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Economic Partnership Agreements between the EU and groups of ACP countries: Will they promote development?

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Abstract

In this paper we explore the nature and effects of the Economic Partnership Agreements (EPAs) between the EU and groups of African, Caribbean and Pacific (ACP) countries. We argue that the direct economic effects from reciprocal trade liberalization - both positive and negative – may be rather limited. EPAs will only marginally increase access of ACP countries to the EU market and empirical studies on the static effects of trade liberalization show a small negative effect on economic development for ACP countries. However, we argue that EPAs can trigger changes that do contribute to development: better regional institutions, reform of agricultural subsidies in the EU, an increased role of the private sector in economic development through foreign direct investment and outsourcing, and a new perspective in the field of migration. Hence, we conclude that the process should not stop at signing regional free trade agreements, but that it should be enlarged into new approaches of economic integration and development of groups of ACP countries.

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The contents of this note may contain views which are not the views of the organizations the authors work for. The authors have elaborated the note in their personal name.

Abbreviations

AU African Union

CU Customs Union

Cotonou The EU-ACP agreement signed in 2000

DFQF Duty free quota free

EAC East African Community

EBA Everything but arms

ECOWAS Economic Community of West African States

EDF European Development Fund

EPA Economic Partnership Agreement

GATT General Agreement for tariffs and trade

GATS General Agreement on trade in services

LDC Least developed country

MFN Most Favoured Nations principle

PTA Preferential Trade Agreement

RTA Regional Trade Arrangement

SPS Sanitary and Phyto - Sanitary Standards

UEMOA West African Economic and Monetary Union

WTO World Trade Organisation

Introduction

The year 2007 will be decisive for the future of the special relation between the EU and the African, Caribbean and Pacific (ACP) countries, for it is marked by the prospective signing of Economic Partnership Agreements (EPA).¹ Over the next couple of years, the EU and regional groups within ACP countries group will implement these EPAs, which should progressively remove trade barriers among them and enhance cooperation in other areas related to trade. The EU has promised to use the EPAs as a main instrument for promoting economic development or, in the words of Commissioner Mandelson, to put "the EPA process under continuing review, so as to make sure that the process really does put development first." Also, cooperation based on notions of equality – for years the main selling point of the Lomé Convention - should not be at risk, or, again in the words of Commissioner Mandelson: "the word partnership in Economic Partnership Agreement is not there by accident".

However, whether the EPAs are a turn for the better for the developing countries concerned is hotly debated. The element of the EPAs that attracts most attention is that the trade regime between the EU and ACP countries moves from unilateral preferences by the EU to reciprocal free trade. This effectively means that ACP countries will, in time, open their markets for EU products, giving them preferential access when compared to third countries. Whether the ACP developing countries are able to cope with the increased competitive pressures or the need for adjustment and reform are questioned by academics, policy makers and NGO's alike. As most commentators agree that the large majority of the ACP-countries will be members of one of the EPAs, much of the current debate focuses on, a) how best to negotiate and implement the new agreements, and, b) in which way to design supporting mechanisms for adjustment, such as trade related assistance and supply side support.

¹ Articles 36 and 37 of the EU-ACP Agreement (Cotonou) signed in Benin on 23 June 2000.

Beyond the trade and development dimensions, EPAs also have a typical regional dimension. Although ACP countries can negotiate an EPA alone or in any group of countries they consider appropriate, the reinforcement of regionalism has been a major driving force of the EPA process from the beginning. Consequently it is no wonder that the 6 groups that actually negotiate with the EU are in fact more or less configurations reflecting existing regional trade arrangements (RTA). The West Africa EPA is negotiated according to a mandate given by West African states grouped in the Economic Community of West African States (ECOWAS), including all francophone West African countries grouped into the West African Economic and Monetary Union (UEMOA). Mauritania, not a member of ECOWAS or UEMOA, is also attached to this group. The Central African negotiating group largely coincides with the Economic and Monetary Community of Central Africa (CEMAC). The four other negotiating groups, for Southern Africa, Eastern Africa, the Pacific and the Caribbean respectively, also correspond to some sort of existing RTA. The strengthening of regional integration in ACP countries is an explicit objective of EPAs as confirmed in article 37.3 of Cotonou. This objective is largely inspired by the success story of regional economic integration inside the EU.

In this paper we explore the nature and economic effects of the EPAs for ACP countries and discuss some of the policy implications. In contrast to most other studies, we argue that the economic effects from trade liberalization - both positive and negative - are over-estimated/emphasised for two main reasons. Firstly, EPAs will not increase ACP countries' access to the EU market by much. Secondly, empirical studies on the effects of trade liberalization show a small negative effect on economic development for least developed countries (LDCs). We do however argue that EPAs can be better used to support changes that contribute to development such as improved (regional) institutions in developing countries, reform of agricultural subsidies in the EU, an increased role of the private sector in economic development through foreign direct investment and outsourcing, and new avenues in the area of migration. As a result, we conclude that the process should not stop at signing free trade agreements, but that it should be followed by dynamic support for economic integration and development of ACP countries.

The paper is structured as follows: Section 2 reviews the origin and state of negotiations of the EPAs and argues that WTO compatibility and increased market access for EU firms together with regional integration effects will be important factors in the negotiation process. The next section discusses a number of challenges that the negotiations will face. Following this, in Section 4, through the use of evidence on the effects of trade liberalization on economic development we argue that the current content of the EPAs is likely to have a small impact on economic growth. Section 5 deals with new insights from trade theory that may help to improve the trade performance of developing countries. Finally, in Section 6 we explore ways in which the EPA can be extended so as to contribute to the development of ACP-countries.

The nature of EPAs between the EU and regional groups within ACP countries

The need to transform the trade chapters of the EU-ACP agreements as they were agreed first in Yaounde then Lome and finally most recently in Cotonou, became clear when the Uruguay Round of international trade negotiations transformed the GATT agreement into the World Trade Organisation (WTO) in 1995 making multilateral trade agreements more binding. By their very nature, the ACP trade preferences obtained from the EU are a violation of article 1 of the WTO – the Most Favoured Nation principle (MFN) – as these trade preferences are withheld to other developing countries, reserved as they are to countries selected on the base of their colonial past. In 2001, at the end of the Doha Ministerial, the ACP group of countries obtained a waiver valid until 2007. However, there seems to be no political consensus to renew this waiver after 2008.

The fact that the EU has lost several trade disputes recently over trade preferences has added to the pressure to make sure that its current trade regime is WTO compatible. For example, in the banana case against the EU it was argued that the EU violated the MFN clause of the WTO by giving special preference to its former colonies. Although giving preferences to developing countries is desirable on economic grounds - for example through the Generalized System of Preferences (GSP) - this is not allowed on non-economic grounds. Hence, retaliation measures were approved against the EU by the

Dispute Settlement Body of the WTO. These damaging WTO challenges and the end of the waiver period have forced the EU to place WTO compatibility at the centre of its EPA policy.

In parallel, the EU is also putting itself under strong pressure to bring the relationship into conformity with WTO rules and to end the waiver due to its strong belief in the necessity for a truly rules-based international trade regime. The EU increasingly dislikes its trade regime to be incompatible with WTO-rules. In addition to this, the EU dislikes the concessions to third parties that the EU-ACP waiver implies and favours a move to reciprocity, as third countries (China, India, the United States) have increased their foreign trade penetration in African markets.

A second basic consideration to introduce EPAs relates to the poor results of the preferential and non-reciprocal trade agreements in the past. A few countries such as Mauritius clearly used these preferences – in this case for sugar – very effectively and based a successful mid-term economic strategy on them. However, generally, economic performance in most ACP countries has not improved and in many cases has become worse during the decades of non-reciprocal preferences.² The core issue here is [international] competitiveness or the lack of it. There is no point in obtaining preferences which at the supply side cannot be matched by adequate deliveries due to a poor economic and political environment, inadequate [public] policies, lack of transport facilities/infrastructure, conflicts and war. Even peaceful countries with sound policies such as Tanzania were unable to fully exploit trade preferences. Therefore another cornerstone of future EPAs is that they should contribute to competitiveness and capacity building in private sectors.

² ACP countries share saw their share in total import by the EU reduced from 8 percent in 1975 to 2.8 percent in 2000. Nearly all commentators agree that the effects of the preferential trade relation between the EU and ACP-countries have failed to contribute to economic development. Some LDCs - of which many are member of the ACP group - utilize less than 50 percent of the size of EU preferences for their exports. Clearly, ACP countries face strong competition from the rise of non-ACP exporters in East Asia. Moreover, progressive trade multilateral liberalization and enlargement have reduced the value of trade preferences. Laird et al. (2002) show that these preferences have a negligible effect on the welfare in ACP-countries. Hence, in the short run, increased market access for ACP-countries is unlikely to result in significant welfare gains.

Regional integration, as mentioned before, is another important factor of the EPA construction. To bring the current Cotonou agreement into compliance with WTO obligations, the EU and the ACP countries are negotiating EPAs in the form of preferential trade agreements (PTAs) that can be cleared under article XXIV of the WTO. However, for a PTA to receive such clearing, preferences between the partners have to be reciprocal and the agreement should cover substantially all trade. Given that in the current agreement the EU gives preferences to its ACP partners but not to other WTO member states, such PTAs will be a significant break with the past.

The EU follows a two-step process in the EPAs. First, it supports regional integration processes among ACP countries that should result in regional free trade areas. Second, the EU negotiates with groups of countries corresponding to regional organizations on the specifics of an EPA with that region. In a certain sense this process reflects the trade philosophy of the EU, where it views preferential trade liberalization as supportive to multilateral liberalization. However, it also reflects the EU 's conviction that, in any case, regional integration among relatively small states is good for development.

Negotiation challenges

ACP countries view agreeing EPAs as a necessary evil because although they need them to maintain their preferred trading position, they are also concerned that they will place strong competitive pressure on their economies. This has meant that as the date of conclusion rapidly approaches, many countries are starting to doubt whether the financial benefits from the preferred position cover the substantive adjustment costs that come from increased competition. Furthermore, all ACP-countries tend to agree that the new trade arrangements benefit the EU more than it does them.

To counter such claims, the EU argues that its exports - mainly consisting of finalized industrial products - do not compete much with domestic production in ACP countries. There is some merit to this argument, however some claim that domestic production is

low because world market prices are depressed as a result of the subsidies given by developed countries to their national industries manufacturing or producing products that LDCs could potentially export. Moreover, it is argued that trade to the EU for products and services is low due to trade barriers including non-tariff restrictions such as sanitary and phyto-sanitary (SPS) measures which remain quite high.

A second concern of ACP countries is that the emphasis on trade will reorient the focus of aid or maybe make aid conditional on market access for EU products, as funds may have to be shifted to achieve the goal of trade adjustment – if and when the EU accepts to do so. Although the reciprocity of trade will entail costs of adjustment, the EU has not yet formally agreed to significantly increase the Economic Development Fund (EDF) that supplements the EU-ACP agreements. Also, in the future, difficult discussions on increasing the EDF are foreseen, as new member states of the EU miss the cultural ties with mostly former French and British colonies.

To avoid competitive market pressures of the EPA process, the ACP countries have lobbied for the inclusion of elements of special and differential treatment (SDT) for North-South PTAs under article XXIV of the WTO, so as to increase the flexibility of preferential trade between economically unequal partners (Onguglo and Ito 2003). However, so far they have achieved only limited success, not least because the EU seems reluctant to support the SDT initiative.³ Moreover, a split between the EU and the ACP countries has arisen over the timing of the signing of the EPAs, as many ACP countries see the implementation of regional free trade as a prerequisite for EPAs, while the EU does not. As it currently stands, the regional free trade areas among the respective groups of ACP countries will be far from finished if EPAs are concluded in 2007.

Another complexity is the issue of configuration. An EPA negotiation is complex in itself as it should match offensive and defensive trade interests of both sides. But in addition, national priorities have to be combined with a regional consensus within the ACP

³ Currently, PTA among developing countries fall under the WTO enabling clause, whereas agreements between developed and developing countries have to comply to the rules of Article XXIV.

negotiating group. Within several of the groups some member states are bound in a customs union (CU) while others in the same group remain outside this CU. Contributions to the regional negotiating consensus on trade matters has to be reached together among the CU member states as they have a common external tariff. This is the case for UEMOA within the West African group and for the Southern African Customs Union (SACU) within the Southern African group. The problem becomes quite complex when member states of a CU negotiate in different groups which is the case of the East African Community (EAC). Here, Tanzania negotiates in the Southern African group while Uganda and Kenya in the Eastern African group. In the Southern African group, the problem is also evident as the dominant partner of SACU, South Africa, is not part of the negotiating group as it has already concluded its own free trade agreement with the EU (a solution to this challenge may soon be apparent as South Africa may be in the process of changing its status as observer in the Southern African group to a full negotiating member). As the EU has agreed in article 37.5 of Cotonou that ACP countries are free to decide on membership of a negotiating group, its interventions are limited to behind the scene discussions with leaders and stakeholders in the concerned states.

A further complication is the distinction between LDC and non-LDC member states within negotiating groups. Most negotiating groups have member states belonging to both types of developing countries. Every EPA-negotiating LDC has obtained the so called everything but arms (EBA) concession from the EU, together with all non-ACP LDCs. This puts these countries in a different position to non-LDC countries that are trying to negotiate an EPA. EBA promises duty free, quota free (DFQF) entry into the EU market for nearly all products originating in LDCs. The effect is divisive within negotiating teams as LDC member states find themselves in a much more comfortable position in terms of market access to the EU and in no need to discuss trade concessions to the EU. Combined with the configuration issue, matters can become extremely complex.

If most LDC countries opt for an EPA instead of the EBA, it may be for the 'wrong' reason. Given that most of the aid flows will be marked as aid for trade in the context of

an EPA, countries that contemplate the EBA route fear that this strategy will reduce their potential for aid. Also the rules of origin for EBA are more restrictive than for Cotonou. Hence, many LDC countries see the trade-off as between the costs of reciprocity versus the non-reciprocal EBA and the benefits of qualifying for EU aid. Clearly, if the aid component and rules of origin of the Cotonou agreement remain intact for non-EPA members, many LDCs may switch strategy.

The same type of argument holds true for the non-LDC countries. If reciprocity within the EPA would erode the competitiveness of certain important sectors too much, abstaining from the EPA would 'condemn' such countries to the GSP-system. This would severely erode their preference margin and they would have to compete with countries that have a significantly higher level of economic development.

Finally, the question remains what is the future of Cotonou when 6 EPAs are signed? The agreement itself was signed in 2000 with a validity of 20 years and beyond its trade paragraphs - which will be without substance once EPAs come into effect - there are many others aspects of association such as political dialogue, development finance support and technical cooperation. Will the political desire to keep together all ACP countries continue to exist after the signing of the EPAs? There are in principle 12 more years to consider whether this is the case, corresponding more or less with the anticipated transition period for EPA adjustments and breakdown of tariffs against the EU. Most ACP states have created new institutions such as the African Union (AU) and the idea of grouping former colonies could cease to be relevant. Curiously enough, 2 North-South organisations created respectively by the UK and France (the Commonwealth and the Francophonie) are closely associated with the EU in the preparation phases of EPAs, including the distribution of funds for research and capacity building through them.

Economic effects of EPAs

As it stands, in 2008 the EPAs will trigger a slow but unprecedented move towards free trade within developing countries and with the EU. Many fear that this puts economic

development in jeopardy. As always, to neo-classically schooled economists the resistance to free trade sounds odd. Basic economic theory argues that liberalization induces two efficiency gains. First, as the price of imported goods declines, real incomes rise. What is often less well understood however, is that this effect also theoretically nullifies the argument that trade liberalization causes a loss in government revenue . If a country is small and, hence, there are no terms of trade gains from protection, domestic consumers pay the tariff for exporters to their own government in the form of higher prices. Therefore, as long as the good is imported, consumers gain more from the reduction in prices than the government wins. For this reason, a domestic lump sum tax should counter the revenue loss, while leaving the price mechanism to freely allocate goods. But clearly, when tax reform is not part of the agenda, reciprocal trade liberalization will transform public income into private income. Then, if public goods - because of externalities - create a higher social surplus than private consumption, trade liberalization entails a social welfare loss.

A second efficiency gain that could potentially follow trade liberalisation is that lower prices for imports make production of some goods at home wasteful in economic terms. Why spend more on domestic resources to produce something than is needed to buy the good on the world market? This brings about production loss in such sectors counting as an efficiency gain. However, this efficiency gain presumes that factors of production that flow out of the import competing sector find employment in sectors in which the country has a comparative advantage. Often, this assumption is not satisfied, certainly not in the short-term. For example, EUROSTEP (2004) estimates that 75% of industries in Ghana will disappear following an EPA with the EU. It therefore follows that when trade liberalization is not well synchronized with adjustment policies, in the short-term, it may create serious unemployment and social unrest.

In addition, the efficiency gains in production and consumption leave open the question as to whom these benefits would accrue. With respect to the consumption benefits, lower prices raise real income of citizens who can afford to buy imported goods. Often in developing countries, these citizens belong to the relatively high income classes.

Therefore efficiency gains in production only accrue to workers when they see their rising productivity in sectors that have a comparative advantage rewarded with a higher wage. However, when labour is not well organized and labour markets uncompetitive, the benefits are likely to end up in the pockets of domestic and foreign capital owners.

Moreover, the static production effects are often seen as unimportant relative to the dynamic effects of trade liberalization. It is argued that comparative advantages are dynamic and to some extent can be created by government intervention. The reason for this is, that when trade is liberalized without policy intervention, developing countries would specialize in the 'wrong' products that have low profitability in the long-term and have volatile prices for their agricultural products and natural resources. Hence, EPAs that liberalize trade may undo industrialization efforts in many LDCs.

Deindustrialization can have severe consequences for ACP countries. Following the endogenous growth theories (Romer 1990), industrialization is seen as an important element in development, as a large share of income growth per capita comes from productivity growth. Productivity growth in developing countries may primarily occur in manufacturing sectors, however, also important are spill-overs from industry to agriculture (Greenwald and Stiglitz 2006). The basic trade-off with respect to trade liberalization is that on the one hand, reducing barriers would reduce production of existing infant industrial sectors that in the long-term would create value based on comparative advantage. On the other hand, however, trade liberalization may trigger vertical FDI and increased production of multinationals which in turn could have a positive spill-over effect on the local economy (Grossman and Helpman 1991).

Following the extensive trade liberalization programs in the 1980s and 90s supported by the World Bank and the IMF under the Washington Consensus, a number of academic papers find evidence that trade liberalization results in growth in per capita income (Dollar 1992, Edwards 1993, 1998). However, in a critical review of the most influential papers, Rodriguez and Rodrik (2001) demonstrate that the beneficial effects of trade liberalization are far from robust.

In a recent study that explores own data as well as the state of the trade and growth literature, the World Bank (2006) summarizes the current convention that trade liberalization has a significant though small positive effect on economic development. It is important to note that to date there are no papers that find a systematic negative effect of trade liberalization on economic development. Moreover, of the success stories of economic development, none of the countries has a closed trade regime. However, to implement free trade in developing countries is not a binary choice, and most countries that are classified as having an open trading regime have moderate levels of trade protection in many sectors. Hence, although there is some evidence that trade liberalization supports economic development, this does not imply that free trade is optimal. Consequently, as the preferential trade agreements introduce a high level of free trade in developing countries, the effects of this are untested.⁴

The specific problem of PTAs is that they introduce *preferential* trade liberalization in contrast to multilateral trade liberalization. This gives rise to the well known effects of trade diversion and deflection. Given that consumers pay the tariff to their own government so that these cannot be viewed as a social loss, when trade diverts to less efficient producers (car producers from the EU when compared to those in, for example, Korea), consumers simply pay more for the same type of products. Therefore, when trade creation of a PTA is likely to be small – as in the case of the ACP-countries with the EU – the net welfare effect is likely to be negative because of the trade diversion effect.

To counter the trade diversion argument, the EU claims that already a large share of the imports of ACP countries comes from the European countries. This may be so, but, in the future, trade with China and India will become more important when ACP incomes rise and citizens start to spend a higher share of their income on manufactured goods and services.

⁴ One example may be the effects of the NAFTA-agreement. The consensus view is that after a start of Maquiladores, Mexico is catching up in living standards.

Some empirical studies have been conducted to investigate the economic effects of EPAs on developing countries. Tekere and Ndlela (2003) analyze the potential effects of an EPA for the Southern African Development Community (SADC) countries and find that the majority of consumers would have net benefits of reciprocal free trade. A study by COMESA (2002) finds a small overall negative effect for its members. Both studies find a significant loss in government revenues. The COMESA study finds a loss of 25% of trade taxes for its members. Tekele and Ndlela find a reduction of 37% for Tanzania. Busse et al. (2004) investigate the effects for ECOWAS and find that the effects of an EPA are unevenly distributed over the members, where Cape Verde loses 80% of its trade taxes and 20% of government revenue. Hence, free trade will entail a significant redistribution away from public goods towards lower consumer prices.

In addition, although the EU is by far the largest trade partner of most ACP-countries, the trade diversion effects would be more than negligible. Meyn (2004) analyzes the effects for Botswana, Mauritius and Mozambique and finds that the trade diversion effects are likely to dominate the trade creation effects. Busse et al. (2004) also find significant diversion effects for the ECOWAS region. These problems are confirmed in two extensive surveys on the impact of EPAs in ACP countries. Price Waterhouse Coopers (2005) find that asymmetric liberalization and substantive support packages are needed to make EPAs beneficial for ACP-countries. In a general equilibrium setting, the ECA (2005) shows that the effects of EPAs are likely to be negative for ACP-countries. However, they argue that this conclusion is dramatically reversed if indeed the EU would opt for free trade in sensitive products and abolished export subsidies.

Summing up, the bulk of the empirical studies find that, especially in the short- and medium-term, EPAs will reduce welfare in most ACP-countries. The reason is that EPAs may destroy domestic production without creating new employment opportunities and in the absence of valid social security nets to support those affected, this is a very serious issue with important political implications. In addition, because of the trade diversion effect, developing countries may end up paying more, not less for their imports.

Dynamic, institutional, and political effects

In the previous section we have argued that the gains from trade liberalization alone will have a negative effect on the economic development of ACP countries. However, it is often stated that the non-traditional and political effects of regional trade integration are more important than the static welfare gains and losses. The reason is that trade policy reform may catalyze institutional reform in general. As institutions provide incentives for economic activity, trade liberalization may be used to promote economic development.

The role of incentives has long been absent from the development debate (Easterly, 2001), however, it has returned with a vengeance. In two key papers starting the debate among economists, Acemoglu et al. (2001) and Rodrik et al. (2004) show that ‘institutions rule’ in economic development. By empirically isolating the deep determinant of economic development, they argue that geography has no ‘own’ effect on prosperity.⁵ The policy implication is that development and institutional reform are closely connected.

The challenge is that good endogenous institutions (the rule of law, property rights, markets and firms) are founded on good political institutions. Acemoglu and Robinson (2005) investigate the causes for good political institutions and find that social conflict is the main obstacle. In turn, social conflicts arise when there is unequal initial distribution of resources. The main point, however, is that the ruling class may well realize that improving economic institutions (market driven institutions, free trade, no monopolies etc.) will benefit their country. Also, in moving towards better institutions, the government has a commitment problem in agreeing to implement good policies. Nevertheless potential traders and foreign firms may realize that as soon as they accumulate resources and engage in trade, the ruling elite may be tempted to break their promises of respecting the rule of law.

⁵ However, this view is hotly debated; see e.g. Sachs (2005).

One way to make promises for better economic institutions more credible is for the national government to allow third parties, for example regional bodies, to share power. The point is that even if benevolent policy-makers try to implement good economic institutions, they may fail because of the commitments problem that inhibits them from convincing the public. Power sharing may make certain promises credible and trigger economic activity. Regional political cooperation therefore may prove an important tool for economic development.

In addition, with respect to how trade itself can influence such core determinants of economic development, the question really is how trade can improve economic institutions through better (regional) political institutions. On the one hand, trade liberalization and increased cooperation can result in mitigating social conflicts as it helps to create a new urban middle class. Over time, this may result in power sharing by elites and better rule of law to secure industrial and other property. On the other hand, there is growing evidence that basic institutional conditions should precede trade liberalization. Hence, sequencing is important. A basic system of property rights, rule of law and transparency in the legal political process should be in place and enforced before trade liberalization is allowed to do its work. Following that, over time trade will strengthen domestic political institutions by providing incentives for the elite and the trading class to share political power.

The connection between reducing barriers to trade and financial liberalization is often discussed. There is considerable support suggesting that financial liberalization is a prerequisite for trade liberalization to have a positive effect on development. The theoretical foundation for this finding is also strong, as trade liberalization entails creative destruction so that new industries have to be set up. Financial development (banks, capital markets) is therefore needed for trade reform to shift economic activity to the use of comparative advantage (Stiglitz 2002). However, as Rajan and Zingales (2003) argue, finance tends to follow trade, not the other way around. Consequently, policies that actively promote financial development before trade liberalization may be needed. One implication is that the EPAs should speed up financial services liberalization, promote the

presence of banks and support microfinance before trade is liberalized. Often, in FTAs among developed countries, liberalization of services is saved for last. However, this does not seem to be the right sequence for North-South FTAs, as the financial service sectors in most developing countries need reinforcement.

Within developing countries there is a legitimate scepticism towards the emphasis on the importance of institutions. It is often argued that the developed countries have created and supported bad institutions and governments for decades to foster their own interests. So, why should recommendations to create better institutions from these countries be credible? Why not let developing countries freely decide on which institutions work best for them? To avoid these criticisms, it is essential that trade reform is supported by a bottom-up process achieved by promoting the role of civil society in the process. For example, trade agreements can clarify and strengthen the role of private actors in the negotiations. In addition, trade agreements can promote the organization of labour and support labour rights, so as to ensure that the benefits from the comparative advantage in developing countries accrue to workers.

A very important area where the rule of law matters is vertical FDI and outsourcing. The main benefits of the EPAs may result from recognizing that much of the increase in world trade comes from vertical specializing across countries, as much of trade can be accounted for by intra-firm dealings that result from vertical FDI and outsourcing/offshoring (Spencer 2005). The two drivers are China for manufacturing and India for services, but other countries have also seen a sharp increase in the exports of intermediate goods. Hence, the increase in openness of countries has not been driven primarily by lower barriers to trade, but by attracting investment and outsourcing contracts.

A burgeoning theoretical literature investigates what triggers vertical specialization of countries and increased intra-firm trade (Antras 2003, Antras and Helpman 2004, Grossman and Helpman 2002, 2005). These papers point to the importance of reduced contract imperfections for FDI and outsourcing. Because the legal environment in developing countries improves and (intellectual) property rights are more secure,

multinational firms make better use of the comparative advantages of developing countries by outsourcing labour intensive part of the production process. Consequently, as investment and supply contracts are key to trade, emphasis has shifted from reducing protection towards improvement of domestic regulatory standards as a tool for development through trade.

This idea meets much scepticism in some developing countries. For example Mbaye (2005) argues that the overemphasis of the EU on rules for investment and the Singapore issues will result in the stealing of African resources by EU multinationals. Again, this is a legitimate concern that has to be assessed by all parties. However, given the experiences in Asia, this may simply be a stage that ACP countries have to go through to build (human) capital themselves. The sharp rise in economic activity through outsourcing in Central Europe that followed from regulatory reform in the 1990s may serve as an example.

Deepening the Economic Partnership Agreements

Given the limited amount of time for the EPAs to be concluded and the priority for the EU to make them WTO compatible, the introduction of reciprocal free trade will form the cornerstone of the agreements. The question therefore arises as to how the EPAs can be improved upon after their conclusion. The discussion above offers ample suggestions.

A first consideration is that the EPAs should support multilateral free trade in addition to reciprocal free trade. When working on the reduction of protection in ACP-countries, the EU should press for multilateral reductions in the level of protection, so as to avoid the harmful effects of trade diversion. Also, when funds are available for capacity building in ACP countries, these should be used to support trade departments that deal with both EPA and WTO issues as is already the case in Tanzania.

Second, both the EU and ACP countries should realize that regulatory and institutional reform is crucial to attract economic activity. At the moment, the discussion is polluted

by the fact that all issues that refer to regulatory reform are stigmatized by referring to the Singapore issues. Clearly, developing countries are right to use these issues as a bargaining chip in the WTO so as to increase market access into developed countries. However, it seems that many developing countries (supported by NGOs) see improvements in competition law, reduction in corruption (this is essentially what is meant by 'trade facilitation') and (intellectual) property rights as intrinsically risky areas given their lack of capacity to implement. However, instead of focusing on the Singapore issues, the incentives for regulatory reform may be better stimulated by using a bottom-up approach, for example by seriously including in the discussion civil society in ACP countries and multinational firms from the EU.

With respect to this last point, when regulatory reform is meant to attract FDI and outsourcing, the EPAs should again make sure that the benefits are multilateral, so as not to discriminate against non-EU firms. For this, it is crucial that the rules of origin requirements of the EPAs are not too stringent. Currently, the EU aims for 50% of value added. Clearly, such a high level reduces the attractiveness of ACP countries for FDI from China, India and Brazil. Aid policy that supplements the EPAs should take account of the increased role of vertical specialization. Antras (2006) shows that in the absence of (intellectual) property rights, production in only later stages of the product cycle are shifted towards developing countries. The reason is that production in those stages is marked by a high degree of standardization, so that property rights are relatively unimportant. Hence, to make ACP countries attractive, not only do they have to improve their legal systems (training of judges, capacity to speed up cases etc.), but also technical skills have to be improved in order to attract more medium skilled jobs in manufacturing.

Furthermore, the EU should realize that trade liberalization on economic grounds is only justified in the absence of market distortions. It is clear that when EU production is subsidized or excesses dumped, prices do not reflect comparative advantage. Hence, in that case free trade distorts the allocation of resources. The EU tends to belittle such claims by arguing that the majority of exports to developing countries are industrial products. However, the EU should recognize that cases such as the infamous tomato

paste and chicken parts rows in Senegal and Ghana attract wide-spread attention in the developing world and are easily generalized. It is therefore important that the EU commits to the phasing-out of agricultural subsidies within the same time-frame as the EPAs will achieve reciprocal free trade.

A last, non traditional gain, that can be obtained from the EPAs is in the migration debate. Leaders from more than 50 European and African nations gathered in Morocco in July 2006 in order to tackle illegal migration. All countries wish to find solutions for the dramatic effects on mostly young migrants from especially West Africa of illegal border trespassing. Migration is not a trade matter but there are opportunities hidden in the WTO Services Agreement that can be used by EPA negotiators to mitigate the effects and change the tide. The so called Mode 4 of GATS (though no agreement has been reached in the Doha Round) allows temporary movement of national persons and this could very well been used by negotiators to obtain concessions from EU in terms of accepting well organised groups of temporary workers in certain areas, especially when there is a common strategy as was confirmed in Morocco.

Conclusion

The major issue discussed in this note is if and how economic partnerships between EU and groups of ACP countries will become tools for economic development rather than simple trade rearrangements useful for the EU to obtain WTO compatibility for its trade regimes with ACP countries. If the EU, notwithstanding firm declarations from its Trade Commissioner, would wish only to preserve its special trade regimes with former colonies while making them reciprocal, then it misses the core challenge. The reciprocity issue is the specific short-term reason why negotiators have to hurry as the waiver expires at the end of 2007, but the development debate is the core issue.

The profound disappointment expressed by some ACP negotiating teams as confirmed recently in Nairobi at the April 2006 meeting of the AU Ministers of Trade, should be taken seriously and is in sharp contrast with the reassuring talk by the EU Commissioner

of Trade and the Commissioner for Development as well. EPAs should become instruments to tackle supply side constraints in developing countries, to reduce agricultural subsidies inside the EU, to support regional integration mechanisms as they are organised by the member states themselves, and to increase temporary access for natural persons according to mode 4 of the GATS.

What is at stake is not so much the short-term view of signing EPAs but the long-term redirection of European cooperation with its former colonies and with other developing countries as well. In order to be really beneficial and welfare enhancing and based on equality the EPA agreements should be as difficult to accept by the EU as they will be hard to accept by the respective ACP partner countries.

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