

EPAs and Export Competitiveness of Africa

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Introduction

Trade has been a key driver of growth in countries that have been successful in achieving high rates of growth over the past 3 decades, such as those in East Asia. If they are to accelerate their growth, trade will have to perform the same role for ACP countries. Designing policies that promote trade and trade competitiveness must be at the heart of growth strategies for ACP countries.

Economic partnership agreements (EPAs) with the EU could be instrumental in a competitiveness framework, but to do so they have to be designed carefully. Any successful EPA will need to take into account critical features of the new global economy:

- intense new competition emanating from large developing countries such as China, India and Brazil;
- simultaneous rapid growth of these economies opening up new dynamic market opportunities;
- explosive growth of services trade, creating new opportunities in the global market and offering new avenues for diversification away from primary commodities;
- the increasing importance of domestic institutions, policies and infrastructure in affecting productivity and the ability of a country's firms to compete in international market.

In this new global context, the EPA negotiations create an opportunity to undertake domestic reforms that promote access to global markets and achieving global competitiveness. These require reforms that (i) improve the incentive framework, (ii) increase access to and lower the costs of backbone services, such as telecoms, transport, energy and finance and (iii) address weak trade supporting institutions, including standards, customs, and trade promotion agencies. "Aid for trade" associated with EPAs (and the multilateral discussions) can help build infrastructure and new institutions to

reduce costs of trading. In addition, the most effective response to a number of the barriers to global competitiveness will require actions at the regional level. EPAs can play an important role in leveraging coherent regional reforms and in putting in place mechanisms that allow for coordinated development support from EU countries.

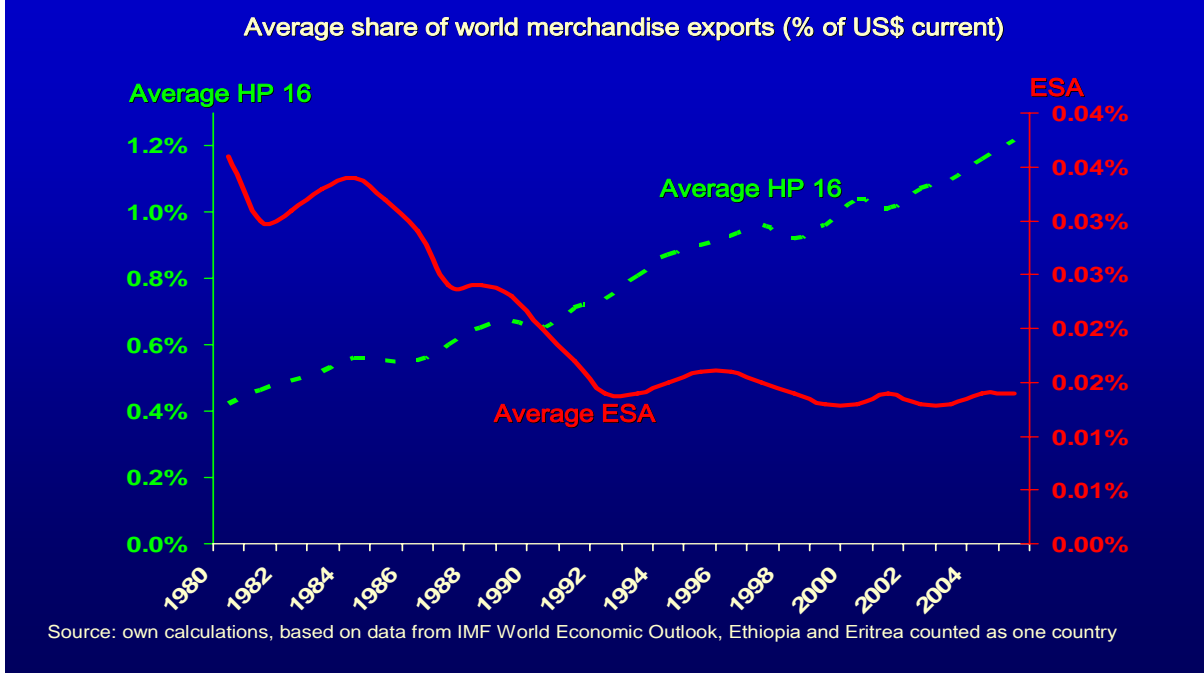
However, there are risks that EPAs may fall short of these achievements. A narrow EPA that focuses solely on trade preferences, preferential access to the EU market for ACP exporters and the opening up of ACP markets just to EU firms, will be ineffectual in driving rapid growth since they will do nothing to leverage the domestic and regional reforms that are necessary to overcome the barriers that limit integration into the global economy. Many ACP countries have seen a very weak supply response to preferences in the past and this clearly will not change unless these supply constraints are ameliorated.

The paper elaborates on these arguments. A first section highlights the trade challenge that ACP countries face and makes the point that preferences in the past have not been effective in preventing the substantial decline in world market share of African countries. A second section describes opportunities that the new wave of globalization is opening up to ACP countries. A third section briefly discusses what this means in terms of a strategy to attain global competitiveness and suggests design features of an EPA that would complement and support competitiveness reform programs.

The trade challenge facing ACP countries

The trade preferences that have been granted to the ACP countries by the European Communities under the Yaoundé, Lomé, and Cotonou Agreements for the last 30 years will expire in 2008. Negotiations for a new WTO consistent trade agreement have been taking place for the last 5 years. To limit the demands of negotiating agreements with each ACP country the EU has pursued negotiations to establish six Free Trade Areas (FTAs). To date, negotiations have advanced only slowly and there is considerable debate as to how EPAs will have to be designed and what elements and commitments they should contain. Before proceeding to these issues it is important to reflect upon the impact of current and previous EU development agreements.

Figure 1: In contrast to a number of fast growing countries, ESA countries have lost market share of the global market for merchandise



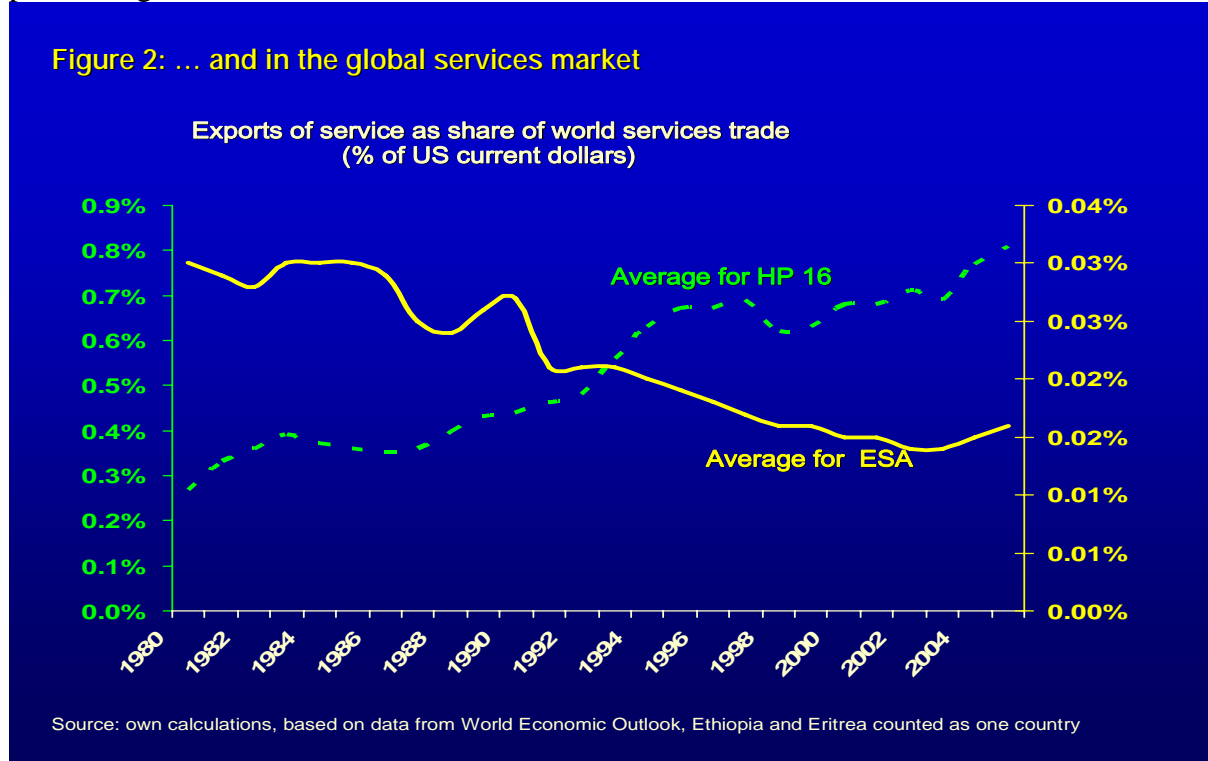
We focus our description of past trends on Eastern and Southern Africa (the ESA-region in the EPA negotiations). We suspect that the trade challenge that we highlight for ESA is the same as that facing most of the other EPA regions. Figure 1 shows the evolution of the average share of global merchandise exports of the ESA countries. This share was initially small and is now less than half of the level of 25 years ago. The figure shows that most of the decline occurred in the 1980s with a leveling off in the 1990s but little subsequent rebound. The figure compares the performance of the average ESA country with the average of a group of 16 fast growing countries¹. The contrast is stark, with a rapidly rising share of global exports (a 3-fold increase over the past 25 years) fuelling the sustained growth that these countries have enjoyed. The figure highlights the importance of trade for the fast growing countries and the enormous potential for sustained growth of exports from the ESA region.

Figure 2 shows a similar story for exports of services. The average ESA country has had a very low and declining share of the global market for services. This is in contrast to the fast growing countries, who have, on average, almost tripled their share of the world market over the past 25 years. Hence, the challenge for ESA and other ACP countries is to provide a trade policy climate in which to attain the sustained increases in exports of both

¹ This group contains non-oil exporting countries that have grown at an average annual rate of growth of 4.5 per cent of more over the past 25 years. The averages are unweighted so that country size does not influence the measure. The sixteen countries are Botswana, Sri Lanka, Chile, Indonesia, Pakistan, Mauritius, Uganda, Burkina Faso, India, Thailand, Malaysia, Taiwan, Cambodia, Singapore, Korea, Rep., and China.

goods and services and rising global market shares that have driven growth in the high performing countries.

Figure 2: ... and in the global services market



These figures also suggest a lack of effectiveness of current and previous agreements with the EU in supporting sustained growth of exports or in dealing with the constraints that have undermined the share of ESA countries in the world market. In other words, this weak performance occurred despite preferential access to the EU and other markets. Preferences alone have not helped to strongly integrate ESA into the global economy. With decreasing margins of preference due to continued multilateral liberalization, they are even less likely to help achieving this objective in the future.

There are three key reasons why preferences have not been effective in stimulating a significant export response in ACP countries.² First, preferences have not dealt with, and may have distracted attention away from, the key supply side constraints that limit access to all markets. Brenton and Hoppe (2007) find that whilst preferences for clothing have supported exports to the EU and US they have not overcome the negative impact of weak governance in Africa on the sourcing decisions of global buyers. The conclusions from a review of the range of diagnostic trade integration studies³ that have been undertaken in least developed countries concludes that the principal constraints to trade are typically those that limit access to and raise the costs of the key backbone services that are critical

² Olareaga and Ozden (2005) suggest that preferences may actually have hindered integration of poor countries into global markets, showing that those countries that received preferences tended to have liberalised their own trade policies less than those developing countries that had not received preferential access to OECD markets.

³ See Biggs (2007)

for competitiveness (transport, energy, finance, telecommunications). These problems are compounded by poorly designed structures of incentives that constrain the flow of resources into their most productive uses and weak and ineffectual trade supporting institutions, such as customs, standards, export promotion agencies, trade ministries themselves, and the often existing fragmentation of authority with regard to trade related issues between a number of ministries, coupled with a lack of coordination among the stakeholders.

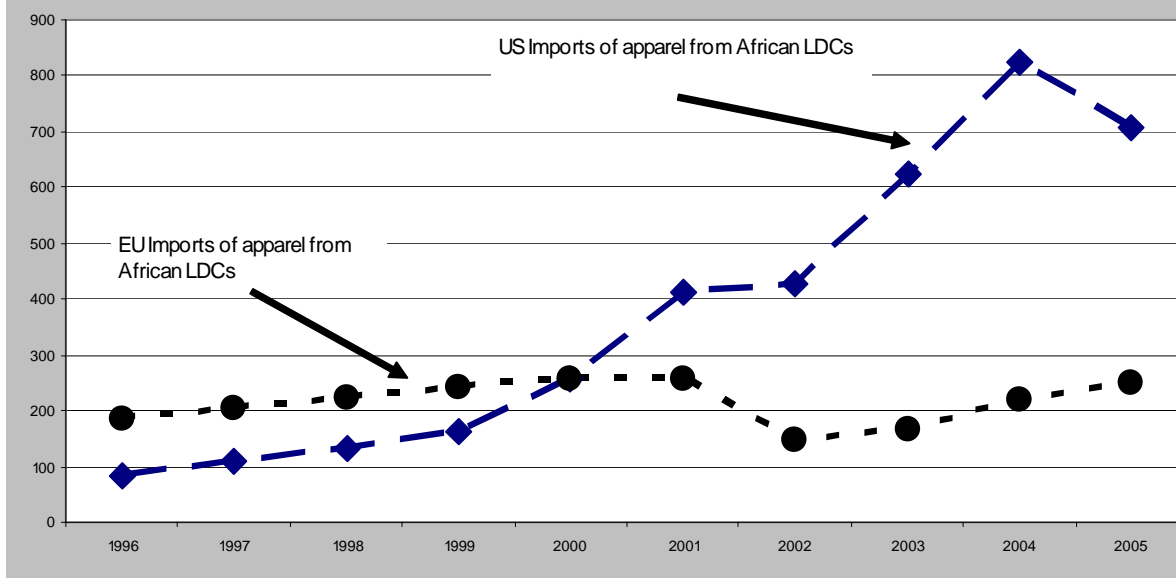
Second, and related, preferences margins for products currently exported by the ACP countries are typically small and have, and will continue, to be eroded, by multilateral trade liberalization and the EU's predilection to sign free trade agreements. It should be pointed out that 46 percent of exports from Africa to the EU are concentrated in oil (products). Of the remaining non-oil exports, 58 percent enter the EU under a zero MFN tariff rate (this percentage is similar for both LDCs and non-LDCs). The value of preferences that many in individual ACP countries perceive is often far in excess of reality. For example, looking at the 13 non-LDCs who may lose some of their preferential access to the EU if they do not sign an EPA and revert to the GSP, the value of preferences under Cotonou amounted to only 3.9 percent of their exports to the EU or EUR 782 million in 2005.⁴ The value of EU preferences for African LDCs is less at 2.1 percent of total exports.⁵ The appendix provides a more detailed discussion of the value of EU preferences under Cotonou and the GSP.

Third, for products where margins of preference have been substantial, such as clothing, market access has been severely limited by restrictive rules of origin imposed by the EU. Figure 5 shows that prior to the end of the ATC, exports of apparel from African least developed countries (LDCs) to the EU stagnated despite preferences, whilst exports to the US under AGOA grew very strongly. Exports of apparel from African LDCs to the EU and US were almost equal in 2000, but the value of exports to the US in 2004 was almost four times greater than the value of exports to the EU.

⁴ Under the GSP the value of their preferences would fall to to 0.5 percent of their exports or EUR 103 million, a loss of EUR 679.

⁵ The value of EBA preferences for all LDCs equals 3.8 percent of their exports. The value of ACP/GSP preferences for all African countries (excluding South Africa) equals 2.6 (3.3) percent of their respective exports. South Africa accounts for about a third of all SSA exports to the EU.

Figure 3: Non-restrictive rules of origin strongly stimulated US imports of apparel from African LDCs; but EU imports stagnated in the face of strict rules



Source: USITC and Eurostat

The key factor explaining why exports to the US grew much faster than to the EU is the rules of origin. EU rules stipulate production from yarn. This entails that a double transformation process must take place in the beneficiary with the yarn being woven into fabric and then the fabric cut and made-up into apparel. These rules prohibit the use of imported fabric, although cumulation provisions allow for the use of inputs produced in other ACP countries. To obtain preferences, apparel producers must use local, EU or ACP fabrics. They may not use fabrics from the main fabric-producing countries in Asia and still qualify for EU preferences—a binding restriction, since few countries in Africa have competitive fabric industries. The EU rules do not allow producers in African LDCs the flexibility they currently have under AGOA to source fabrics globally. It is worth remembering that the EU has granted preferences to African countries for apparel subject to these strict rules of origin for more than 20 years under the Lome and then Cotonou agreements. However, these strict rules have done little to encourage the development of an efficient fabric industry in Africa, the main justification for their imposition,⁶ and are likely to have severely constrained the impact of preferences in stimulating the clothing industry.⁷ This is in particular because a competitive clothing sector is the most important driver for a local textile industry because the demand for short lead times will create pressure to source locally. At the same time, the lack of regional infrastructure and market size for textile products have hindered the exploitation of economies of scale and scope in competitively producing high quality textiles and specialized textile products.

⁶ See Brenton (2006) for a discussion of why restrictive rules of origin are inappropriate as a development tool and are more likely to reflect protectionist interests in the preference granting country.

⁷ See Brenton and Ozden (2005) for a more detailed analysis of the impact of the EBA and AGOA on apparel exports from African LDCs and the role of the rules of origin.

Opportunities and Challenges in the Changing Global Economy

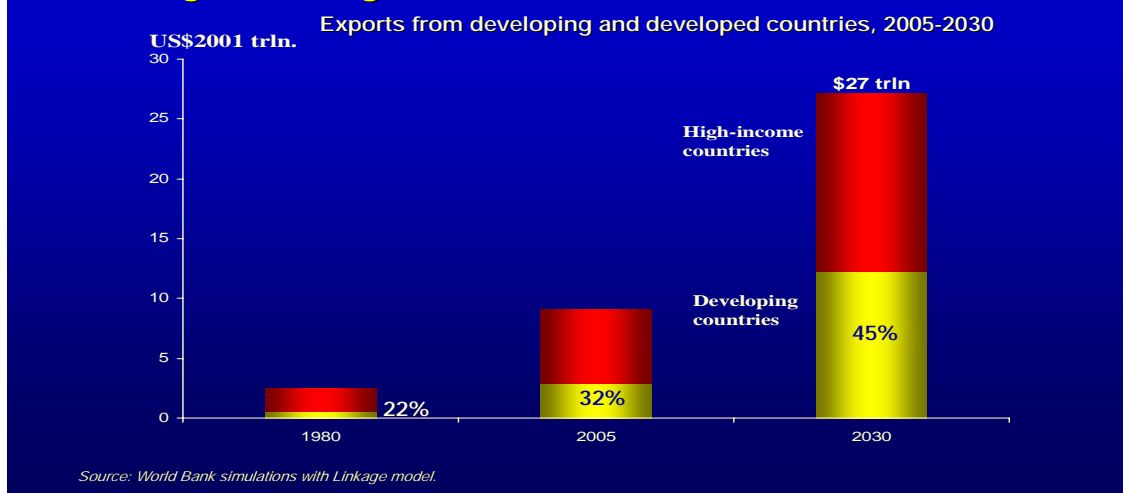
The negotiation of EPAs is taking place in a rapidly changing world economy. EPAs will be successful if they leverage the reforms and supporting aid for trade that are essential if ACP countries are to exploit the opportunities that are available to them in the global economy whilst effectively addressing the challenges that come from an increasingly competitive global economy. Concentrating on locking-in preference dependent trade with the EU will not be a recipe for success. This section briefly discusses the emerging opportunities for ACP countries in the world economy, with a focus on Africa. It highlights the growing importance of east Asia in the global economy and the surge in trade in services that has accompanied declining telecommunications costs.

The rising importance of developing countries in the global economy

The pace of global integration is likely to intensify and will be powered increasingly by developing countries. World Bank (2006) suggests that the size of the global economy will rise from \$35 trillion in 2005 to \$75 trillion (at constant market exchange rates and prices) in 2030, an average annual increase of more than 3 percent—2.5 percent for high-income countries and 4.2 percent for developing countries. Developing countries, once considered the periphery of the global economy, will become main drivers. The share of developing countries in global output will increase steadily and China's output will exceed that of the European Union and that of the United States sometime around 2015 (in purchasing power parity terms). Global integration is likely to enter a new phase. In virtually every growing economy the importance of trade—captured by the ratio of trade to GDP—will rise, continuing the trend of the past two decades.

Global trade in goods and services, growing faster than output, is likely to rise more than threefold to \$27 trillion in 2030. Roughly half that increase will come through developing countries, with the share of developing countries in global exports rising from 32 percent now to 45 percent in 2030 (Figure 4). This means that a growing share of global production of goods and services will be performed in those developing countries able to take advantage of new opportunities and respond to the emerging challenges. Whether countries exceed projections—or fall short—depends heavily on the policies they adopt over this long period.

Figure 4: Developing countries share of world trade will rise as global integration intensifies...



The new wave of globalisation brings important challenges for developing countries. Developing countries with wages higher than those in China and India risk losing ground following the entry of these countries into the global marketplace. The sheer size of China and India may also preclude the diversification of the poorest countries into manufactures and so close of a route to growth and development (Cline (2006)). However, what matters is productivity. In middle income countries is the wage gap with China greater than the difference in productivity and can productivity differentials be maintained? Similarly, least developed countries in Africa that have lower wages than China and India, will be able to compete in the global market if levels of productivity are close to those in India and China.

Another problem with the view that the global market will be swamped by products from China and India is that the law of comparative advantage entails that there will always be opportunities for other countries to export even though India and China will come to dominate certain sectors. In general, as the global demand for say Chinese manufactured products increases, (dollar denominated) wages in China will tend to increase, through higher wage demands from Chinese workers (especially if the rural and urban labor markets remain partially segmented) and from the inevitable additional pressure on the Yuan to rise. There is evidence that this process has already begun (Figure 5)

Figure 5: But China's surge – and that of other developing countries – represents more opportunity than threat

- Exporting requires importing
- Surging growth means rising wages

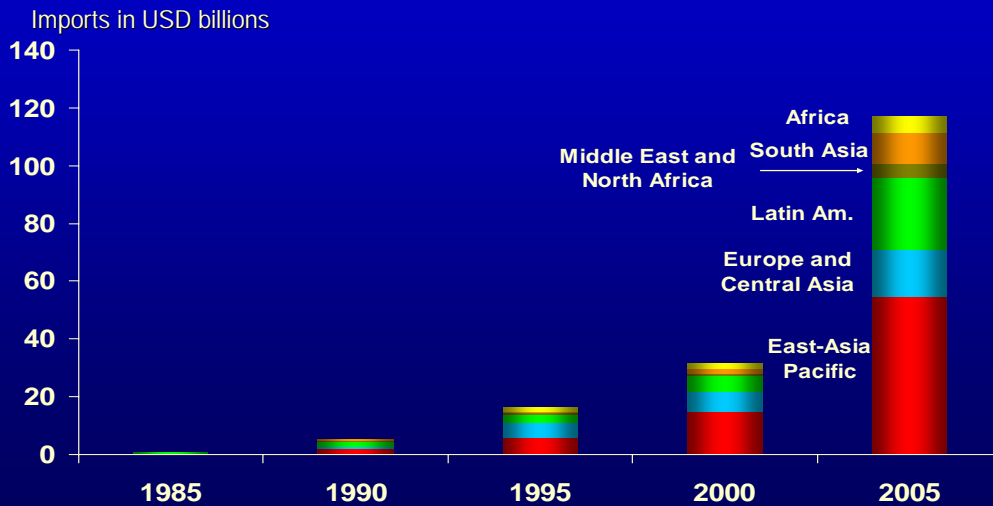


Thus, Chinese development will not preclude the lowest income countries being able to export low skilled intensive products. However, this will only arise if these countries put in place a business climate that supports investment and trade. For example, in Africa, competitiveness from low cost labor is undermined by high indirect costs, with the main barriers being corruption, crime and inadequate infrastructure (Eifert et al 2005). The poor business environment leads to lower returns to labor and capital in production which depresses investment, labor demand and real wages.

The entry of these large economic entities into the global market offers opportunities as enormous as the challenges posed for developing countries. The large markets in India and China have changed the dynamic of south-south trade (Figure 6) and offer developing countries a route to decreased dependence on rich countries, demand in which for products produced in the poorest countries has been growing slowly for a long period.

Figure 6: China's surge – and that of other developing countries – represents more opportunity than threat

- Exporting requires importing, and China's imports are rising rapidly



Nevertheless, at the beginning of the 21st century, African countries still ship nearly two thirds of their total exports to EU and the US. There has been, however, a recent shift in export patterns. Demand in Asia, and primarily in India and China, has been the main source of the accelerated growth of African exports since 1990 and the growth of such exports has intensified in the 2000s (Broadman (2007)).

In table 1 we show, using a very simple simulation based on the gravity model and scenarios of growth in the different regions drawn from Global Economic Prospects 2007, that the importance of China and other East Asian countries as a destination for Africa's exports should increase substantially over the next 25 years⁸. The main adjustment that takes place is a shift away from Europe. If bilateral trade flows continue to be driven by incomes and location then Europe will cease to be the largest destination market for SSA exports. Exports to the EU market will remain critical for many exporters and important new markets and niches will clearly arise. However, if EPAs are narrowly focused on bilateral trade between the EU and sub-Saharan Africa and fail to address the key constraints to global competitiveness then they will fail to assist the ACP countries in exploiting these new opportunities in the global market.

⁸ The growth rates for each region are based on simple projections of average performance over the past 15 years. The approach is based on simply applying the coefficients on exporter and importer GDP from a standard gravity model to the changes in income over the next 25 years.

Table 1: Destination of Sub-Saharan (non-oil) Exports

Destination	2004	2030
<i>Asia</i>	18.3%	31.3%
<i>Eastern Europe and Central Asia</i>	8.2%	8.6%
<i>European Union</i>	53.3%	38.7%
<i>The Americas</i>	8.0%	5.7%
<i>o.w. USA</i>	6.2%	4.3%
<i>o.w. Brazil</i>	0.3%	0.2%
<i>Middle East, North Africa</i>	2.0%	2.5%
<i>Oceania</i>	0.3%	0.2%
<i>Sub-Saharan Africa</i>	9.9%	12.9%
Total	100.0%	100.0%

source: Linkage model, COMTRADE, own calculations; non-oil trade only

Opportunities from the Global Sourcing of Services

The global competition that has been underway in goods for decades is now visible in services, as falling telecommunications costs and greater openness to FDI enable different parts of the services value chain to be performed in different locations around the globe—global sourcing of services. Global sourcing has increased competition in services markets for a wide variety of activities, from low-skilled such as data entry, word processing and call centers to higher skilled activities such as software development, consultancy, medical services and R&D. A range of services that were previously thought to be non-tradable are now being provided electronically over large distances. The potential number of service jobs that may migrate from rich to poor countries is uncertain but could be large (World Bank (2006)).

This phenomenon is creating considerable opportunities for development in poor low wage countries, both in terms of export possibilities as well as access through imports to cheaper services inputs that raise productivity when used in other sectors. Global sourcing is providing important new employment. In the relatively low-value segments such as call centers, wage costs are important determinants of location (along with language skills) and competition is fierce among developing countries. At the higher skill end, global sourcing of services may be reducing incentives for skilled migration by creating new opportunities at home. It is also important to note that a large number of those employed as a result of global sourcing are women, offering a different route to development than that based on growth of agriculture and manufacturing.

The services revolution and global sourcing are offering opportunities for new exports and for attracting services-related foreign investment for a range of poor countries. IT and global sourcing offer new and alternative drivers of development that circumvent some of the key constraints to growth driven by the expansion of exports of agricultural and manufactured goods. This is most apparent for landlocked countries and small (often island) economies that face very high costs for physical transportation (by air, road and sea). For example, development in Rwanda has to confront an extremely adverse location, one of the highest population densities and a high population growth rate. While increasing the quality of quantity of exports of traditional agricultural exports (coffee) and minerals is crucial to increases in incomes for the poor in the short to medium term, the government of

Rwanda has identified the provision of IT intensive services, both locally and abroad, as a base for growth in the long run, to provide for employment and to turn the country's high, but very young, population into a driver of development rather than a constraint. While India and China will come to dominate the market for global sourcing of services, comparative advantage will ensure that there are opportunities for many developing countries. Small island economies in the Caribbean, for example, have been able to attract certain back office activities from the United States, such as data entry.

While there are important new opportunities for developing countries there are also considerable challenges regarding the provision of necessary infrastructure, the design and implementation of appropriate regulation and effective education strategies to increase the supply of human capital. While telecommunications infrastructure is clearly crucial, access to relatively cheap and reliable electricity is also necessary (a critical problem for many poor countries). Providing access to high-quality telecommunications infrastructure is not sufficient. It is also necessary to establish a competitive framework for the provision of telecommunications services. Liberalization of the trade and investment regime can be central to ensuring the efficient and competitive provision of the backbone telecommunications services complemented by an appropriate and effective regulatory environment. Considering the difficulties in establishing such a framework, it is in this sector that Aid for Trade and technical assistance, similar to the concept of "twinning", are needed. This concept has been used very successfully in EU accession countries where administrations and agencies of member and accession countries exchanged personnel to transfer knowledge and procedures.

Competitiveness Reform Programs and EPAs

It is important that developing countries put in place strategies that enable them to exploit the opportunities that global integration offers to raise and sustain rates of growth. This calls for more attention to policies that facilitate trade and improve competitiveness – supported where necessary by Aid for Trade. In this context it is useful to have a framework in which to assess the range of issues that affect countries' ability to compete in international markets. There are three critical complementary elements:

1. *The incentives regime.* A key challenge for policy makers is to ensure that domestic resources are channeled to their most productive activities. This requires a careful analysis of the structure of incentives in the economy to ensure that land, labour, capital and technology are moving to a) sectors in which the country has a long-term capacity to compete and b) to the most productive firms within sectors. In turn, this necessitates a clear understanding of how trade, tax, the business environment and labour market policies interact to affect investment, output and trade decisions. In many small low income countries the economy tends to be dominated by a small number of sectors so that many of the key issues regarding the allocation of resources can be unearthed by analysis that focuses on these sectors. This method, however, is likely to miss growth potential in sectors that are only on the verge of becoming successful as they do not figure in the policy makers' mindsets. There would hence be a bias towards already established sectors, missing the potentially large growth potential in non-traditional sectors.

2. *Lowering the costs of backbone services.* Of great importance in today's globalised economy is that domestic firms have access to efficiently produced critical backbone services inputs. Firms that have to pay more than their competitors for energy, telecommunications, customs services, transport and logistics, finance and security will find it hard to compete in both the domestic and overseas markets. Competition and regulatory oversight in these services industries lie at the heart of the policy challenge. In many developing countries lack of infrastructure is a critical constraint on the availability and cost of backbone services. Other critical services are those related to education and training that are necessary to ensure supply of the type of labour required by the more productive expanding sectors in the economy and to foster a process by which value is increasingly added to the products and services produced in the country.

3. *Pro-active policies to support trade.* It is important to address a range of market and government failures that tend to afflict countries as they seek to expand exports and growth. In many cases these constraints to competitiveness require specific interventions and institutions. These are likely to include export and investment promotion agencies, standards bodies, agencies to support innovation and clustering. Pro-active policies that increase competitiveness would also include an increasingly flexible labor market. To obtain the necessary political support, governments should focus on protecting workers instead of protecting jobs. This means that effective safety nets for those workers losing their jobs due to increased competition should be put in place. In tackling government failures and weak capacity for policy formulation and implementation, an effective mechanism can be to establish an empowered and dedicated trade and competitiveness policy unit within government that brings together stakeholders and coordinates policies on export processing zones, duty refund schemes, and other initiatives. It is important that these initiatives are brought together within a strategy for competitiveness rather than as a series of ad hoc interventions. In isolation these agencies tend to be rather weak and ineffective, and by potentially duplicating efforts will most likely waste scarce skilled resources.

The role of EPAs

To improve the competitiveness of the economy, countries will have to go ahead with substantial domestic reforms. But because many of the ACP countries are small in population and economic size and/or are landlocked, some of the issues listed are best addressed at the regional level. This is where EPAs can play an important role by committing countries to, strengthening, and moving forward the process of regional integration which will allow to solve those problems that need a regional solution. Well-designed EPAs can offer an opportunity to harness the power of trade negotiations to further internal regional development and spur integration into the global economy as well as improving access to the EU market and leveraging aid for trade to support reform programmes. In contrast, a poorly designed EPA that would not foster regional integration could seriously undermine development. Box 1 suggests and summarizes key elements of a pro-development EPA. The following section elaborates on how EPAs can support reform in the three areas that are crucial for global competitiveness.

The incentive regime

Domestic incentives: Reducing the dispersion and then the level of tariffs will be a critical element of a competitiveness strategy in many of the ACP countries as it will correct distortions in the incentive regime. The reduction of external tariffs is also necessary in an EPA to avoid potentially damaging trade diversion. Trade liberalization in the EPA regions should be a staged process with intra regional barriers removed first. Considering the delays in agreeing on the form of customs unions, governments should consider establishing well functioning FTAs as soon as possible first, and to continue working towards customs unions subsequently, instead of postponing significant advancements in regional integration by devoting too much energy to negotiations of common external tariffs.

In this context, MFN peak tariffs should quickly be capped at the regional level and in a coordinated manner to remove the largest distortions in domestic markets. In the same coordinated manner, but not necessarily under a CET, average MFN tariffs should be lowered to pursue global competitiveness and integration into global market. Lower tariffs will contribute to an improved incentive regime that allows domestic firms access to needed inputs at world market prices and which avoids bias against exports and the bottling up of resources into low productivity activities. Subsequently, tariffs against imports from the EU could be removed under an EPA. It is essential that preferences for EU suppliers are only implemented after the reduction of MFN tariffs since lack of competition among EU suppliers in small ACP markets could lead to unchanged prices and simply to a transfer of revenue from the customs authority in the ACP country to EU suppliers.

Incentives in export markets: At the same time, EPAs can offer ACP countries two important improvements in market access, more favorable rules of origin and certainty of access. EPAs can also offer larger market access to non-LDC ACP countries as coverage of the GSP scheme is not as generous as current Cotonou preferences. Current product specific EU rules of origin are highly restrictive, especially for those products in which African countries have potential to expand exports of non-traditional products; clothing, fishing and processed foods. The EU has long posited that restrictive rules of origin should lead to industrial development and integration in beneficiary countries. More than 20 years of restrictive rules of origin, however, have not induced integrated industrial developments in ACP countries and have not contributed to a more dynamic export performance. Restrictive rules of origin have not led to the emergence of an efficient ACP-wide textile industry even though ACP cotton producers exist. The penalty on using local (more expensive or low quality) inputs often exceeds the expected benefits from using EU preferences. The small market size of most ACP countries makes vertical integration a less profitable option. Rules of origin have proven to be a highly distortive and grossly ineffective instrument for achieving integrated industrial development. Thus, exports from Africa to the EU would be stimulated by a requirement to satisfy *either* a simple 10 percent value added criteria as proposed by the Blair commission report *or* a change of tariff classification.

Under an EPA, certainty of access would be assured in a way that voluntary preferences under the EBA and the positive lists enrollment in GSP do not permit. EBA preferences, though unlikely, can be withdrawn. GSP is subject to review and withdrawal, and since it is awarded on a positive list basis, its support for diversification is much less.

Due to the limited additional gain that LDCs can expect from an EPA with regard to preferential access in goods (except certainty and less restrictive rules of origin), EPAs should also contain a program, however small, of temporary movement of persons (mode 4). Preferential access of workers to the EU market from these countries could lead to increased incentives to invest in education and larger transfers of knowledge when workers return to their origin countries after temporarily working in the EU. In case the EC will not be able to obtain the mandate to include temporary movement in the negotiations, one could consider additional side-agreements between ACP countries and EU member states.

Lowering the costs of backbone services and trading

Trade-related services throughout Africa are less efficient than in other regions. In Sub-Saharan Africa, 52 percent of firms report unreliable electricity supply as a constraint. This compares to 42 percent in South Asia and 24 percent in East Asia and Latin America (World Development Report 2005) The DTIS's for a number of countries highlight that electricity, telecommunications, transport, and water charges are often higher in low-income countries and that access to these and other services, such as financial services, are extremely limited. Access to telephone services remains low with the number of mobile phone subscribers varying strongly between countries and averaging 58 per 1000 inhabitants in 2002 (ranging from 0.2 in Niger to 447 on the Seychelles).

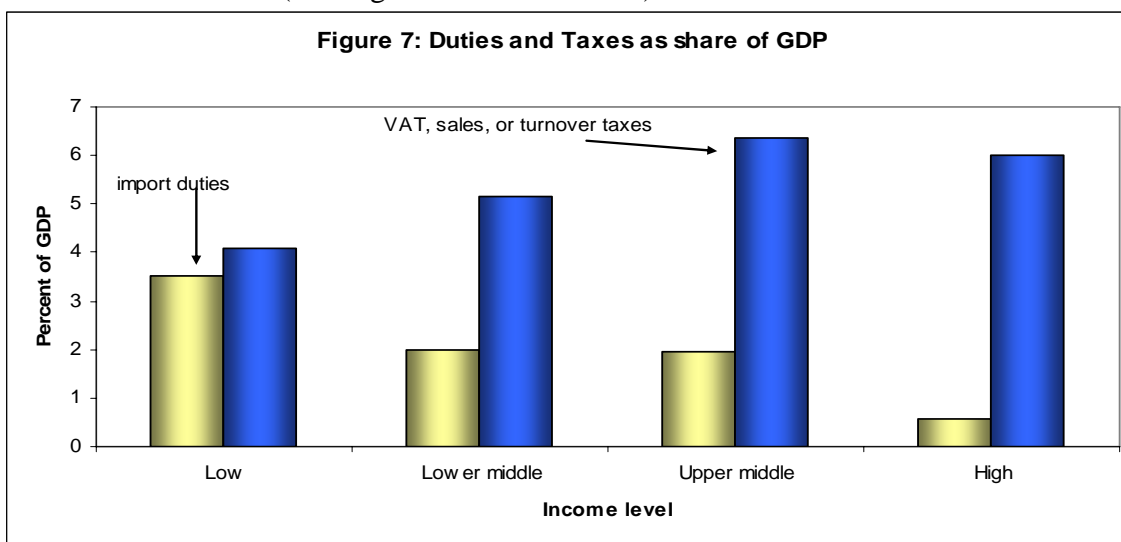
Regional integration can help overcome these problems. The domestic markets of many ACP countries are too small to realize full economies of scale in network services and their regulation. In addition, regional approaches can lead to regulatory frameworks that allow for greater competition, with positive effects on prices and efficiency. EPAs offer the opportunity to bring all relevant stakeholders together and to lock in domestic reforms and regional integration with regard to the regulation and supply of crucial telecommunication, electricity, water, and financial services needed for exporting. Regional integration in this field should be coupled with phased programs of services liberalization on an MFN basis to avoid the enlargement and entrenchment of existing monopolies or their transfer to EU suppliers. ACP countries have to keep in mind that the importance of having efficient services as inputs into final goods and services production most likely exceeds the employment effects directly related to the service providers.

With regard to trade facilitation, a regional approach also promises to be most effective. This refers to both external borders and addressing the large barriers that land-locked countries face when they have to transit their goods through neighboring countries. To overcome problems of coordination, harmonization of documentation and regulations, regional strategies are likely to be more effective than domestic policies. Again, aid for trade will be needed to address the large investment demands that will address problems in regional infrastructure networks within each EAP region.

Reforms that will increase access to crucial backbone services should also aim at setting up of simple but functioning, region-wide, competition authorities. Linking EPAs to small but firm commitments on establishing a supra-national competition policy within each EPA region could help to advance policy reforms. Due to the extensive experience of the EU with the establishment of a supra-national competition policy, the EU should consider offering aid for trade in this area, in particular in the form of technical assistance and twinning.

Pro-active policies to support trade

While integrating into the world economy requires that import taxes are low and relatively uniform, for the least developed countries they are a key source of revenue relative to VAT and sales taxes (Figure 7). High-income countries are able to recover revenues lost from trade liberalization from other sources: on average, middle income countries recover 45-60 percent of lost tariff revenues while least developed countries recover less than 30 percent of lost tariff revenues (Baunsgaard and Keen 2005).



Source: Bank staff calculations

But many countries collect far less in tariff revenue than the applied tax rates would suggest, due to the widespread (discretionary) granting of exemptions. Preliminary analysis of data for certain ESA countries suggests that a large share of statutory customs revenues is not collected and that these exemptions tend to be more prevalent for imports from the EU, such that the revenue impact of tariff reform vis-à-vis the EU will be much less than would be expected on the basis of statutory tariff rates. At the same time, capping prohibitive tariffs at an MFN basis could lead to increased imports of these goods which would increase revenue collection. Exemptions make the tax regime opaque and difficult to administer and can lead to a distorted incentive structure that discriminates against small firms with less influence. Further, there is little evidence that exemptions have a significant impact on investment, their primary justification. Many countries could substantially reduce applied tariffs while maintaining or even increasing revenue if exemptions were

removed and collection improved. However, it is still necessary to address the development challenge highlighted in Figure 7 of moving from easy-to-collect trade taxes to harder-to-collect consumption and income taxes. Simply implementing a VAT is not sufficient; a high degree of collection efficiency (the ratio of actual to potential revenues) is needed.

To meet this development challenge and obtain the necessary funds to finance relevant projects requires an increase in the tax base for the “difficult to collect taxes” which will be achieved through economic growth, simplification, in terms of fewer rates and less exemptions, an increase size of formal relative to informal sector and through improved revenue collection. A key objective for many of the ACP countries is customs reform to increase the efficiency of collection of taxes applied at the border. This in turn requires initiatives to raise the capacity of customs. Regional reform and harmonization of tax administration and structures will promote regional integration and help replace lost tariff revenue. It will furthermore simplify and streamline the regional incentive regime if done properly.

Addressing the revenue implications of tariff reform will also be important as economic reforms will create high financing demands. For example, making labor markets more flexible will be an important element to increase global competitiveness. Governments in ACP countries, however, will have to overcome domestic resistance to such reforms and should do so by changing the focus from protecting jobs to protecting workers, demanding substantial financial means. Allowing more labor movements within EPA groupings could help in making labor markets function more effectively.

Last, the continuing prevalence of substantial non-tariff barriers between countries of the same regional block also calls for region-wide approaches to remove these barriers. EPAs could help to commit to these reforms.

Box 1: Elements of a Pro-Development EPA

What does a pro-development EPA look like? Here are 8 elements that would collectively constitute central tenants of a pro-development EPA. A guiding principle of these measures is that all 8 are in the fundamental interest of all countries as part of their development strategies—and of the EU in its objective of promoting development. These would include:

1. A program of phased and variable geometry for MFN reductions in external tariffs, consistent with regional development programs. For example:
 - Phases 1 and 2: Eliminate all **internal tariff barriers** in CU/FTA to promote regional trade.
 - Phases 1 and 2: Bring down MFN peak tariffs to average to promote intra-African and other efficient trade with third parties.
 - Phases 2 and 3: Bring down MFN **average** levels toward East Asian levels in EPA group.
 - Phase 3: Allow preferential for the EU; taken as a final step, the adverse risks of trade diversion and hub-and-spokes development would be lessened.
2. Nonrestrictive rules of origin for ACP access to the EU market (choice of satisfying either a 10% value-added requirement or change of tariff heading); if the value-added requirement is higher, cumulation should cover all developing countries to allow ACP producers maximum access to the

world's lowest-cost inputs and to avoid putting regional suppliers outside the EPA group at a disadvantage.

3. A program of gradual but purposeful reforms of tax administration and intra-regional tax policy to harmonize tax structures so as to promote regional integration and replace lost tariff revenues. This can complement tariff and customs reforms at the regional level.
4. A phased, region-specific program of services liberalization designed to promote wider access to lower cost trade-related services, such as efficient telecommunications, electricity, and transport; this should be undertaken on an MFN basis, so as to avoid entrenching monopolies from one or another country.
5. A program of trade facilitation measures—for example, improvements in customs, ports, border posts -- to reduce costs, linked to intra-regional programs to lower costs of trading, with special attention to lowering transit costs of land-locked countries, with specific benchmarks for implementation;
6. A program, however small, of temporary movement of persons (mode 4); while not currently in the negotiations, this may be easier to achieve in regional arrangements than in multilateral talks.
7. Agreements could include new IPR rules and rules on investment, but these should be back-loaded and phased in accordance to a region's capacity to implement – and to benefit from them. Agreements could include adoption of competition policies consistent with national development strategies and in accordance with a region's capacity to implement and benefit from them.
8. “Aid for trade” in the form of a program of technical and financial assistance to support competitiveness reform programs through funding projects that improve trade facilitation, SPS, and alleviate supply side constraints (e.g., infrastructure) as well as funding programs that address the adjustment costs that arise from trade reform.

Derived from Hinkle, Hoppe, and Newfarmer (2005)

Conclusions

Both the EU and the ACP countries will have to work hard to achieve pro-development EPAs. Time is short and much remains to be done. Key issues must be addressed to avoid the risks that come from a badly designed agreement. Because tariffs are relatively high and internal barriers within groupings still prevalent, enacting EPAs without prior action on these issues could result in a hub and spoke pattern of trade integration, trade diversion, and the possibility of net losses of income. Without action on external and internal barriers, giving EU firms preferential access to their markets could well divert trade to EU-producers from more efficient producers based in the rest of the world and even from those based in the regional grouping if the internal non-tariff barriers exceed the external tariff. As a result, trade liberalization vis-à-vis the EU might not lead to lower consumer prices but rather to a transfer of tariff revenue to EU producers. This problem is aggravated by the fact that many national markets in Africa are small and transport costs to these markets can be high. Markets are often monopolized by one external supplier and competition among EU producers is not likely to increase after the implementation of the EPAs. Thus, an EPA focused on preferential tariff removal for EU suppliers that is implemented in the absence of a strategy to raise competitiveness in Africa through reductions in internal and external barriers to trade, attention to supply side constraints such as lack of infrastructure, and

active policies to support trade and address trade related adjustment costs, will likely undermine development.

To achieve pro-development EPAs, the EU has to be willing to provide greater market access through nonrestrictive rules of origin, to defer its own preferences in ACP markets until important MFN liberalization has occurred in the regions and to support ACP countries implement their reform programs through “aid for trade”. The ACP countries will have to work hard to develop regional strategies for integration that harness the potential power of the EPA process to move forward on reforms that will promote their competitiveness, integration, and growth and be willing to lock-in a program of implementation consistent with its own development priorities and pace of reform.

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Appendix

The current value of preferences in the EU market

How important are the trade preferences that African countries' consider the trade preferences they enjoy as important for their exports to the EU. But current EU trade preferences for the 13 non-LDCs in Africa amounted to only 3.9 percent of their exports to the EU or EUR 782 million in 2005.⁹ The value of preferences for all African LDCs is much less with 2.1 percent of total exports but is less relevant in this discussion as these countries have access to the EBA which will continue to secure them duty and quota free access to the EU market, even though under the more restrictive rules of origin of the GSP (EBA is a special form of GSP).¹⁰

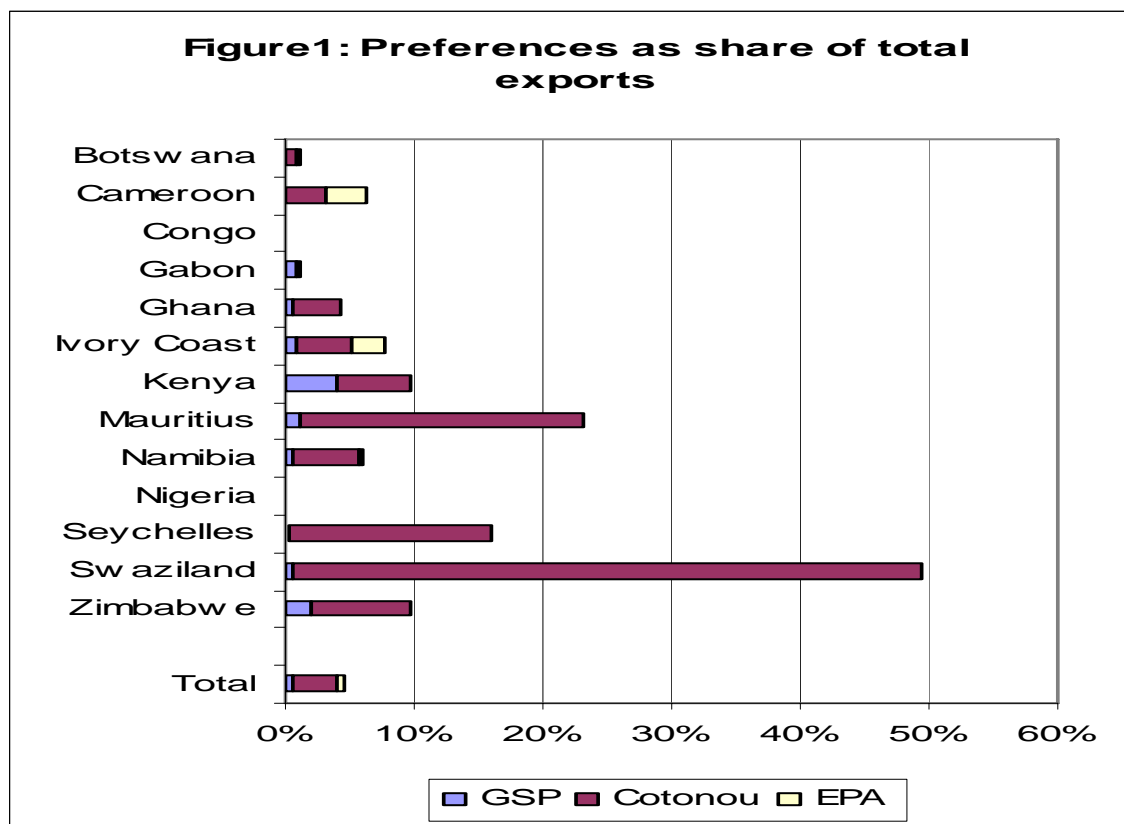
One of the problems that one faces when talking about the value of preferences is that this is an artificial concept. The value of preferences is the amount of import duties that exporters did not pay because of preferential tariff rates; it is the volume of trade multiplied by the difference between MFN and preferential tariffs, taking utilization rates into account. Its calculation is based on actually observed trade flows and omits the fact that some of these trade flows might only take place because of the preferences. In that case, the whole export value would be additional value that is transferred to the exporter because preferences are granted.

At the same time, the data do not allow us to identify the economic agents that actually benefit from the preferential rates. The issue is that tariffs create a wedge between the producer price in the exporting country (including transport costs to the export market) and the consumer price in the importing country. Here, we assume that the exporter actually benefits as he continues to sell the goods in the destination market for the higher consumer price but does not have to pay the import duties. He hence receives a net transfer of the value of preferences. Depending on the market power of the importer, the exporter, or an intermediary, it could be also be the importer or the intermediary who benefit from the reduction in tariff rates. If market power of the importer is high, he can continue to pay the producer price to the exporter (keeping his income constant as compared to the situation without trade preferences) but sell at the higher consumer price in the importing country, keeping the difference in price as a profit. Similarly, the intermediary could benefit from the lower tariff rate by buying from the producer at producer prices and selling to the final reseller at consumer prices. In this situation, the intermediaries income increases while both income for the exporter and final importer stay constant (as compared to the situation without tariff preferences). The 'value of preferences' is hence a high estimate for the value that is transferred to the exporting country given the observed trade patterns (Olarreaga and Ozden 2005).

⁹ We use a new dataset the EU has recently made available. Assuming that Cotonou preferences expire and no new preferences will be in place by that time, 2008, it is possible that these countries would only have access to preferences under the GSP. Other things equal, this would reduce the value of their preferences to 0.5 percent of their exports or EUR 103 million, a loss of EUR 679.

¹⁰ The value of EBA preferences for all LDCs equals 3.8 percent of their exports. The value of ACP/GSP preferences for all African countries (excluding South Africa) equals 2.6 (3.3) percent of their respective exports. South Africa accounts for about a third of all SSA exports to the EU.

Given the increasing dominance of large supermarket chains it is probably fair to assume that at least a large share of the preferences will accrue to the importers as these will rather have monopsony power than small producers in developing countries having some kind of monopoly power (see also Cling xxx for an example in Mauritius). The question then remains whether the margin of preferences actually creates trade relationships that otherwise would not have taken place. This more global value of preferences is impossible to estimate without specific knowledge of export prices from a larger number of suppliers and the final sales prices.



note: all values in EUR1000, calculation of preferences takes current utilization rates into account

Source: COMEXT, EU preference data, TRAINS, own calculations

Overall, actually claimed preferences for all 13 sub-Saharan non-LDCs¹¹ represent 3.9 percent of their exports to the EU. If only GSP preferences were available, this value would fall to 0.5 percent of total exports or EUR 103 million, a loss of EUR 679. The fall would be substantial for all countries but particularly high in the case of Mauritius, the Seychelles, and Swaziland where the value of preferences would fall from about 23, 16,

¹¹ South Africa is not included in the analysis as it is only an ACP country since 1998 and is not a signatory to the commercial provisions of the Cotonou Agreement, which foresees the negotiation of EPAs. While South Africa has signed an FTA with the EU in 1999, its partners in the customs union (SACU) are supposed to sign an EPA. Both arrangements are likely to create barriers within SACU. South Africa has expressed interest to join the SADC EPA but this has been rejected by the EU.

and 50 percent respectively to nearly zero. Alternatively, if EPAs with Cotonou-type rules of origin were to be in place by 2008, the value of preferences could increase to 4.5 percent of exports, a notional gain of EUR 107 million.¹² If EPAs were concluded with very simple rules of origin, however, preferences could be much higher because this could make a number of export products competitive in the European market. For example, less restrictive rules of origin for apparel products in the US under AGOA have led to an increase in clothing exports from about USD 250 million in 2000 to more than USD 800 million in 2004.

The actual value of preferences under an EPA, however, would depend on the rules of origin that were to be agreed. While the 4.5 percent figure assumes identical utilization rates as under the current regime, inclusion of non-restrictive rules of origin in EPAs could increase that value to 5.2 percent assuming constant trade flows. It would, however, be likely that non-restrictive rules of origin such as the 10% value-added rule proposed by the Blair commission or a simple change of tariff heading rule would open a range of new export opportunities for beneficiary countries, increasing the value of preferences. It is very difficult to estimate the potential value of these changes in competitiveness, however, but they could potentially be very large.

The importance of preferences also differs strongly by country, mainly due to differences in the composition of exports to the EU. For example, the ratio of actually claimed preferences to exports ranges from 0.1 percent for Nigeria, which mainly exports oil to the EU, to 49.5 percent for Swaziland that mainly exports sugar to the EU which benefits from large preferences (see figure 1). While the importance of preferences as a share of exports varies between countries, more detailed analysis shows preferences are usually concentrated in a few products, indicating that they have only opened up certain sectors (where MFN protection is high). These products are in particular sugar (36 percent of preference value), edible fruits and nuts (12 percent), and preparations of meat, fish or crustaceans (12 percent).

Continuing multilateral liberalization in the Doha round is likely that MFN tariffs will be reduced further. While this will be desirable as barriers to other large and growing markets will be reduced, it will also mean that the value of preferences of exports to the EU will decrease because of shrinking preferential margins. In those cases where preferential tariffs are zero, the value of preferences will approximately decline in line with MFN reductions. Where preferential tariffs are larger than zero, the value of preferences will decrease stronger (or completely disappear). A rule of thumb puts the costs of proving rules of origin at three percent of the goods value. If one deducts these costs from the value of preferences calculated, the value of preferences will be even smaller. With falling preferential margins, this margin might fall below three percent in many cases, making usage of preferences no longer worthwhile.

¹² The value of preferences under the EBA initiative would change significantly, showing the limited additional coverage that EBA preferences offer over Cotonou preferences