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Matthew McQueen\*

## After Lomé IV: ACP-EU Trade Preferences in the 21<sup>st</sup> Century

*The ACP countries and the EU recognise that the present non-reciprocal and discriminatory Lomé preferences must be replaced with WTO compatible arrangements. This means that the agreements conform either to the free trade area provisions of Article XXIV or to the GSP. This article sets out the key elements of ACP preferences and examines the potential advantages and disadvantages for various groups of ACP countries of possible forms of free trade areas and a 'Lomé-equivalent' GSP.*

The fundamental problem of Lomé preferences for the ACP (African, Caribbean and Pacific) countries is that being non-reciprocal, they are not covered by Article XXIV of the GATT, while being available only to the ACP countries and not to all developing countries, they are discriminatory and not covered by Part IV of the GATT or the Enabling Clause of 1979. The current Convention is covered by a waiver from Article I(1) and the EU will seek to obtain a further waiver when the Lomé IV expires on 29th February 2000. A renewal of the waiver should not, in principle, be difficult to achieve. Lomé is not the only preferential trade agreement covered by a WTO waiver and Australia, Canada and the US currently have a total of 5 waivers covering arrangements with particular regional groupings of developing countries. It is also recognised that Lomé covers most of the world's poorest and most vulnerable countries, although crucially, it does not cover all of the world's poorest countries, while some of the ACP group are clearly middle income countries. Both the ACP and the EU recognise, however, that in the post-1994 orthodoxy emphasising a WTO rules-based system for international trade, a further waiver will only be acceptable to the member states of the WTO if it is clearly a transitional measure to allow sufficient time to replace the Convention with WTO consistent arrangements, although the ACP and EU differ on the time period of the transition. Also, as the bananas dispute has vividly illustrated, any WTO member state can challenge any aspect of the Convention and the disputes panel and the Disputes Settlement Board (whose decision can only be

overturned by an unlikely 'consensus to reject') will narrowly interpret the waiver to allow departures from WTO rules only for measures strictly required by the Convention, which do not raise undue difficulties for trade from other countries, and for which WTO compatible procedures are not available.

The only WTO compatible options are reciprocal ACP-EU preferences, covered by the free trade provisions of Article XXIV, or unilateral EU preferences under the GSP, although it is important to note that even these arrangements may also be subject to challenge, at any time, in the WTO.

The EU's negotiating mandate<sup>1</sup> emphasises the benefits of all ACP regions and sub-regions in Sub-Saharan Africa concluding Regional Economic Partnership Agreements (REPA)s the trade element of which would conform with Article XXIV and which would incorporate a degree of asymmetry favouring the ACP. The negotiation of agreements would take place in the period 2000-2005, with an implementation period thereafter of ten years or more. ACP countries which are not classified by the UN as least developed (LCDs) and which are for 'objective reasons' not in a position to join REPA)s may be offered Lomé-equivalent preferences in the review of the GSP in 2004 by making use of differentiation permitted by WTO rules.<sup>2</sup>

In a parallel, but separate development, the EU (following the WTO ministerial meeting in Singapore, December 1996) has extended the 'super GSP' to give all least developed countries (classified by the UN) tariff preferences equivalent to those of the Lomé Convention on all products not subject to tariff

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<sup>1</sup> 'Negotiating directions for the negotiation of a development partnership agreement with the ACP countries', Information note 10017/98, Brussels, European Union, The Council (30 June).

<sup>2</sup> 'Mandate', page 18, note 8.

quotas.<sup>3</sup> As a result, the 39 ACP-LDCs which do not conclude REPAs should be able to retain their tariff preferences for all products, except sugar, beef and bananas (which may be covered under separate Protocols), not subject to tariff quotas.

The ACP's negotiating mandate is for Lomé to be extended by a ten year WTO waiver to 2010 and for discussions on alternative trade arrangements to Lomé to begin in 2006, when there should be more information available on the revision of the GSP in 2004, the new Millennium Round of multilateral trade negotiations in the WTO, reform of the CAP and EU enlargement. There is little enthusiasm either for REPAs or the GSP option but on balance, the former is preferred, provided WTO rules on Article XXIV are relaxed to allow looser free trade areas (FTAs), in terms of product coverage and the schedule for import liberalisation.

The two negotiation mandates, however, are a compromise between substantial differences of opinion within the ACP and the EU on appropriate forms of future trade arrangements (as demonstrated, for example, by the late inclusion in the EU mandate of a possible Lomé-equivalent GSP for the non-LDC, ACP countries). The debate also takes place against a substantial erosion of ACP preferences and, partly as a result of this, a general recognition that the new arrangements need to focus more on developing the international competitiveness of ACP countries than has occurred, in practice, in previous ACP-EU agreements.

This paper seeks to clarify these complex issues by outlining the key elements of ACP preferences as the background to analysing the options of free trade agreements and a Lomé-equivalent GSP.

### Preferences for Protocol Products

ACP exports of bananas, beef, veal and sugar to the EU are governed by individual Protocols in the Lomé Convention and the 'value' of these preferences, in terms of the 'tariff revenue forgone' by the EU in 1995 was Ecu 579.3 billion, or three-quarters of the total 'value' of ACP preferences.<sup>4</sup>

*Bananas:* EU imports of bananas from the ACP are almost wholly accounted for by France (from Cameroon and Côte d'Ivoire) and the UK (from the Caribbean, particularly the Eastern Caribbean). The

production costs of Caribbean bananas are more than twice those of 'dollar bananas' from Latin America, while shipping and handling costs are substantially greater because of the larger number of port calls needed for the Caribbean islands and the lack of modern port handling facilities. Risks of low yields and crop failure are high because of highly variable rainfall and hurricane damage. In addition, dollar bananas attract a quality price premium in the EU market because of a lower wastage rate and greater attractiveness to consumers.

Most Caribbean producers can therefore only export to the EU under high levels of protection. Protection solely through exemption from EU tariffs would require a common external tariff which would be unacceptably high for most Member States and so the EU has operated a complex system of import licenses, country specific tariff quotas and tariffs. 'Traditional ACP suppliers' and 'non-traditional ACP suppliers' were allocated separate duty free tariff quotas, with a reduced rate (Ecu 750 per tonne) of duty for above-quota imports from 'non-traditional suppliers'. Dollar bananas were allocated a tariff quota, based on their previous level of exports to the EU, subject to a duty of Ecu 75 per tonne and a further above-quota duty of Ecu 850 per tonne (equivalent to an ad valorem duty of about 200%). Import licenses for dollar bananas were divided into three groups of which the most controversial were 'B licenses' which allocated 26% of dollar imports to ACP banana importers. The purpose of this arrangement was, effectively, to cross-subsidise imports of high-cost ACP bananas from the quota rents earned on imports of dollar bananas.

This import regime was subject to a successful challenge by the US and by the Latin American producers in the WTO. The EU response in 1998 was to abolish 'B licenses' but to retain the remainder of the import regime and, in the absence of agreement with the dollar exporters, to use Article XIII(2)(a) to impose country specific tariff quotas on 'traditional operators' based on EU imports for 1994-96. A further objection was made against the EU and in 1999 the WTO again ruled against the revised import regime.

The final outcome has, to date, not been determined but it is clear that the EU will only be able to provide the Caribbean producers with a much lower level of import protection than in the past, within the framework of the Lomé waiver and compatible with Article XIII. Without this level of protection, Caribbean production will collapse with particularly serious effects on the economies of the Eastern Caribbean.

<sup>3</sup> Council Regulation (EC) No. 602/98.

<sup>4</sup> C. Stevens, M. McQueen, J. Kenman: *After Lomé IV: A Strategy for ACP-EU Relations in the 21<sup>st</sup> Century*, London, Commonwealth Secretariat, December 1998, Table 2.

Theoretically, a more efficient solution would be an export subsidy provided by the EU and it might be argued that this could be permitted, because the 1994 Agreement on Agriculture excludes the prohibition on export subsidies contained in Article 3 of the 1994 Agreement on Subsidies and Countervailing Measures. The Dispute Settlement Board ruling on bananas, however, specifically states that GATT 94 must take precedence over the Agreement on Agriculture in any dispute and given the history of the bananas dispute, it seems likely that export subsidies would be subject to successful challenge in the WTO.

It has been argued that aid would be more efficient than trade protection. The total aid required to offset a collapse of banana production, however, would be very substantial and required for an indefinite period of time and is not, therefore, either reliable or probably politically feasible.<sup>5</sup>

Export diversification has been attempted over the past thirty years with little success and diversification into other agricultural products depends on the crucial transport link provided by the banana ships. Indeed, it is important to appreciate that banana production and export diversification are complementary activities, not substitutes.

When Lomé (and the WTO waiver) cease, preferences for ACP banana exporters will also cease. The options are then either to seek a special waiver for the EU's import regime for bananas, or to devise a scheme under the GSP which would be acceptable in the WTO, or to incorporate the banana import regime into a new WTO Agreement on Agriculture. All of these options are subject to considerable uncertainty and possible challenge, but the latter option may be the most feasible and could be given added security if it were part of a Caribbean-EU free trade agreement compatible with Article XXIV. Under such an arrangement the EU could extend its domestic banana policy for the Canary Islands, Madeira, Crete, Guadeloupe and Martinique, to the Caribbean producers. This could combine a support system of deficiency payments with adjustment assistance both to phase out very-high-cost producers and to increase the productivity and quality of output of the remaining producers.

**Beef and veal:** Six ACP countries receive tariff quotas providing zero duties on the ad valorem element and a 92% abatement to the specific component of

the EU's customs duties (currently Ecu 2,400 per tonne). In total, this provides a significant tariff concession which has, in the past, been worth Ecu 60 million in increased export earnings. The ACP, however, have had difficulty filling the tariff quota and the utilisation rate has fallen from around 80% in 1995 to under 50% in 1997, with only Zimbabwe filling a substantial proportion of its tariff quota (17.5% of the total). As in the case of bananas, these quotas are part of the Lomé Convention and would cease unless replaced by an alternative arrangement such as a REPA. In addition, the direction of reform of the CAP is to lower border protection and shift the burden of agricultural support from EU consumers (through high prices) to taxpayers (through direct aid to farmers). As part of this process, the Commission has proposed a 30% reduction in the current market support price of beef (Ecu 2,780/t to Ecu 1,950/t) in three tranches up to 2002. EU support prices are currently 50% above market prices and a decline in beef prices towards market levels will not only reduce ACP export earnings but threaten ACP exports with competition from high quality beef from Latin America. A further competitive threat could come from trade concessions granted by the EU as a result of current discussions with the Mercosur countries.

**Sugar:** The EU, in a Protocol independent of the Lomé Convention, undertakes to import for an 'indefinite period' of time, 1,294,700 tonnes of sugar cane (white sugar equivalent) allocated between thirteen ACP countries, at guaranteed prices (related to CAP support prices). If the Lomé Convention ceases to exist then the EU is committed to adopting 'appropriate institutional provisions to ensure the continued application of the Protocol'. This is, by far, the most valuable preference obtained by the ACP in terms of providing almost two-thirds of the 'tariff revenue forgone' by the EU. Prices received by the ACP sugar exporters have been twice to three times the world price since the early 1980s and have been a particularly important source of export earnings for countries such as Fiji, Guyana, Jamaica, Mauritius and Swaziland.

Further security of access also arises from the current access tariff quota commitments by the EU in the Marrakesh Agreements and included in the Agreement on Agriculture, which lists 'ACP 1,297,200 tonnes in accordance with the provisions of the Lomé Convention'. It is sometimes argued that the reference to the Convention means that if Lomé ceases then so too will the EU's obligations, but this is probably incorrect and the reference to Lomé should be interpreted as referring to the arrangements for the

<sup>5</sup> For a survey of the controversy see D. Hallam, M. Peston: The Political Economy of Europe's Banana Trade, University of Reading, Department of Agriculture and Food Economics, Occasional Paper No. 5, January 1997.

distribution of the overall tariff quota (the current access commitment) between the beneficiary ACP states.

A potentially more serious threat to the Sugar Protocol is a successful challenge in the WTO. The first possibility arises from the challenge to the legality of country-specific tariff quotas arising from the decision of the Disputes Settlement Board on the bananas case, which concluded that the EU's inclusion of allocations (of country specific tariff quotas) was inconsistent with the requirements of Article XIII. Article XIII reflects the MFN clause and specifies that tariff quotas should, as closely as possible, represent 'the shares which the various contracting parties might be expected to obtain in the absence of such restriction' (XIII.2). Since most of the ACP are relatively high-cost producers, whose current market shares are therefore higher than would prevail in 'the absence of such restrictions', it follows that the country specific tariff quotas of the Sugar Protocol are potentially subject to challenge as violating Articles I and XIII. The only (temporary) security from such a challenge would be through a WTO waiver from the provisions of Articles I and XIII and, given the bananas case, this may be difficult to obtain, or only possible if the EU were to make substantial trade concessions in the WTO.

In addition to uncertainty over quotas, the value of ACP preferences may be reduced. First, the EU has excluded from its Uruguay Round declaration on subsidised sugar exports an amount equivalent to imports of ACP sugar. This seems difficult to justify and if successfully challenged in the WTO then the EU might seek to offset the additional costs of adjustment to EU producers (through reductions in exports of subsidised sugar) by decreasing imports from the ACP countries. Second, the EU has entered into discussions on reciprocal trade preferences with the Mercosur countries and, if successful, this may lead to imports of cane sugar from Brazil, competing with ACP supplies. Third, although Agenda 2000 (the EU's plan to prepare for the next round of multilateral trade negotiations on agriculture and for eastward enlargement of the EU) does not cover sugar, the general thrust of CAP reform policy is clear, namely to limit the supply of products where excess production is currently exported (using subsidies) and to reduce CAP prices towards world prices. Both of these CAP reforms will, in the long run, substantially erode ACP sugar preferences.

Greater security for sugar preferences could possibly be obtained through incorporation in a free trade

### ACP Regional Groups

**CARICOM** (Caribbean Community): Antigua and Barbuda, Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, St. Kitts & Nevis, St. Lucia, St. Vincent & Grenadines, Suriname, Trinidad & Tobago. (The Bahamas are members of the Community, but not the common market. The Dominican Republic is negotiating an FTA with CARICOM.)

**EAC** (East African Cooperation): Kenya, Tanzania, Uganda.

**Pacific** (no regional organisation): Papua New Guinea, Fiji, Kiribati, Samoa, Solomon Islands, Tonga, Tuvalu, Vanuatu.

**SADC** (Southern African Development Community): Angola, Botswana, DR Congo, Lesotho, Malawi, Mauritius, Mozambique, Namibia, Seychelles, South Africa, Swaziland, Tanzania, Zambia, Zimbabwe.

**UDEAC-CEMAC** (Union Douanière et Economique de l'Afrique Centrale – Communauté Economique et Monétaire de l'Afrique Centrale): Cameroon, Central African Republic, Congo, Gabon, Chad, Equatorial Guinea.

**UEMOA** (Union Economique et Monétaire Ouest Africaine): Burkina Faso, Mali, Niger, Côte d'Ivoire, Senegal, Guinea-Bissau, Togo.

Not in regions above: Burundi, Cape Verde, Comoros, Djibouti, Eritrea, Ethiopia, Gambia, Ghana, Guinea, Liberia, Madagascar, Mauritania, Nigeria, Rwanda, Sao Tome & Principe, Sierra Leone, Somalia, Sudan.

agreement with the EU. This may be particularly useful to Fiji and the Caribbean countries, though it poses more complex issues for Mauritius and the sub-Saharan African countries. In the long term, these countries need to reduce their dependence on sugar exports to the extent to which these have been stimulated by the false comparative advantage created by EU preferences. One means of stimulating this process would be to transfer the administration of the country specific tariff quotas from the EU to the ACP countries. If the governments of these countries then auctioned the sugar export licenses, the quota rents from the preferences would accrue to the ACP governments (rather than, as at present, EU traders) and could be used to further agricultural restructuring and export diversification.

### Preferences for Agriculture, Fisheries and Industrial Products

All industrial products originating in the ACP countries currently enter the EU free of duties and 'measures having an equivalent effect'. In 1997, ACP countries exported Ecu 7.4 billion of manufactured goods to the EU, representing about a third of their

total exports. However, 80% of these goods obtained a margin of tariff preference of less than 5%. Only footwear (Ecu 36 million) and textiles and clothing (Ecu 1481 million) obtained tariff preferences over GSP rates of 5.5%, 7.8% and 11.2% respectively. In addition, the ACP countries have been exempt from the quantitative restrictions of the Multi-Fibre Arrangement (MFA) and this has probably been a crucial factor in the rapid development of clothing exports since the early 1980s by the major ACP exporters.<sup>6</sup> The MFA quotas, however, are scheduled to be phased out by 2005, leaving a margin of preference of around 10%. This is unlikely to be sufficient to protect some of the relatively high-cost ACP producers against competition from Asia, although the larger manufacturers in countries such as Mauritius (the main ACP exporter) have either adjusted or are in the process of adjusting to this loss of preference and have moved up-market into less price-sensitive sectors of the market and re-located the less skilled activities into lower-cost countries such as Madagascar.

ACP exported Ecu 6.6 billion of non-protocol agricultural and fisheries products to the EU in 1997 and although most of these products were not subject to any MFN duties, more than one-third offered a margin of preference over the GSP greater than 5%, with just under one-fifth obtaining a preferential margin greater than 10%. Of particular significance are preferences for processed meat and fish (preferential margin over the GSP in 2000 of 23.5%); tobacco (12.9%); fish, crustaceans and molluscs (6.8%); processed fruit and vegetables (14.6%); fresh vegetables (8.6%) and cut flowers (9.6%).

Despite these substantial margins and preferences, only eight ACP countries have achieved export growth rates over the past ten years of around 10% or more in these products: Mauritius, Jamaica and Madagascar in the clothing sector; Kenya and Zimbabwe for fruit and vegetables and cut flowers; and Côte d'Ivoire, Namibia and Senegal for fish. This demonstrates that preferences can only be one factor determining the supply price of a product and that price is only one factor determining export demand.

### Regional Economic Partnership Agreements

In order to retain these preferences the EU wishes to replace Lomé with regional and sub-regional free trade agreements, called Regional Economic Partnership Agreements (REPAs), the content of which would be acceptable to the member countries of the WTO under Article XXIV, as well as consistent with the CAP.

The EU recognises that both the level of economic development and the non-EU trade interests of the member states of the ACP differ widely and so emphasises that the content and timing of the agreements need to be as flexible as possible.

With regard to the content of the agreements, the Commission appears to envisage a permanent degree of asymmetry in the liberalisation of trade. Article XXIV refers to 'duties and other restrictive regulations of commerce (being) eliminated on substantially all the trade between the constituent territories'. GATT/WTO working parties have never been able to agree on the precise meaning of this phrase and the 1994 'Understanding on the Interpretation of Article XXIV' only states that the contribution of such agreements to the expansion of world trade is 'diminished if any major sector of trade is excluded'. While recognising that the interpretation of this is controversial the Commission considers that a REPA covering 90% of all trade would probably be acceptable in the WTO. If the beef and sugar protocols were included in the agreements, so that all existing preferential imports from the ACP were covered, then 97% to 100% of ACP exports to the EU would be covered by a REPA, in which case it would appear that the ACP sub-regional groups would only have to free trade on around 80% of their imports from the EU (and around half of imports in the case of the Pacific) and this would minimise the problems of adjusting to an FTA.

The country composition of the sub-regional groups is a matter for the ACP to decide but studies recently carried out for the Commission<sup>7</sup> have emphasised both the limited institutional capacity to negotiate REPAs of most existing sub-regional groups (with the exceptions, perhaps, of CARICOM and EAC) and the necessity of the timetable for the introduction of REPAs being coordinated with the regional liberalisation of trade. The latter is most notably the case for the Caribbean countries, which simply wish to guarantee preferential access to the EU market for existing levels of traditional exports and where the future growth of exports is envisaged as being generated from free trade agreements with North and South America, for example through the FTAAs. Equally, concluding a REPA without also offering equal access to those countries would, almost certainly, lead to retaliation and exclusion from existing

<sup>6</sup> M. McQueen: ACP Export Diversification: The case of Mauritius, Overseas Development Institute Working Paper 41, London 1990.

<sup>7</sup> For a summary see M. McQueen: The impact studies on the effects of REPAs between the ACP and the EU, ECDPM Discussion Paper No. 3, Maastricht, March 1999.

and future preferential access to those markets. The Pacific ACP countries face a similar situation with respect to the eight other member countries of the South Pacific Forum, notably Australia and New Zealand. These considerations imply that the EU's timetable of concluding REPAs by 2005 with all ACP countries which wish to do so, is just about conceivable for some of the South and East African countries (such as SACU, Zimbabwe, Mauritius, Kenya, Uganda and Tanzania), possibly for UEMOA (although this will depend on the progress of regional integration in West Africa) and most unlikely for the Central African countries. REPAs with the Caribbean and Pacific countries will crucially depend on wider hemispheric FTAs.

The combination of the abolition of duties on existing imports from the EU and the increase in imports from the EU as a result of trade diversion, will lead to a decrease in revenues from import duties. The EU accounts, on average, for one-third to one-half of sub-Saharan African imports (with a higher proportion in the CEMAC countries) and where this is combined with high tariffs and other duties and charges on imports and a high dependence of government revenues on these duties, then the decrease in government revenues from a REPA could be substantial and was estimated in the 'impact studies' as ranging from 10%, through 15% to 30% (Seychelles).

In view of these factors the Commission envisages a flexible process in terms of the membership of REPAs, the length of the transitional process and the timetable for eliminating barriers to trade. At least for some ACP countries, REPAs may not be introduced until after 2005, the transition to free trade would probably extend beyond the ten years in the 'Understanding' in Article XXIV, could be 'end-weighted' so that higher tariff lines were liberalised towards the end of the transition period, and, as previously discussed, need only cover around 80% of imports from the EU.

### Difficulties with REPAs

The difficulty with this approach is that it rests on a number of questionable assumptions. First, WTO waivers would be required both to extend Lomé beyond 2005 and to depart from the 10 year 'Understanding' on the interpretation of paragraph 5(c) of Article XXIV. Given the shift in global orthodoxy towards strengthening WTO disciplines, such waivers will probably be contested and may be difficult to obtain and subject to substantial modification. Second, as the Commission acknowledges, there is

increasing support in the WTO Committee on Regional Trade Agreements for the view that 'substantially all trade' should be measured at the tariff line and not simply on total trade. This would probably imply that the ACP could not exclude major sectors of the economy protected by high tariffs and would have to liberalise more than 80% of trade.

Even if these obstacles could be overcome, there remains the question of whether the gains to the ACP are likely to offset the costs of REPAs.

The trade creation and trade diversion effects are likely to be small or zero for the Caribbean and Pacific countries, where the EU accounts for a small proportion of imports and where, in any case, a REPA will probably depend on hemispheric trade liberalisation. The gains to these countries are in terms of continued preferential access to the EU market for traditional products.

The static effects of a REPA could be more substantial in sub-Saharan Africa where the EU accounts for anything between one-third and three-quarters of imports. Given the wide differences in the structures of production and income levels between these countries and the EU, customs union theory would predict that the beneficial trade creation effects would be relatively small and outweighed by detrimental trade diversion effects. In practice, those effects are difficult to quantify and subject to a large degree of uncertainty. Not only are the values of the relevant elasticities unknown but the reaction of domestic prices to a removal of tariffs against imports from the EU is uncertain. Most ACP markets are very small and characterised by a host of non-tariff barriers such as high transport costs, differences in language, strong links with ex-colonial EU countries and high levels of market concentration, all leading to a limited contestability of markets. As a result, the removal of tariffs in a REPA may largely lead to increased profits for traders at the expense of government revenues, with little or no beneficial trade creation effects.

The static effects of a REPA, although important, have only a 'once-and-for-all' effect on the level of income and the recent literature on FTAs has emphasised non-traditional gains increasing the growth of income and providing decreased uncertainty and increased credibility to the policy environment in developing countries.<sup>8</sup> In particular, 'locking

<sup>8</sup> See, for example, P. Collier, P. Guillaumont, S. Guillaumont, J. W. Gunning: The future of Lomé: Europe's role in African growth, in: *The World Economy*, 20, 3 (1997), pp. 285-305.

in' the trade liberalisation of a REPA could lend credibility to trade and trade-related reforms since policy reversal in the future would require a country to leave both the REPA and the sub-regional preferential trade group. The enhanced credibility of policy reforms could be expected to increase long-term domestic and foreign investment and increase the transfer of knowledge and technology, all of which help provide the foundations for increasing the growth of output and employment and decreasing poverty. The Commission also emphasises that the 'partnership agreements' are not simply trade agreements but will cover a wide range of measures to increase the efficiency and enhance the supply side, particularly the private sectors, of these economies.

One response to this argument is that if the ACP countries wish to give credibility to these trade policy reforms then why not bind them in the WTO. As argued by Fernandez and Portes, however, the WTO agreements cover less trade-related policy instruments than FTAs, while there are fewer incentives to punish a deviating member of the WTO than in an FTA.<sup>9</sup> The WTO suffers from diffuse responsibility for challenging policy reversal by a member state and the costs to the latter, in terms of WTO compatible retaliation, may be minor. In an FTA, it is clear who is hurt and has the responsibility to retaliate to maintain credibility and reputation, while the costs to the country breaking the agreement, in terms of denial of preferential access, are probably significant. Also, a number of sub-Saharan African countries have failed to use the WTO to provide credibility for trade reforms and have declared tariff bindings well in excess of applied tariff rates.

There are, however, a number of difficulties with these arguments. First, a REPA only 'locks in' trade with the EU, not total trade and, as occurred during the recent financial crisis in Mexico, there is nothing to prevent tariffs being raised against non-FTA countries, within loose WTO bindings. Second, the credibility of the 'lock in' depends on the willingness of the EU to retaliate against a particular ACP country that broke the terms of the agreement. Since this would probably occur during a crisis for the country concerned, it must be questioned whether there would be sufficient willingness for the EU to take such an important political decision and whether the sanctions imposed would be a real deterrent, especially since they may,

in the short term, make the crisis even worse. In practice, there are likely to be safeguard clauses in the agreement which allow departures from the implementation of free trade and the implementation of these derogations is essentially a political decision whose rigour of enforcement in the future is not predictable. Third, the EU has indicated a willingness to accept a substantial degree of asymmetry of import liberalisation which would mean that the most protected, final goods sectors of the ACP countries could remain protected. Indeed, as tariffs and other barriers to trade fall in the less protected sectors such as in investment goods and intermediate products, so the levels of effective protection of 'sensitive' final goods production can be expected to rise, contrary to the objectives of structural adjustment policies. Fourth, while the efficiency of the non-trade, supply side elements of the partnership agreements might be improved by linking them with the formation of a free trade area, they could also be implemented independently of an FTA, with efficiency being improved through conditionality. Fifth, a REPA would increase the dependence of the sub-Saharan African countries on the EU market, whereas a more rapid and stable growth of exports may well require diversification to non-EU markets.

The non-traditional gains for the sub-Saharan African ACP countries from a REPA would therefore seem problematic and not necessarily superior to the benefits from binding tariff rates in the WTO at applied rates.

### The Generalised System of Preferences

The only WTO compatible alternative to a Lomé waiver and a REPA is the GSP. The least developed ACP countries (LDC-ACP) now benefit from a Lomé-equivalent GSP offered to all LDCs, the 'super GSP'. This is, however, not entirely 'Lomé-equivalent'. It does not cover Protocol products or agricultural products subject to tariff quotas in 'Lomé'; rules of origin, cumulation provisions and tolerance thresholds are all significantly inferior to Lomé, while the GSP safeguard clause is more restrictive than Lomé. Also, the GSP is a unilateral offer by the EU, not a negotiated agreement and can be (and has been) subject to substantial changes in its access terms and this may create uncertainty for traders and investors who may then regard GSP treatment as a windfall gain rather than as an incentive to trade and invest. There is also some uncertainty over the EU's treatment of LDC-ACPs after 2005. LDC not part of any regional arrangement entering into a REPA are guaranteed the 'super-GSP'. This seems to imply that

<sup>9</sup> R. Fernandez, J. Portes: Returns to regionalism: An analysis of non-traditional gains from Regional Trade Agreements, in: *The World Bank Economic Review*, 12, 2 (1998), pp. 197-220.



LDC-ACPs that are part of a regional arrangement but which do not take part in a REPA may be excluded from the super-GSP. This, however, would probably violate the EU's undertakings in the WTO.

The main impact of not concluding a REPA would fall on the non-LDC-ACPs who would face a relative deterioration in the terms of access if they had to adopt the standard GSP both in terms of Lomé and in relation to more preferred countries such as the Mediterranean states. As indicated in the earlier part of this paper, this would adversely affect exporters of Protocol products (and seriously affect 12 of these countries), a range of agricultural products and clothing. A recent study by the Commission<sup>10</sup> indicated that of the 31 non-LDC-ACPs only 9 countries would be able to retain a margin of preferences 'globally equivalent' to the GSP (largely because these 9 countries have failed to take advantage of Lomé preferences). In addition, on the basis of the present 'graduation' criteria of the GSP, Mauritius would lose its preferences for clothing and Trinidad and Tobago its preferences for fertilisers.

The EU has committed itself to examining, in the review of the GSP in 2004, all alternative possibilities of producing a Lomé-equivalent GSP for the non-LDC-ACP.<sup>11</sup>

The Commission's analysis of extending a Lomé-equivalent GSP on non-Protocol products to all developing countries under the terms of the existing GSP in terms of product coverage and production, indicated that only 2% of non-LDC-ACP exports would not face increased competition from existing GSP beneficiaries. These products were mainly virginia tobacco, beans and peas, benefitting Zimbabwe and Kenya. Conversely, improving the GSP to the level of Lomé would lead to a substantial erosion of non-LDC-ACP preferences on 29% of their exports to the EU. This would mainly affect fish, vegetables, fruit, flowers, clothing and some industrial products such as aluminium oxide and ferro-chromium. ACP countries such as Namibia, Kenya, Ivory Coast, Senegal and Zimbabwe would face increased competition (on equal terms) particularly from Argentina, Brazil, Chile, Malaysia, Philippines and Indonesia. (China, Hong Kong and Thailand have been graduated out of preferences in most of these products.)

The alternatives are either to change the existing criteria for product differentiation in the GSP in such a way that the new criteria largely favour the non-LDC-ACP, or to change the Enabling Clause of 1979, providing the legal base for the GSP, in such a way as to allow differentiation between non-LDCs. Following the WTO initiative to provide a super-GSP for the LDCs, this new differentiation could also not be time-bound, while security of preferences for LDCs and a new group of more preferred developing countries could be provided by binding the offer in the WTO.

Two possibilities for differentiation currently under discussion are the construction of an index of 'vulnerability' and preferential quotas based on a small share of world trade. The problem with the former is that it appears to be very difficult to construct an index which is transparent and easily understood and conforms to generally acceptable developmental criteria (such as output volatility caused by exposure to the world economy, remoteness and exposure to environmental hazards). The difficulty with the latter is that it is difficult to envisage a share of world trade in goods and services which might be generally acceptable and which would benefit the non-LDC-ACP. The Commission, for example in its recent study, conducted such an exercise using the criterion of a 0.03% share of world trade (a criterion used by the WTO Finance Committee). Given, however, that the current preferences on Protocol products could not be included in the GSP and that some of the ACP countries would already obtain Lomé-equivalent treatment under the current GSP, it appears that only three countries (Seychelles, Senegal and Surinam) would benefit from such differentiation.

### A Proposal for Differentiation

What has tended to be lacking in the debate on reforming the GSP and making it 'Lomé-equivalent' is the development of a set of criteria for the provision of trade preferences based on appropriate economic principles. It is not obvious, for example, that trade preferences are an appropriate policy instrument to assist 'vulnerable' economies. Similarly, a country may have a low level of per capita income but a large size of population, such as India, and it is unclear how preferences could significantly assist economic development.

The fundamental case for providing preferences is based on the application of the infant industry and infant economy arguments to small economies.

<sup>10</sup> 'Consequences for the ACP countries of applying the GSP', European Commission DGVIII, Brussels, 20 April 1999, CE/TFN/GCEC3/29-EN.

<sup>11</sup> 'Negotiating directives for the negotiation of a development partnership agreement with the ACP countries', EU Council, Information Note 10017/98, Brussels: EU, The Council, 1998 (30 June).

Developing countries with a small size of domestic market have to grow by entering into international trade at a relatively early stage in their economic development, but because of their state of underdevelopment, they find it difficult to compete in world markets against well-established competitors. They are characterised by having infant industries which need time both to move down their long-run average cost curves to achieve a minimum efficient scale of production and to 'learn-by-doing'. Secondly, they are infant economies, which lack a network of suppliers of intermediate goods and services essential to the maintenance of a competitive and flexible structure of production in rapidly changing world markets. Thirdly, because they are small economies with simple structures of production, external shocks feed directly through the economy and the amplitude of these shocks is not diminished by the more complex set of input-output relationships found in larger economies. These disadvantages result in high costs of production and greater risks of operating in small, underdeveloped, economies and this will be reflected in a premium required on the normal rate of return on domestic and foreign investment. Trade preferences can provide this premium and so increase investment and growth in the economy, although they suffer from the disadvantage of being second best policies that could create a 'false' comparative advantage and distort the allocation of resources.

This approach to the use of trade preferences as a policy instrument for development, combined with the need for criteria to be plausible and easily understood and implemented, suggests the use of a combination of GDP, measuring the absolute size of the economy, and per capita GNP, reflecting the level of economic development, as criteria for special and differential treatment. The size distribution of both measures is essentially continuous, there is no theoretical justification for any specific threshold and choice must therefore be a matter of judgement. There are, however, essentially two types of economy. The first are economies that are small in terms of population and have a middle income level of per capita GNP. The combination of these two variables means that they have a small size of domestic market (measured by GDP) but have not reached a sufficient level of economic development (indicated by per capita GNP) to overcome this constraint by relying on world trade for sustained economic growth. A good example of such an economy is Mauritius, with one of the highest levels of per capita GNP of the ACP states but which has not yet been able to diversify its exports beyond

clothing, sugar and tourism. The second group of countries have a larger size of population but low per capita incomes. These economies have a large size of domestic market (GDP) but face similar problems to smaller economies in diversifying their exports because of a relatively low level of economic development. Examples of such countries among the ACP group would be Kenya, Senegal and Côte d'Ivoire. Finally, we need to allow for the fact that the use of per capita GNP as a simple indicator of economic development is subject to well known distortions, particularly for resource-rich commodity exporters such as Nigeria, Gabon and Botswana.

A survey of the data for 1996 suggests two criteria for a special 'super GSP' equivalent to Lomé. First, all low income countries (as defined by the World Bank), with a GDP of less than \$32 billion (this would include Nigeria but exclude the next ranked countries of Romania and Morocco who, in any case, receive special EU preferences under other arrangements). Second, developing countries with a per capita GNP of less than \$4,000 (this would include Gabon but exclude the next ranked countries of Hungary and Malaysia) and a GDP of less than \$16 billion (this would include Guatemala but exclude the next ranked developing country, Uruguay). As we have emphasised, the thresholds are inevitably arbitrary but they would appear to be a reasonable and (WTO) acceptable approximation to the economic rationale outlined above.

If we apply these two sets of criteria to the data for 1996 and exclude the least developed countries (who already obtain Lomé equivalence), developing countries with special preferences under the EU's present or future schemes (for example, the Mediterranean FTA and preferences for Central and Eastern Europe and Central Asia) and ACP countries who would already qualify for a 'globally-equivalent' GSP under the existing scheme, then we obtain the following results. First, among the ACP countries, only the Seychelles (per capita GNP of \$6,850) and St. Kitts and Nevis (per capita GNP of \$5,870) would be excluded from Lomé-equivalent preferences, and a special arrangement for imports of tuna fish would resolve this problem for the Seychelles. Second, the first criteria would extend Lomé preferences to five low income countries (Sri Lanka, Vietnam, Mongolia, Honduras and Nicaragua); under the second criteria they would be extended to four Latin American countries (El Salvador, Paraguay, Costa Rica and Panama) and three small island states (Maldives, Micronesia and the Marshall Islands), providing

greater consistency to EU preferences for developing countries and increasing the acceptability in the WTO for such differentiation:

This exercise is illustrative and would, almost certainly, need to be rigorously developed and tested to be acceptable to the member states of the EU and the WTO. It suggests, however, that the ACP and the Commission's view that an acceptable, Lomé-equivalent GSP for non-Protocol products for the non-LDC-ACP cannot be devised, is unduly pessimistic. To be fully Lomé-equivalent, the super GSP would also have to be adapted and extended to provide the full product coverage (non-Protocol products subject to tariff quotas) and rules of origin (for example, derogation procedures, cumulation and 'tolerance levels').

### Conclusions

Preferential access to the EU market is important for particular ACP products and countries but in attempting to maintain the relative level of those preferences in a form acceptable to the member states of the EU, the ACP and the WTO, the Commission has produced a complex set of solutions which could harm, rather than assist, the ACP countries.

Under the proposed arrangements, imports from the EU could enter individual ACP markets either with non-preferential duties (with the countries concerned exporting to the EU under various GSP schemes) or under a number of reciprocal preferential REPAs whose content, product coverage and timing will differ substantially. This will create new barriers to intra-regional trade between ACP countries, particularly in sub-Saharan Africa, as rules of origin will have to be tightened and vigorously enforced to avoid trade deflection. It will also enhance the 'hub and spoke' effects of the EU's myriad of preferential agreements, concentrating the gains from such agreements on the EU at the expense of the partner countries on the 'spokes'.<sup>12</sup>

By emphasising flexibility in the negotiations of REPAs, the EU raises the prospect of ACP countries only having to liberalise imports of less protected goods, over perhaps a fifteen year period, with liberalisation being weighted towards the end of this period. Such a schedule would increase effective rates of protection over the transition period, with eventual (partial) liberalisation only taking place by

2020 to 2025, possibly with exemption clauses in the agreement extending this transition period.

These effects weaken the incentives for overall trade liberalisation and are contrary to the objectives of the structural adjustment policies of those countries which are necessary for their future growth and development. It should also be recalled that the costs of these effects are additional to the trade diversion and possible monopoly enhancing effects of REPAs in sub-Saharan Africa.

It must be recognised that the EU and ACP countries have an unenviable task in negotiating post-Lomé trade arrangements, however, there is a clear need to simplify the proposals and introduce measures which reduce, rather than increase, the trade distorting effects of the proposals. Preferences also need to be used as a means of stimulating and reinforcing the process of trade policy reform which has taken place in most ACP countries in recent years.

The Caribbean and Pacific countries basically require continued preferential access for Protocol products and to be compatible with the CAP and WTO rules this will probably require WTO waivers and a REPA, but with the latter closely coordinated with regional and hemispheric trade liberalisation. Sub-Saharan Africa could be covered by a Lomé-equivalent GSP, bound in the WTO, with the offer to the non-LDC-ACP being conditional on membership of the WTO and binding tariffs in the WTO at applied rates (rather than notional rates which are often 100% or more) and thereby strengthening and providing credibility to current import liberalisation measures.

Alternatively, REPAs could be offered to all of these countries with aid and technical assistance incentives to the LDCs to induce them to relinquish their current right to a Lomé-equivalent GSP. In addition to the WTO membership and binding requirements stated above, the economic costs of a REPA to the ACP countries would be minimised by having a 'cascade' reduction in tariffs (rather than 'end-weighted' reductions) over the transitional period, with the highest tariffs reduced by more than the lower tariffs. Linking the reduction in tariffs against the EU with unilateral reductions against the rest of the world would minimise the trade diversion effects and reduce the possibility of EU enterprises exercising monopoly power in ACP markets. Minimising the differences in content and timing of the sub-regional agreements would minimise barriers to intra-regional trade and harmful 'hub and spoke' effects. In this way REPAs could strengthen, rather than weaken, the economic transformation of sub-Saharan Africa.

<sup>12</sup> For a discussion of this issue see M. McQueen: ACP-EU trade cooperation after 2000: an assessment of reciprocal trade preferences, in: *Journal of Modern African Studies*, 36,4 (1998), pp. 669-692.