastian Edwards: *Trade Liberalization and Unemployment: Policy Issues and Evidence from Chile*, in: J. Borkakoti, C. Milner (eds.): *International Trade and Labour Markets*, London 1997, pp. 8-43.

⁶ David Dollar: *Outward-Oriented Developing Economies Really Do Grow More Rapidly: Evidence from 95 LDCs, 1976-1985*, in: *Economic Development and Cultural Change*, Vol. 40, No. 3, pp. 523-544.

⁷ Jeffrey D. Sachs, Andrew Warner: *Economic Reform and the Process of Global Integration*, in: *Brookings Papers on Economic Activity*, Vol. 1, pp. 1-95.

⁸ Jeffrey A. Frankel, David Romer: *Does Trade Cause Growth?*, in: *American Economic Review*, Vol. 89, No. 3, pp. 379-399.

⁹ Francisco Rodriguez, Dani Rodrik: *Trade Policy and Economic Growth: A Sceptic's Guide to the Cross-National Literature*, in: Ben Bernanke, Kenneth S. Rogoff (eds.): *NBER Macroeconomics Annual 2000*.

index because it is almost entirely determined by criteria that do not really capture trade interventions. They also argue that the study by Frankel and Romer fails to demonstrate a positive effect of trade liberalisation on income in developing countries because it is concerned with the connection between trade volumes and income and not with the effects of trade policy. For this reason, no statement is possible about the causality of trade policy and income.

More recent studies indicate that the impact of trade liberalisation must be judged in the light of the institutional framework.¹⁰ To cope with structural adjustment problems, institutions are needed which enforce property rights and ensure the rule of law (market-creating institutions), which intervene to correct market failures (market-regulating institutions), contribute to price stability, smooth economic fluctuations and prevent possible financial crises (market-stabilising institutions), and which (e.g. by establishing social safety nets) preserve and shape the economic system (market-legitimising institutions).¹¹ As it takes time to develop the necessary institutions, a trade policy is needed which takes into account the institutional quality of the developing countries.

Alternatives

Based on the theoretical and empirical results, the next question is how far the existing WTO regulations for regional agreements address the adjustment problems of the developing countries, and what alternatives are conceivable in terms of development policy and are being discussed in the Doha Round.

The WTO's regional exception covers trading arrangements between individual countries – from a single region or from different regions – as well as between regional country groupings like the EU or associations of ACP states. In the literature, such trade regimes are classified under the heading "Preferential Trade Agreements" (PTAs). In order to make sure that market opening in the bilateral and regional framework of PTAs proceeds faster and is also broader and deeper than multilateral liberalisation, the WTO specifies a number of conditions that must be fulfilled

For trade in goods, the conditions of the regional exception as stipulated in Article XXIV GATT – basically the "elimination" of trade barriers for "substantially all

the trade" within "a reasonable length of time" – apply in principle to all parties to a PTA. Preferential treatment for developing countries is, accordingly, solely a matter for the discretion of the partner countries. The "Understanding on the Interpretation of Article XXIV", reached in the Uruguay Round, has not fundamentally changed this situation. The Understanding merely sets the "reasonable length of time" for completing a full customs union or free trade area at ten years, and creates the possibility of exceeding this standard in "exceptional cases". However, it does not specify these cases in any more detail.

For services, by contrast, a specific distinction is made based on the state of development of the partner countries. GATS Article V requires "flexibility" in the application of the conditions in economic integration agreements "in accordance with the level of development of the countries concerned". Flexibility is required with regard to the breadth of liberalisation ("substantial sectoral coverage") and in particular the depth ("absence or elimination of substantially all discrimination") and speed ("reasonable time frame") of liberalisation.

The pros and cons of exempting developing countries from disciplines imposed by the system of multilateral trade between the partners in the North-South PTAs have long been a matter of debate. In the process, there has been a clear shift of emphasis from excluding to "accommodating" these agreements. Whereas GATT Article XXIV was to be reformed in the 1960s and 1970s with the aim of excluding "incomplete" (i.e. not sufficiently reciprocal) PTAs from its scope, exactly the opposite is currently being called for.¹² For North-South agreements, the requirements of the regional exception are to be relaxed, with further differentiation depending on the level of development of the partner countries. The aim of this is to make it possible to structure a liberalisation process in, for example, the ACP states which is adapted to the capability and development policy priorities of the countries and at the same time meets WTO requirements.

The practice of review of PTAs by GATT Working Parties and the WTO Committee on Regional Trade Agreements (CRTA)¹³ reveals a high degree of uncertainty. While GATT Working Parties concluded in only

¹⁰ Confer, for instance, Dani Rodrik, Arvind Subramanian, Francesco Trebbi: Institutions Rule: The Primacy of Institutions over Geography and Integration in Economic Development, in: *Journal of Economic Growth*, Vol. 9, No. 2, 2004, pp. 131-165; as well as David Dollar, Aart Kraay: Institutions, Trade, and Growth, in: *Journal of Monetary Economics*, Vol. 50, 2003, pp. 133-162.

¹¹ Cf. Hans-Rimbert Hemmer, Andreas Lorenz: *Grundlagen der Wachstumsempirie*, Munich 2004, p. 220.

¹² For the different positions, cf. F. A. Haight: Customs Unions and Free Trade Areas under GATT: A Reappraisal, in: *Journal of World Trade Law*, Vol. 6, No. 4, 1972; and Bonapas Onguglo, Taisuke Ito: In Defence of the ACP Submission on Special and Differential Treatment in GATT Article XXIV, ECDPM Discussion Paper No. 67, October 2005, European Center for Development Policy Management, Maastricht.

¹³ The CRTA was set up in 1996 as a permanent body to replace the ad hoc Working Parties.

6 out of 69 cases that the requirements of Article XXIV were met, with no decision reached in the remaining cases.¹⁴ The CRTA procedure has so far not led to any final report, either positive or negative. It is remarkable that not even RTAs with exceptionally long implementation periods for one partner of 15 (Canada-Costa Rica), 16 (Korea-Chile), 18 (Canada-Chile; USA-Australia) or 20 years (New Zealand-Thailand; Australia-Thailand) have been rejected.¹⁵ A key reason for this failure to finally assess the compatibility of RTAs is the lack of political interest: WTO members do not want to spoil a "business" from which all hope to profit. Another reason is the vagueness of the existing regulation: central criteria such as "substantially all the trade" or "substantial sectoral coverage" are defined differently by WTO members. There is also uncertainty about the permissibility and scope of infant industry protection to ease structural adjustment pressures.

The regional exception is under consideration in the Doha Round. The Doha Declaration's mandate to the Rules Negotiating Group was to clarify and improve the disciplines and procedures applying to PTAs within the WTO. In addition, the special adjustment problems facing developing countries from forced market opening in this context need to be taken into account.

Several WTO members have submitted reform proposals from the development policy point of view, including the EU and ACP states. The ACP proposal of April 2004 relates directly to the economic partnership agreements and seeks to grant Special and Differential Treatment for developing countries "formally and explicitly" in North-South agreements. With regard to the breadth of liberalisation, they should be allowed to set lower limits than their partner countries; with regard to the depth of liberalisation they should be granted extensive freedom of action in using safeguard measures; and in terms of the speed of liberalisation there should be an upper limit of "not less than 18 years".¹⁶

EU Proposals

The EU has put forward two proposals. In its first proposal, of July 2002, the EU emphasises the need to seek a high level of reciprocal market opening. At the same time, the needs of the ACP countries should be met in line with the provisions of the Cotonou Agreement (Article 37:7) by being "as flexible as possible" on the duration of the transitional period, the final

product coverage at the end of the transitional period and the degree of asymmetry in tariff dismantlement.¹⁷ However, there is no provision for formally specifying this flexibility. Yet in its second proposal, of May 2005, the EU moves closer to the position of the ACP states, no longer ruling out "separate and differentiated, i.e. lower, thresholds (concerning the breadth and depth of liberalisation) for developing countries and least developed countries." As to the duration of the transition period, the right to depart from the general rule of ten years maximum should be reserved for developing countries and especially least-developed countries.¹⁸

Since the second EU proposal, two further proposals with an emphasis on the development dimension of PTAs have been submitted in the Doha Round: Australia, in a submission also dating from May 2005,¹⁹ very generally "reaffirms its willingness to consider S&D-specific provisions in enhanced disciplines for RTAs (Regional Trade Agreements)". China, in July 2005, submitted a proposal that calls for SDT to be granted to developing countries in North-South trade agreements "so that they will be subject to a lower threshold and receive other less-than-full-reciprocity treatment on the substantive requirement of RTA disciplines".²⁰ This comes close to the ACP proposal mentioned above. Concerning the transitional period, China proposes that only developing countries should take advantage of "exceptional circumstances" and thus be allowed to exceed the ten years' limit stipulated in the Understanding.

In development policy terms, harmonisation of the regional exception for trade in goods and the service sector would be an appropriate approach to reform. The flexibilisation (and asymmetrical formulation) of the central liberalisation criteria (breadth, depth, duration) contained in GATS Article V for the benefit of less developed countries could be extended to GATT Article XXIV. In this context, the right to exceed time-limits could become an exclusive privilege of developing countries. Flexibilisation could also explicitly involve measures for infant industry protection.

Outlook

However, there is little likelihood that any substantial reform of the regional exception will emerge from the Doha Round. It is more probable that the regulations will be redefined on a case-by-case basis in the course of settling disputes. Among WTO members there is a clear preference for ambiguity.²¹

¹⁴ Cf. WTO: *Regionalism and the World Trading System*, Geneva 1995, p. 16.

¹⁵ For a detailed analysis of product coverage and transitory periods of recent RTAs cf. Robert Scollay, Roman Grynbern: "Substantially all Trade": Which definitions are fulfilled in practice? An empirical investigation, 2005, at: <http://www.thecommonwealth.org>.

¹⁶ Cf. WTO document WT/GC/W/155 of 28.04.04.

¹⁷ Cf. WTO document WT/GC/W/14 of 09.07.02.

¹⁸ Cf. WTO document TN/RL/W/179 of 12.5.2005.

¹⁹ Cf. WTO document TN/RL/W/180 of 13.5.2005.

²⁰ Cf. WTO document TN/RL/W/185 of 22.7.2005.

Advances are most likely in the form of increased transparency. One innovation, currently on a voluntary and experimental basis, is the reporting by the WTO Secretariat on PTAs following notification. This practice could evolve into a regular trade policy review mechanism for members of preferential trade areas, on the lines of the established trade policy reviews for individual countries, and also yield evidence on the development impact of special and differential treatment as factually applied in North-South PTAs.

Finally, there is the question if and how considerations from the current reform debate will flow into the current EPA negotiations and ACP and EU countries will meet their obligation to make the EPAs compatible with the multilateral regulations.

Under the Cotonou Agreement (Article 37:7 and 35:3). EPAs must be formulated to take into account the level of development, the socio-economic impact of the planned trade liberalisation and the adjustment capacity of the ACP countries. The breadth, depth and speed of liberalisation should accordingly satisfy the principles of special and differential treatment and asymmetry.

As far as the specific formulation of the constitutive features of the EPAs is concerned, there are still diverging ideas in the negotiations, which have been proceeding since February 2002.²² The ACP countries introduced a transitional period of at least 18 years, which is also meant to be incorporated in the WTO rules. They are also arguing for a five-year moratorium to exempt them from liberalisation measures during the initial period of the EPAs. Finally, they proposed a review process intended to ensure that the transitional phase does not end before the economies of the participating ACP countries have reached a specific level of development (benchmarking).

The EU rejects extremely long transitional periods for the EPAs, which would otherwise degenerate into nonreciprocal free trade agreements and would in fact be incompatible with the WTO. Instead, it argues for binding, tightly formulated liberalisation time

schedules which should, however, be tailored to the specific needs of the LDCs in particular, i.e. possibly exceeding the ten-year standard. Modification of the liberalisation plans in the transitional phase would be possible in the EU's view.

The breadth of the range of products to be liberalised under the EPAs is also still unsettled. The EU has proposed an average figure of 90%, but has accepted asymmetry. It would allow the ACP countries a lower degree of liberalisation while requiring the EU to accept a higher degree. The EU is conceding a longer transitional period explicitly for all the sectors which are sensitive for ACP countries. This also applies to subsidised EU agricultural exports.

While the ACP countries do not see any obligation under the Cotonou Agreement to liberalise trade in services within the EPAs, the EU sees this as a question of when – rather than if – liberalisation must begin. There is, however, apparently agreement that attention needs to be paid to asymmetry and SDT in trade in services, and that provision is needed for special safeguard mechanisms.

The EU has already announced its readiness to accept a general revision clause. For this purpose, both sides have agreed on an ongoing evaluation of adjustment processes in the ACP countries, in order to identify serious problems in a timely manner and modify the liberalisation programme if necessary.

Even after the end of the transitional period, the ACP countries should be able to monitor adjustment pressure. Safeguard clauses will accordingly be a standard part of the agreement in the EPAs.

There also seems to be agreement on the sequencing of intraregional and interregional trade liberalisation. The ACP countries wish to start by consolidating integration within their own regional groupings, as they are concerned about being overwhelmed by simultaneous liberalisation vis-à-vis the EU.

Perspectives

The Cotonou Agreement and negotiations to date between the ACP countries and the EU show that a narrow interpretation of the existing WTO rules would not be in their interest. While the ACP countries are endeavouring to secure formal amendment of the WTO rules in parallel with the EPA negotiations, the EU believes that the existing rules are flexible enough and should be retained.

As there is now little hope of clearer WTO rules, it is unlikely that the EU and ACP countries will be able – as planned – to negotiate the EPAs under reformed multilateral rules, ensuring WTO compatibility. EPAs are

²¹ Cf. Georg Koopmann: Die WTO und der Regionalismus, in: Wirtschaftsdienst, Vol. 85, No. 2, 2005, pp. 80-81.

²² For the present state of the EPA-negotiations cf. ACP: ACP-EU Negotiations of Economic Partnership Agreements, Areas of Convergence and Divergence, ACP/61/113/03 Rev.1, Brussels 28 September 2003; ACP/EC: ACP-EC EPA Negotiations, Joint Report on the all-ACP-EC phase of EPA negotiations, ACP/00/118/03 Rev.1, ACP-EC/NG/NP/43, Brussels, 2 October 2003; Peter Mandelson: The ACP-EU relationship in the global economy, speech held at the ACP-EU Ministerial Meeting in Brussels on 1 December 2004, <http://europa.eu.int/rapid/pressReleasesAction.do?reference=SPEECH/04/505&format=HTML&aged=0&language=EN&guiLanguage=fr>; Commission of the European Communities: The Trade and development Aspects of EPA Negotiations, Commission Staff Working Document, SEC(2005)1459, Brussels 9.11.2005.

accordingly likely to join the large number of regional agreements in which the WTO rules are interpreted according to the specific needs of their club members.

EU and ACP countries will have to notify the WTO of the EPAs – as usual – and justify these to the organisation. They can use such a “defence” of the EPAs to the WTO to press at the same time for an interpretation of GATT Article XXIV which is favourable to developing countries in North-South agreements on the lines of GATS Article V. EU and ACP countries have the chance to show that the constitutive framework for North-South agreements can be structured to strike a balance between the limited adjustment capacity of particularly poor and sensitive countries on the one hand and their need to adjust and the necessary pressure to adjust on the other hand.

While successful trade liberalisation requires capable institutions, these are poorly developed or virtually nonexistent, particularly in the least developed ACP countries.²³ Creating such institutions requires a stable political and economic environment together with energetic and sustained efforts in the ACP countries, compliance by the EU with its commitment to provide financial and technical assistance under the Cotonou Agreement, and substantial complementary commitments by the rest of the donor community. Given all this, trade liberalisation which promotes development is possible in the ACP countries within a reasonable period.

²³ Axel Borrmann, Matthias Busse, Silke Neuhaus: EU/ACP Economic Partnership Agreements: Impact, Options and Prerequisites, in: *INTERECONOMICS*, Vol. 40, No. 3, pp. 169-176.