

Acknowledgments



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Abbreviations and Acronyms

ACP	Africa, Caribbean, Pacific (group)
CET	Common External Tariff
COMESA	Common Market for Eastern and Southern Africa
CTN	Common Tariff Nomenclature
CU	Customs Union
DRC	Democratic Republic of Congo
EAC	East African Community
EBA	Everything But Arms
EC	European Commission
EDF	European Development Fund
EPA	Economic Partnership Agreement
ESA	Eastern and Southern Africa (region)
EU	European Union
FTA	Free Trade Area
GSIM	Global Simulation Model
GSP	Generalised System of Preferences
HS	Harmonized Commodity Description and Coding System
IDS	Institute for Development Studies
IGAD	Inter-Governmental Authority on Development
IOC	Indian Ocean Commission
LDC	Least Developed Country
MFN	Most Favoured Nations
NEPAD	New Partnership for Africa's Development
ROW	Rest Of The World, The
RTA	Regional Trade Arrangement
WTO	World Trade Organization

Revenue Impacts of the Economic Partnership Agreement Between the European Union and Eastern and Southern African Countries



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Abstract

This paper seeks to provide empirical estimates of the potential revenue impact on ESA countries of trade liberalisation under the proposed Economic Partnership Agreement (EPA) between the European Union and 16 Eastern and Southern African (ESA) countries. It assesses the impact of the EPA in line with the COMESA Customs Union Road Map, which sequentially implies the existence of a COMESA Customs Union prior to the EU-ESA Free Trade Agreement. The paper uses 2003 trade and tariff data to simulate the revenue effects.

The results clearly show that the impact of the EU-ESA FTA on revenue would be largely negative, but to varying degrees depending on the extent and sequencing of tariff reduction. The potential revenue losses would be mitigated somewhat once adjustment is made for the formation of the Customs Union, proposals for which could entail the complete removal of tariffs on capital goods and raw material. Hence the sequential approach demonstrated in the paper implies that the EU-ESA FTA will cause tariff changes and potential losses in mainly the intermediate and finished products, as capital goods and raw materials from all sources will have already been adjusted to zero at the stage of implementing the Custom Union.

The paper finally considers the issue of which products not to liberalise (or exclusions) and their shares of total revenue, using different assumptions of what “substantially all trade” means.

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1.0 Introduction



Sixteen African countries collectively known as the Eastern and Southern African (ESA)⁵ Group (belonging to the Common Market for Eastern and Southern African (COMESA) regional grouping) have committed themselves to negotiate an Economic Partnership Agreement (EPA) as a Group, with the European Union (EU). In the negotiations, the EU will most likely have a significant edge because its member countries intend to negotiate as a bloc and will be backed by a powerful, well-informed and legal bureaucracy looking after their interests. Clearly, the ESA countries recognise that EPA trade negotiations, given the anticipated benefits, will require considerable negotiation skills and reliable information.

It is widely acknowledged that EPAs could potentially impose deleterious effects on some economies and regions in that, while benefits are generally expected from the EU-ESA EPA, harmful side effects, including adverse revenue impacts, could similarly happen. This is particularly possible for the ESA countries as tariffs are an important source of fiscal revenue.

The COMESA Secretariat, which is the lead regional organisation, working together with East African Community (EAC), the Indian Ocean Commission (IOC) and the Inter-Governmental Authority on Development (IGAD) in supporting the ESA EPA negotiations, commissioned this study so as to provide information about the potential revenue impact on ESA countries of trade liberalisation under the proposed EU-ESA EPA. Among other things, the study specifically seeks to examine: the fiscal implications of the EPA that will establish the Free Trade Area (FTA) between the EU and ESA; and the fiscal implications of the COMESA Common External Tariff (CET) for ESA countries.

The study uses a partial equilibrium global simulation model (GSIM) with multiple regions and imperfect substitutes in world trade. The model is calibrated with trade and tariff data from the COMESA Eurotrace and UNSD COMTRADE datasets in combination with data on elasticities from other official sources. Various EU-ESA FTA sequencing scenarios are explored.

The study makes several important observations about the potential revenue impact of the EU-ESA EPA.

The rest of this report is organised as follows: Section 2 provides a detailed background exposition of the envisaged EPA between the EU and ESA; Section 3 states the objectives of the study; in Section 4, the structure of trade between the EU and ESA countries is considered; in Sections 5 and 6, the COMESA Customs Union and CET, and the tariff and revenue aspects, respectively, are briefly discussed; Section 7 discusses the methodology, including the model, data description, model sequencing strategy and study limitations; Section 8 presents and discusses the results; and Section 9 offers the conclusion.

⁵The 16 countries are Burundi, Comoros, DR Congo, Djibouti, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Rwanda, Seychelles, Sudan, Uganda, Zambia and Zimbabwe



2.0 Background to the ACP- EU Agreement

The negotiations on Economic Partnership Agreements between Africa, Caribbean, Pacific (ACP) countries and the European Community were launched in Brussels on 27 September 2002. The Cotonou Agreement provides for the basic procedures of the negotiations, including that EPAs entering into force by 1 January 2008 at the latest.

The first phase of the negotiations took place at an all-ACP-EC level and addressed horizontal issues of interest to all parties. On 2 October 2003, the ACP Council of Ministers and the European Commission (EC) Commissioners for Trade and Development declared that the results of the first phase had been satisfactory with regard to the high degree of convergence reached. They adopted a Joint Report on the all-ACP - EC phase of EPA negotiations, which serves as a point of reference, and provides guidance, for the negotiations between Eastern and Southern Africa and the EC.

Based on the Cotonou Agreement and the outcome of the first phase negotiations, both the ESA Group and the EU agreed that the overall objectives of the ESA-EC EPA will be the sustainable development of ESA countries, their smooth and gradual integration into the global economy and the eradication of poverty and disease. More specifically, the ESA-EC EPA will promote sustained growth, increase the production and supply capacity of the ESA countries, foster the structural transformation of the ESA economies and their diversification and support regional integration initiatives in the ESA Region.

In addition to the activities outlined in Article 37.3 of the Cotonou Agreement, negotiations will aim to take account of issues such as more efficient use and sustainable utilisation of natural resources.

The main principles for the EPA negotiations follow the above mentioned Joint Report on the all-ACP-EC phase and include:

- * the EPA will be an instrument for sustainable development; accordingly, the development dimension will be reflected in all areas of negotiations;
- * the EPA will support regional integration among the ESA group and will be coherent and consistent with the New Partnership for Africa's Development (NEPAD);
- * the EPA will be compatible with World Trade Organization (WTO) rules then prevailing;
- * economic and trade co-operation shall take account of the different needs and levels of development of ESA countries and that special and differential treatment should be provided to all ESA States in a way that takes due account of the vulnerabilities of small, landlocked and island countries; and
- * in accordance with Article 36.4 of Cotonou, the ESA EPA will preserve the *acquis* by maintaining and improving on the current level of preferential market access into the EC, with particular regard to the special and differential needs of least developed countries (LDCs) and preservation of the benefits of the Everything But Arms (EBA) initiative and existing preferential arrangements.

It is important to note that the WTO has granted a waiver for the Cotonou Agreement to allow for the continuation of the non preferential trade arrangements of the Cotonou Partnership Agreement. This waiver expires on 1 January 2008, at which time it is expected that the ACP countries will have concluded the FTA component of the EPA negotiations with the EU.



2.1 EPAs and Everything But Arms Initiative (EBA)

The Everything But Arms Initiative was approved by the European Union in February 2001. It agreed to the immediate elimination of all quotas and duties on all products (free access for rice, sugar and bananas will be introduced after a transition period) except arms and ammunition imported into the EU from the world's Least-Developed Countries (LDCs). The ACP LDC countries have, in general, welcomed the EBA initiative. There is, however, a concern in some countries that it will make it more difficult to negotiate regional EPAs since allowing better access into EU markets for LDCs compared to developing countries may reduce the interest of LDCs to join with other developing countries in a regional grouping to form an EPA. This is because all LDCs now have duty-free access into the European market and, if an LDC prefers to opt for a more shallow form of integration with the EU (a Generalised System of Preferences (GSP) rather than a negotiated trade agreement), this improved market access, coupled with resources provided under the European Development Fund (EDF), may satisfy the trade relation requirements of the LDC with the EU. If this is the case, there may be little incentive for LDCs members to enter into regionally based EPA negotiations with the European Commission. In this regard, the EU has already accepted that the LDCs will not experience a decline in trade preferences even in the event that they do not negotiate an EPA. This is one of the major challenges of EPAs - how to make differentiation for some countries compatible with the reinforcing and consolidation of the regional integration processes.

There are, however, a number of important reasons why LDCs may want to join the EPA negotiations, including the fact that an EBA is an EU unilateral initiative and, as such, could be unilaterally removed without negotiation or notification and that the Rules of Origin under the Cotonou Agreement, and probably under EPAs, if successfully negotiated, are less restrictive than for EBAs, which are GSP Rules of Origin.

Another major difference between the EBA and the EPA is that EBA is non discriminatory as its preferences are accessible to all LDCs without reciprocity, while EPA is only accessible to ACP countries and reciprocity will occur.

2.2 Challenges of the Proposed EPAs

Some of the challenges the ACP countries may face as a result of the EPA are not fiscal in their nature. These challenges are:

- i. De-industrialisation of ESA states;
- ii. Adjustment costs;
- iii. EPA may overshadow the other regional integration programmes in Africa;
- iv. Consumer and producer effects;
- v. The problem of overlapping and conflicting Regional Trade Agreements (RTAs); and
- vi. The non-EU countries to face reduced market shares in Africa.

Bearing these challenges in mind, as well as the concerns among ESA countries regarding the possible economic implication of the envisaged EU-ESA EPA, it is important to gauge from an empirical perspective the potential impact of the EPA. Therefore, towards informing ESA trade policy about the implications for ESA countries of trade liberalisation, this study assesses the revenue impact of establishing an EPA between the EU and ESA group.



3.0 Objectives of the Study

This study seeks to establish the potential revenue impact on ESA members of trade liberalisation under the proposed EU-ESA EPA. Specifically, the study seeks to explain:

- * the fiscal implications of the FTA component of the negotiated EPA between the EU and ESA on ESA countries; and
- * the potential combined fiscal implications of the COMESA Common External Tariff (CET) and the ESA-EU EPA on the ESA countries.

Towards fulfilling these objectives, it is important to understand, among other things, the structure of trade between the main blocs negotiating the EU-ESA EPA. Therefore the EU-ESA structure of trade is discussed in the next chapter.

4.0 Structure of Trade between the EU and ESA Countries

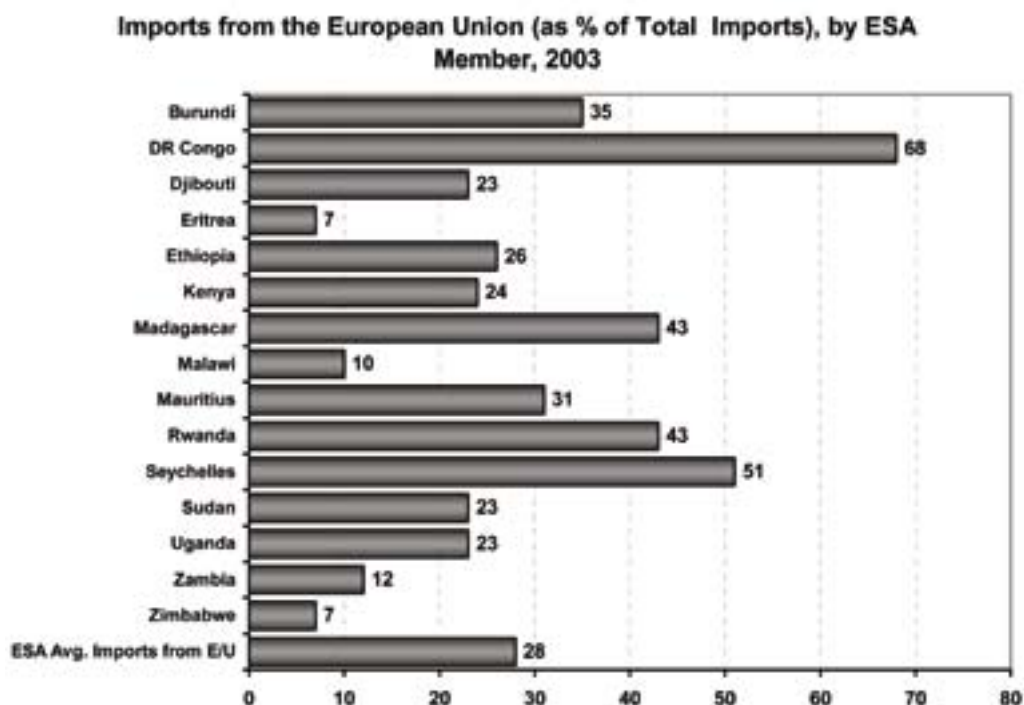


Historically, the EU has been the most important trading partner for most ESA countries. Over most of the economic history of trade between the two blocs, trade took place on a non-reciprocal basis, with the EU offering trade concessions and preferences under various agreements. The following discussion considers imports, exports and net exports of the ESA group in turn:

Taking 2003 as a base year, an annual regional average of 28 per cent of aggregate ESA imports originated from the EU (see **Fig. 4.1** below). As would be expected, at the country level within the ESA group there are significant variations in the importance of the EU as a source of imports. Four groups of countries can be identified within the ESA configuration:

- * At the one extreme DR Congo was the most heavily reliant on the EU as a source of imports in 2003, with about 68 per cent of its total recorded imports coming from there;
- * DR Congo was followed by Seychelles, Rwanda and Madagascar, which respectively obtained from the EU, 51, 43 and 43 per cent of their total imports;
- * Burundi, Mauritius, Kenya, Ethiopia, Djibouti, Sudan and Uganda imported between 23 and 35 per cent of their imports from the EU; and
- * Eritrea, Zambia, Malawi and Zimbabwe imported between 7 and 12 per cent of their imports from the EU.

Fig. 4.1: Source: Authors' own construction based on COMESA Eurotrace and UNSD COMTRADE datasets

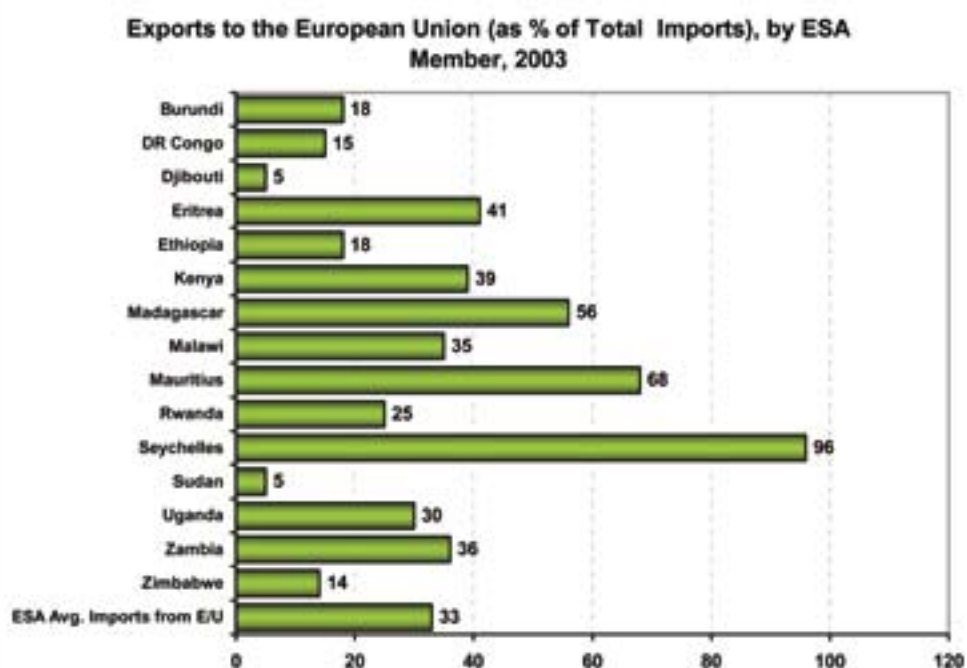




In terms of exports, a regional average of 33 per cent of the ESA group's exports went to the EU in 2003. Again, there were variations in the importance of the EU as a destination for ESA country exports. This is reflected in ESA exports to the EU as a percentage of total ESA exports, by country (see **Fig. 4.2** below). Five groups of ESA members with similar (or unique) patterns of exports to the EU are observed in this case:

- * Firstly was Seychelles, exporting about 96 per cent of its total exports to the EU in 2003;
- * Secondly, were Madagascar and Mauritius, which, respectively exported 53 and 68 per cent of their total exports to the EU in the same year;
- * Thirdly, Eritrea, Rwanda, Uganda, Malawi, Zambia and Kenya, were closer to the ESA regional average, having exported between 25 and 41 per cent of their total exports to the EU in 2003;
- * Fourthly, were Burundi, Ethiopia, DR Congo and Zimbabwe with EU-bound exports in the range of 14 to 18 per cent of total exports in 2003; and
- * Finally, Djibouti and Sudan exported about 5 per cent of their total exports to the EU. On the face of it, it would appear that the most important export destinations of Djibouti in 2003 were Ethiopia and the rest of the world (with the rest of the world comprising mainly countries in the Middle-East), respectively taking up 31 and 62 per cent of total exports. However, this has to be interpreted with caution as Djibouti is the sea outlet for Ethiopia so that export figures may in fact include trans-shipments. For Sudan, most exports (61 per cent of the total) went to China in the same year.

Fig. 4.2: Source: Authors' own construction based on COMESA Eurotrace and UNSD COMTRADE datasets

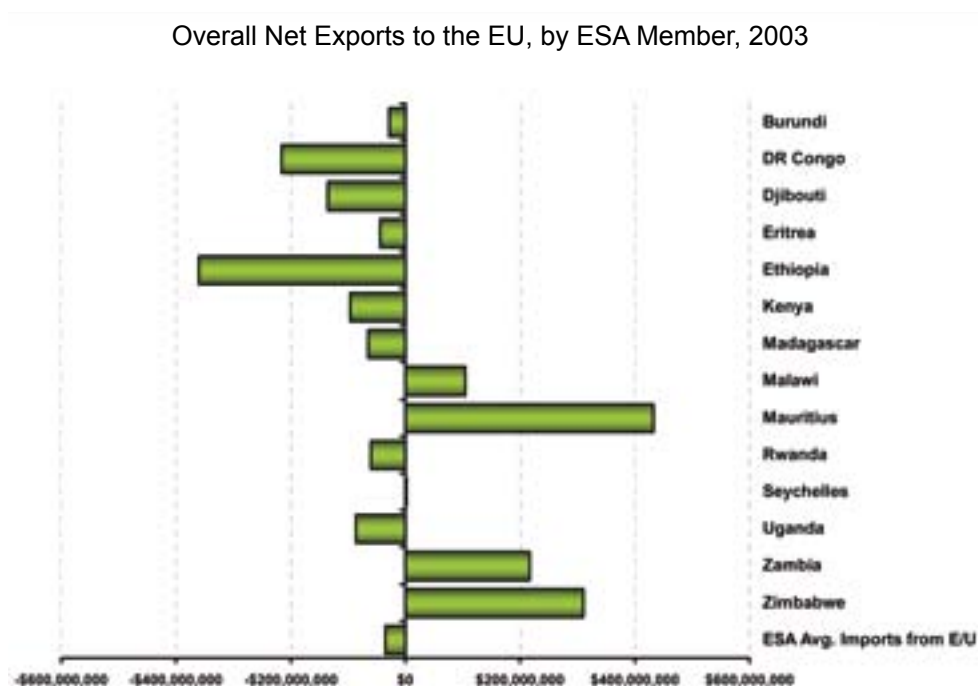


Net export positions (i.e. total exports less total imports) with the EU were worked for each ESA country for 2003. **Fig. 4.3** below highlights the 2003 trade balance positions of ESA countries with the EU. Only four of the ESA countries (Malawi, Zambia, Zimbabwe and Mauritius) recorded significant positive net export positions with the EU in 2003. Among the four countries, trade surpluses ranged from US\$ 104 million to US\$ 432 million, and for one additional member, Seychelles, a marginal positive balance of US\$ 2 million was recorded in the same year. The remaining 11 ESA countries had negative trade balances ranging from moderate deficits of less than



US\$ 100 million (among Burundi, Kenya, Eritrea, Madagascar, Rwanda and Uganda) to significant deficits of between minus US\$ 136 million and US\$ 499 million (among Djibouti, DR Congo, Ethiopia and Sudan in that increasing order) in the same year. As would be expected, the regional average net export position was a moderate trade deficit with the EU of about US\$ 35 million.

Fig. 4.3: Source: Authors' own construction based on COMESA Eurotrace and UNSD COMTRADE datasets



Beyond simply considering aggregate trade, ESA trade with the EU was disaggregated into the four Common Tariff Nomenclature (CTN) categories, these being raw materials, intermediate goods, finished goods and capital goods (**Fig. 4.4** below)⁶. In a similar way to the above analysis, the net export positions by CTN category (i.e., CTN exports less CTN imports) were determined.

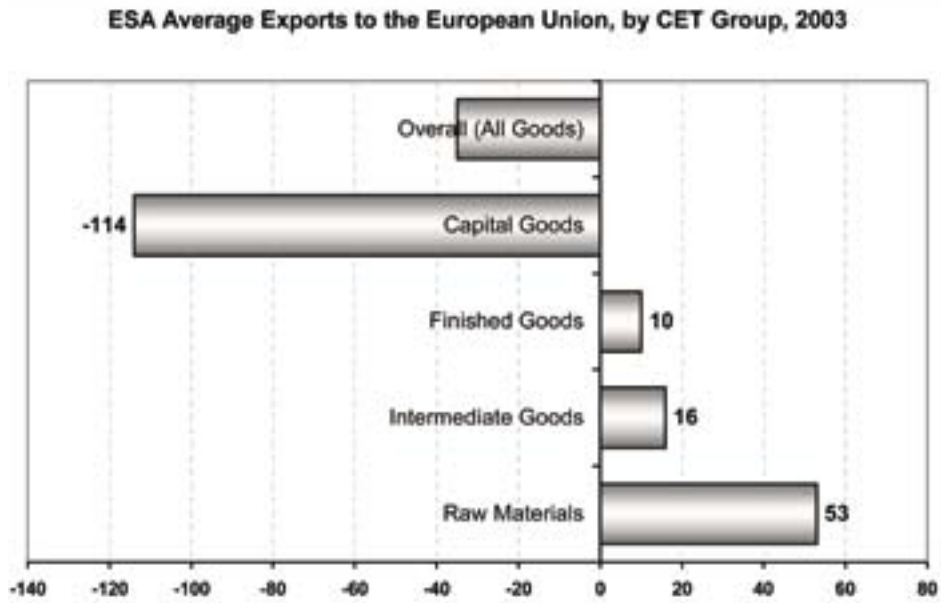
Fig. 4.4 presents a regional picture of average net exports to the EU, by CTN categories for 2003. As already noted above, overall average net exports of the ESA group to the EU recorded a deficit of US\$ 35 million in 2003. Within the overall deficit position, the net export trade by CTN category shows that ESA net exports of capital goods to the EU registered a huge negative balance (of minus 114 million) in 2003 but net exports in the other three categories were positive.

Average net exports of finished and intermediate goods to the EU (from the ESA group) recorded positive net positions of US\$ 10 million and US\$ 16 million, respectively, in 2003. Finally, the ESA group's largest positive trade balance with the EU was in raw materials where the group recorded a US\$ 53 million surplus in 2003. Ultimately, the positive outturns in the latter three CTN groups were not sufficient to result in a net trade surplus with the EU, hence the US\$ 35 million deficit overall. The observed patterns for the ESA group in 2003 lend support to the widely held view that sub-Saharan African countries' international trade achievements have mainly been in relatively low value-added raw material exports while achievements in exporting higher value-added (capital and finished) products have been rather limited.

⁶In this study, the four CTN categories are taken as the industry level of trade among the countries captured in the analysis.



Fig.4.4: Source: Authors' own construction based on COMESA Eurotrace and UNSD COMTRADE datasets



5.0 COMESA Customs Union and the Common External Tariff



As has been noted previously, all ESA countries are also members of COMESA so that what has been agreed under the Regional Trade Agreement (RTA) of COMESA should, realistically, be factored into the future ESA EPA negotiations. The COMESA Treaty provisions allow for COMESA to move from a Free Trade Area (FTA) to a Customs Union (CU) and on to a Common Market. The COMESA FTA was established in the year 2000 and has a membership of 11 countries.

At the same time as consolidating and expanding the FTA, COMESA has also agreed on a roadmap towards a CU. At the COMESA Summit meeting held in Kigali, Rwanda in June 2005, COMESA agreed to implement the CU Roadmap so as to attain a CU by December 2008.

The COMESA member states are yet to agree on the final CET harmonisation for intermediate and final goods. However the following tariff bands have been proposed and this study uses these in ascertaining the fiscal implication of the COMESA CU for the ESA countries: 0 per cent for both raw materials and capital goods categories, 10 - 15 per cent for intermediate goods and 20 - 40 per cent for finished goods.

In implementing the COMESA CU, Member States will each have to phase out the internal tariffs charged on imports from the other CU member countries. This will imply that COMESA CU members will eliminate tax charges on the corresponding imports from other Member States.



6.0 Import and Revenue Changes

The implementation of the CU will impact on COMESA ESA countries in a number of ways. The new CET tariff schedule should change domestic prices of imported goods and so affect the demand by consumers. This may also change the supply by domestic producers of such goods if there are domestic suppliers. In theory the influence of a change in Most Favoured Nations (MFN) tariffs on import demand is straightforward: if the MFN tariff is lowered, import prices decline and the volume of imports expand to a level which is dependent on the demand elasticity. On the other hand, if the MFN tariff is increased, import prices increase and imports should decrease to a level which is dependent on the demand elasticity.

The fiscal impact of a tariff reduction should depend on the size of the tariff cut, the response of importers to the tax change (demand elasticity of imports), and the relative importance of import tariff as a source of government revenue. These are exactly the aspects that this study seeks to understand in terms of the potential fiscal implication of tariff reductions for the ESA group of countries under an EPA with the EU.

The fiscal impact of a tariff reduction should also depend on what happens to other taxes and how they, in turn, affect government revenue. Consideration of the intricate interrelationships of internal taxes is however not within the scope of this study and is therefore not factored into the associated analyses.

7.0 Impact Assessment Methodology



The approach used for assessing the impact of the ESA-EU EPA on international trade (customs) revenue and so imputing fiscal implications, is a partial equilibrium methodology, which is industry focused but global in scope. The approach accounts for multilateral, regional and unilateral trade liberalisation efforts. It combines information on trade flows and trade (tariff-change) policy for CTN product categories, thus yielding information that allows policy-makers to weigh - overall and at the CTN category level - the potential effects on fiscal revenue of an EU-ESA Free Trade Area (FTA).

Partial equilibrium analysis offers some useful advantages. The analysis focuses on a very limited set of factors and so allows for relatively rapid and transparent analysis of a wide range of commercial policy issues with a minimum of data and computational requirements. It also allows for lower (HS 6-8 digit) levels of trade disaggregation. It is widely held that as long as the limitations of the partial equilibrium approach are kept in mind, useful insights can be drawn with regard to relatively complex, multi-country trade policy changes at the industry level, while avoiding the problems associated with deficient or missing data and high-level aggregations.

7.1 The Model

The model used is the global simulation model (GSIM) developed in Francois and Hall (2003): “Global simulation analysis of industry-level trade policy”. The model is a multi-region, imperfect substitution model of world trade. It is designed to require a relatively small amount of data on trade flows, export supply, aggregate import demand and substitution elasticities while still providing insight into the impact of trade policy changes on trade flows and the welfare aspects of trade and tariff revenue effects. The model is also designed to account for trade distortions such as bilateral export and domestic production subsidies.

To specifically assess the revenue impacts of trade policy changes associated with regional trade arrangements and the EPA on ESA countries, the model was modified to retain the original, relatively simple yet flexible framework while incorporating features that make it most relevant to assessing the ESA configuration. In this regard, the model was calibrated as a 23x23 GSIM configuration, including 15 of the 16 ESA countries⁷, their main trading partners (namely, USA, Japan, EU, China, India and South Africa), and the rest of the world (ROW). The modified variant of the GSIM, which retained the key features of its original form, was calibrated with data on detailed trade policy changes, tariff and trade flow data from the COMESA Eurotrace and UNSD COMTRADE datasets, and data on elasticities from other official sources.

Another important aspect of the model is that it uses trade-weighted bilateral tariffs⁸ as the input tariff data.

7.2 Data Description

For this study, the trade and tariff data used was from the COMESA Eurotrace and UNSD COMTRADE datasets. The trade data were disaggregated to the HS 8-digit level, which formed the basis of aggregation into the four COMESA CTN categories and overall (aggregate) trade. The COMESA CTN categories describe the industry level of trade. The tariff data were manipulated to derive estimates of both simple arithmetic average and trade weighted tariff rates at the CET level⁹.

⁷Comoros was excluded from the analysis owing to constraints imposed by missing tariff data while Djibouti is selectively represented because it does not apply customs duties on imports. Instead it applies a “taxe Interieure á la consommation”, which this study felt was not appropriate to treat as a customs duty, meaning that Djibouti’s customs duty tariffs are set at zero. The implications of treating the country this way are explained in each relevant modelling scenario in the results section (Section 8) below.

⁸In effect, the model works with either trade-weighted or (simple) arithmetic bilateral tariffs data and the results can therefore be checked for sensitivity to changing assumptions about tariff outlooks.

⁹Only the results of the trade weighted tariff rates are reported in the results section of the study however.

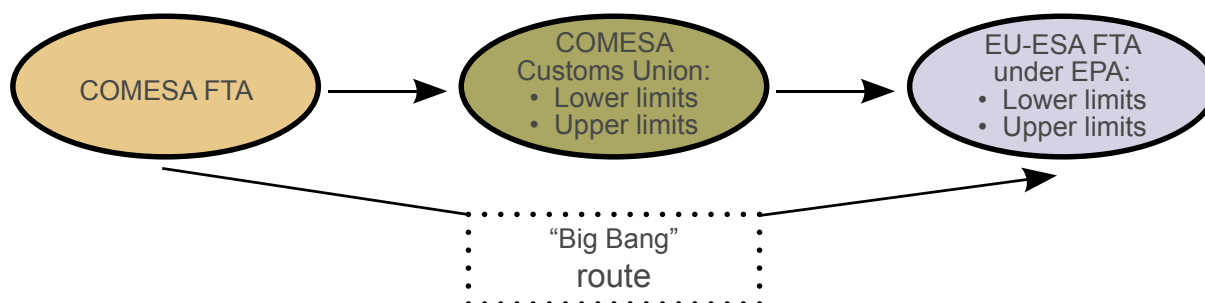


Data on composite import demand, export supply and substitution elasticities were obtained from secondary sources including Kee *et al* (2004) and Devarajan *et al* (1999). Kee *et al* provided a recent list of global estimates of import demand elasticities by country while Devarajan *et al* gave global estimates of export supply and substitution elasticity estimates.

7.3 Sequence of Tariff Revisions towards an EU-ESA FTA

In this section, the two alternative sequences of tariff revision towards establishing an FTA between the EU and the ESA are described, as illustrated in **Fig 7.1**. Broadly, the first of the two alternatives involves a one-step or “big bang” approach to tariff phase-down, as described further below, while the second alternative involves a more gradual approach to tariff reduction (the gradual approach subsumes two scenarios). These two broad alternatives were the guiding principles for calibrating the GSIM and simulating revenue impacts in the study.

Fig 7.1: Sequencing Options for the EU-ESA FTA



The assumptions about the two ways in which the tariff phase-down could be sequenced were guided by the Report of the Third Technical Workshop on the Preparations towards the Customs Union (prepared by the COMESA Secretariat) and the terms of reference of the assignment. In each alternative, the end-line of tariff reduction was zero rates on tariffs between the ESA and EU. It is important to realise that although the tariff phase-down ultimately entailed zero tariffs, the sequencing of tariff reduction and intermediate tariff levels were expected to play a significant role in influencing the potential revenue impact. It was therefore important to understand exactly how tariff revisions could be modelled in sequence in the GSIM.

Essentially the modelling first tackles the impacts of the EPA assuming that all tariffs in ESA countries go to zero immediately. This “big bang” approach entails these countries introducing zero tariffs on all categories of the CTN.

Secondly, the modelling shows the impact of introducing the CU using two possible options for CET rates. The first option represents the CU roadmap with a 10 per cent CET for intermediates and a 20 per cent CET for finished goods, while raw materials and capital goods are at a 0 per cent CET. The second option represents a Customs Union roadmap with intermediates and finished goods at 15 per cent and 40 per cent, respectively. Capital goods and raw materials remain at zero.

Thirdly, the modelling then follows a logical sequence of assessing the impact of the EPA by incorporating first the CU CET and then introducing the EU-ESA EPA. This scenario assumes the establishment of an FTA under the EU-ESA EPA, with the COMESA CU having first been established. Notice that the trade circumstance in this case would be different from the trade situation related to an FTA established through the big-bang approach.



Finally, the “big bang” approach would imply a one-step approach to tariff phase-down, which meant that it was necessary to establish an EU-ESA FTA based purely on the 2003 trade situation. This approach was used in the model simulation to give an indication of the potential impact of trade liberalisation between the two blocs in the absence of tariff reductions that are in line with the agreed COMESA Roadmap to achieve a Customs Union.

All Tariff reduction sequences were based on initial trade circumstances in which Djibouti, Kenya, Madagascar, Malawi, Mauritius, Sudan, Zambia and Zimbabwe trade under the COMESA FTA. Externally, trade was assumed take place with the EU offering non-reciprocal, free market access to ESA goods under the EBA arrangement. As indicated previously, the CTN trade categories, which were defined according to the COMESA CTN classification, describe the industry level of trade in this study.

7.4 Limitations

The GSIM, in common with most variants of the model, has a number of shortcomings, the main one being the static nature of the partial equilibrium model, which fails to take account of the dynamic effects that usually accompany changes taking place in economies as a result of policy changes.

In addition, the model, as applied in this study, does not incorporate domestic production because these data are not available for most of the ESA countries at the HS-8 digit level. This means that the extent of trade change could be underestimated in the analysis, since it does not include changes in “own trade.”

Thirdly, bilateral export and domestic production subsidies, which are meant to measure trade distortions, are not included in the current version of the model due to the lack of data on such subsidies. Thus, it is assumed that the estimated trade changes are overstated, given that only tariff barrier changes are incorporated in the simulations, and non-tariff barriers are ignored.

Fourthly, the analysis does not accommodate the wider revenue implications of country-specific internal tax structures in VAT, excise tax and other taxes that are variously applied in the ESA countries.

Finally, the trade data used in this analysis slightly understates the actual extent of trade of ESA countries with their partners in 2003 because in aggregating the data from the HS 8-digit level to the CTN level, some traded products that did not fall into any CTN classification category (i.e., were undefined according to the CTN classification) could not be added to any CTN industry type in the analysis. Such products were dropped from the final dataset, with the result that the actual extent of trade was slightly understated. This is however, a minor limitation because the number of CTN indefinable goods was a very small proportion of the total ESA trade, by CTN.



8.0 Results

The results of the study are presented in terms of the four stages of modelling and analysis listed below:

- * Impact of a “big bang” approach to establishing an EU-ESA FTA under the 2003 trade situation;
- * Impact of the COMESA Customs Union (CET) on Revenue; and
- * Impact on Revenue of the EU-ESA FTA under an EPA, with the ESA countries having established a Customs Union prior to the EPA.

8.1 Impact of a Big Bang Approach to the EU-ESA FTA

To gain insight into the potential revenue implication of establishing an FTA under an EU-ESA EPA in the absence of any harmonising of the external tariffs as envisaged in the COMESA Customs Union Roadmap, the study assesses the impact of an EU-ESA FTA based on the prevailing trade situation in 2003. The starting point in deriving the ensuing results under this first simulation - dubbed the “big bang” approach to FTA establishment - was the assumption that trade took place at 2003 levels with Djibouti, Kenya, Madagascar, Malawi, Mauritius, Sudan, Zambia and Zimbabwe conducting trade under the COMESA FTA (i.e. the 2003 status) and therefore already applying zero tariffs on goods traded amongst themselves.

In addition, the external trade circumstances in 2003 implied that the EU was offering free, non-reciprocal access of ESA goods to the EU under the EBA arrangement. This means the EU cannot - and does not in the modelling - suffer any tariff revenue losses from the new trade arrangements of the ESA group, regardless of how the arrangements are sequenced.

With the above trading circumstances in mind, the revenue impact of establishing an FTA with the EU was modelled. The results of the analysis are presented in **Figure 8.1** below.

For overall trade (i.e. all CTN categories combined) in the “big bang” scenario, the ESA region’s average revenue loss from establishing an FTA with the EU would potentially be about 44 per cent of total tariff revenue collected in 2003. Overall, with the exception of Eritrea, all ESA countries would potentially lose tariff revenue.

From the estimates, the most remarkable potential customs revenue loss would be for Seychelles which, under the FTA with the EU, would potentially stand to lose almost 85 per cent of its 2003 tariff revenue. This striking outcome is perhaps due to the fact that Seychelles is particularly heavily import dependent in all CTN classes of goods and relies considerably on the EU as its main source of imports.

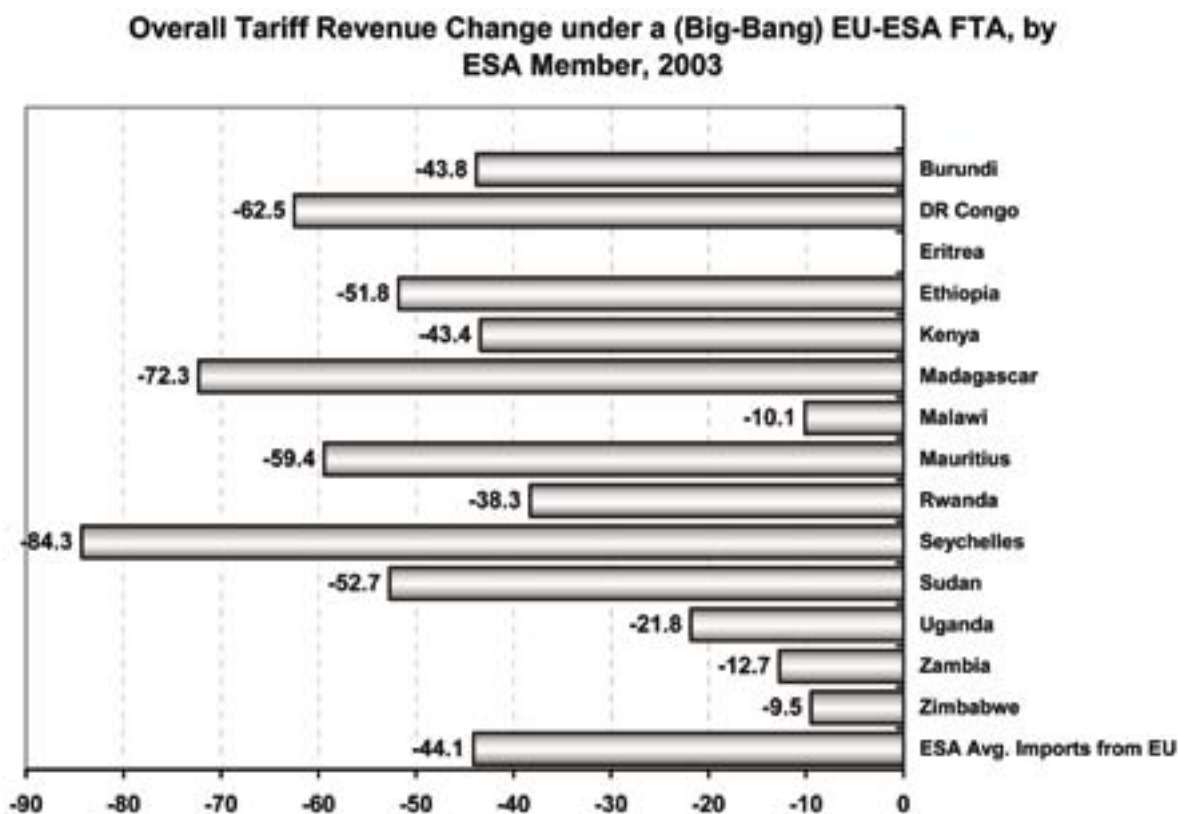
Other countries that would potentially suffer significant tariff revenue losses of between 38 and 72 per cent of total 2003 tariff revenues are Burundi, DR Congo, Ethiopia, Kenya, Madagascar, Mauritius, Rwanda and Sudan. The rest of the ESA group (Malawi, Uganda, Zambia and Zimbabwe) would potentially suffer modest revenue losses of less than 15 percent of total tariffs, assuming 2003 trade circumstances¹⁰.

Overall the estimated average tariff revenue losses of the ESA group (of 44 per cent of total regional customs revenue) would potentially be considerable under a “big bang” approach to FTA establishment.

¹⁰Notice that Djibouti is not represented in the “big bang” analysis, for reasons previously discussed (see Section 7.1). That is, the country moves from zero tariffs before the “big bang” FTA to zero tariffs under the FTA, implying that no change actually takes place.



Fig. 8.1: Source: Model Estimates



Another aspect for consideration was the revenue impact of the EPA at the industry (i.e. CTN category) level. The regional outlook of customs revenue changes, by CTN category, for the ESA bloc is presented in **Figure 8.2** below. Specifically, **Figure 8.2** summarises the regional average tariff revenue changes that would potentially happen, by CTN classification, for the ESA bloc based on 2003 trade circumstances.

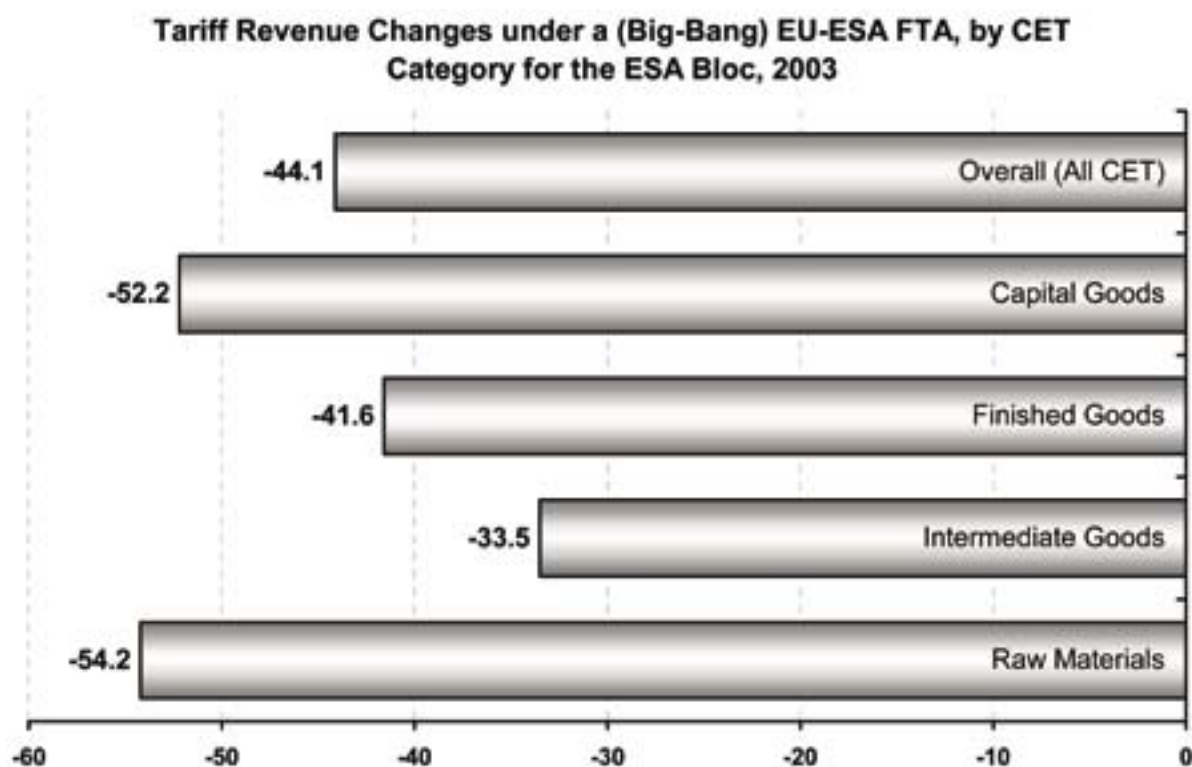
As already stated, the study estimates the potential overall tariff losses at 44 per cent for the ESA bloc. The bloc would potentially suffer tariff revenue losses across all CTN categories.

As would be expected, the largest potential revenue loss would be in capital goods because the group's highest dependency on EU imports is in that class of imports. It is estimated that the ESA would potentially lose about 52 per cent of its total capital goods revenue in 2003. The intermediate and finished goods CTN categories were also found to be associated with potentially high customs revenue losses as a result of the establishment of the FTA. The model estimates that over 33.5 and 41.5 per cent of total intermediate and finished goods tariff revenues, respectively, would be lost on a regional average basis. Raw materials imports would experience a 54 per cent loss in tariff revenue, albeit from a low base.

In summary, the analysis suggests that under the 2003 conditions of trade, the ESA would potentially suffer considerable losses of tariff revenue from establishing the EU-ESA FTA using a "big bang" strategy. Consistently, all CTN categories would potentially suffer losses at the regional level, although at varying degrees. At the country level the assessment found significant revenue losses by CTN categories (not reported here).



Fig. 8.2: Source: Model Estimates



8.2 Impact of the COMESA Customs Union Common External Tariff on Revenue

COMESA countries have committed to a Customs Union Roadmap. It is therefore logical to consider the Customs Union as a prior event to the ESA. In this section we assess the potential customs revenue impact where the COMESA countries adopt the CET under two alternative tariff revision scenarios.

The first scenario considered is the one with lower tariff proposals for intermediates and final goods of 10 and 20 per cent respectively as well as zero rating of capital goods and raw materials.

At the industry level, the implementation of the above proposal intuitively yields total losses in any existing tariff revenue for raw materials and capital goods. Gains are however, evidenced in finished goods and intermediate categories. Perhaps the most significant thing to note in connection with the overall tariff changes is that once the 100 per cent tariff revenue losses on both raw materials and capital goods (which make up the most significant parts of the total import bill) are taken into account, 5 out of the 13 countries (Burundi, DR Congo, Rwanda, Seychelles and Zambia) making gains in intermediate and finished goods, have their gains turn to overall losses. However, Zimbabwe, Uganda, Madagascar, Mauritius, Malawi, Kenya and Ethiopia also variously maintain the potential revenue gains¹¹.

On the other hand, all the rest variously suffer either modest or significant losses, except for Sudan, which just breaks even, making neither a gain nor a loss. Considering all the country gains and losses in all the CTN categories, the ESA region potentially makes a regional average gain of only 18.4 per cent of total tariff revenue collected overall.

In summary, the ESA regional average tariff revenue changes would potentially be as presented in **Figure 8.3** below:



In the second scenario of Customs Union formation (Fig. 8.4), the ESA is assumed to establish a CU implementing the upper limits of the CET tariffs proposals indicated in the COMESA CU Roadmap. Raw materials and capital goods were again both modelled at zero per cent tariff rates, but intermediate and finished goods modelled at 15 and 40 per cent respectively, in line with the upper limit of the proposed harmonised scenario.

Fig. 8.3: Model Estimates

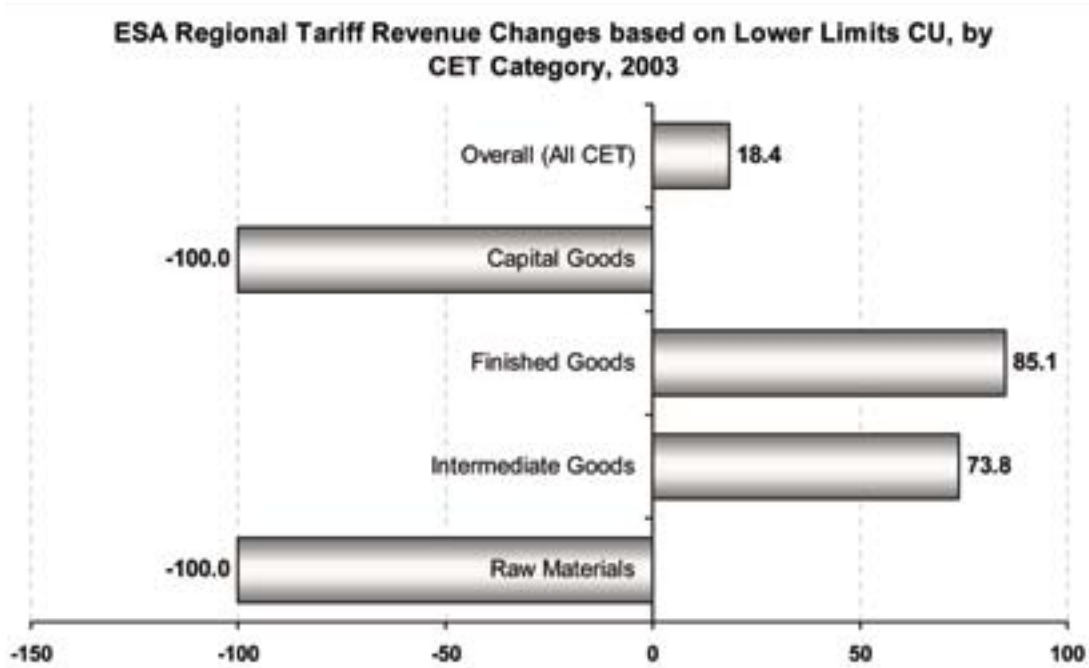
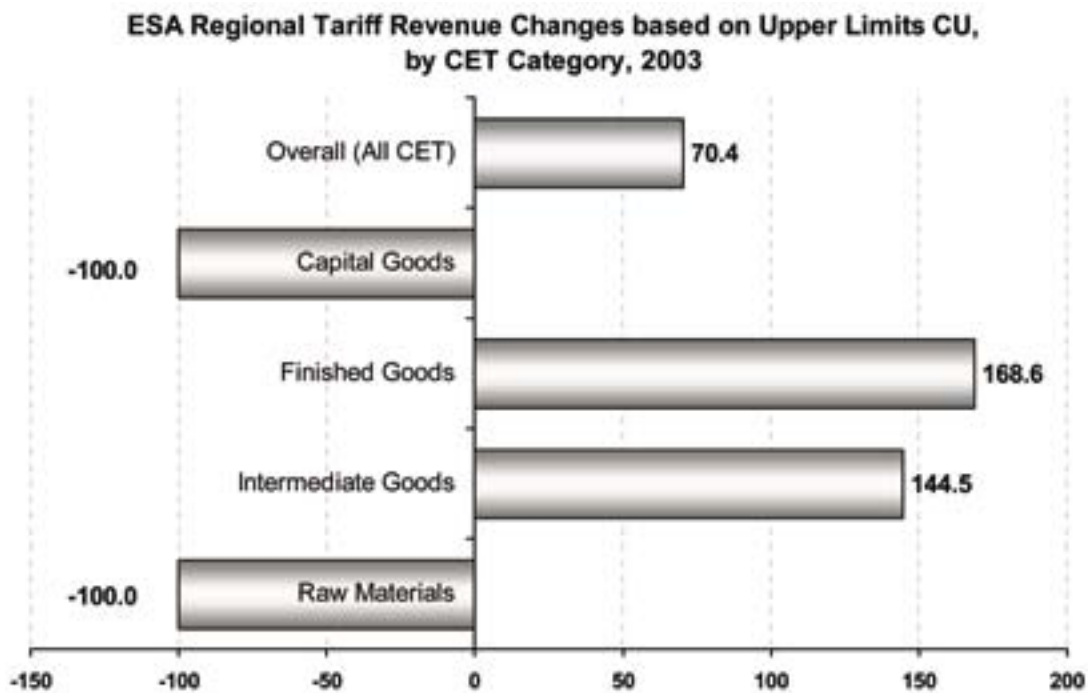


Fig. 8.4: Model Estimates





On the basis of a regional average at the industry level for the ESA group, raw materials and capital goods tariff revenues would potentially record losses of 45 and 40 per cent of their sector tariff revenues respectively. On the other hand, customs revenues on intermediate and finished goods would potentially register significant gains of 145 and 169 per cent respectively, of total 2003 collections in the CTN categories. As in the case of the lower limits scenario, the implementation of zero per cent tariffs on raw materials and capital goods intuitively means total losses in any existing tariff revenue for those classes of goods.

Ultimately, under the upper limits scenario, which applies higher positive tariff rates to intermediate and finished goods among the CET groups, the ESA regional average tariff revenue would potentially gain overall, about 49 per cent more tariff revenue than in the lower limit scenario.

8.3 Impact of the EU-ESA FTA on Tariff Revenue in a Customs Union Framework

Taking the establishment of the COMESA Customs Union as the precursor to establishing trade liberalisation in the EU-ESA FTA, second stage lower- and upper-limits scenarios, describing the potential revenue impacts on the FTA, were simulated. These are presented in turn in terms of **Figures 8.5** and **8.6**. In consonance with the previous section, the lower- and upper-limit CET harmonisation rates indicated in the COMESA Customs Union Roadmap schema are maintained, with tariff rates between the ESA and EU being set at zero.

In **Figures 8.5** and **8.6** below, the study presents the assessment's graphical results for the lower limits FTA, which applies a CET of zero per cent for capital goods and raw materials and 10 and 15 per cent respectively for intermediate and finished goods outside the FTA.

In terms of overall trade, establishing an FTA with the EU pursuant to the COMESA Customs Union would potentially result in an ESA regional average revenue loss of 21 per cent of total tariff revenue collected in 2003. Overall, all ESA countries would potentially suffer tariff revenue losses varying from modest levels (as would be the case for countries like Zimbabwe and Zambia) to significant (as for countries like DR Congo and Rwanda)¹².

At the industry level, the potential percentage losses in tariff revenue on intermediate and finished goods are estimated at 21.6 and 19.6 percent, respectively. Of course, for raw materials and capital goods, no tariff revenue changes are recorded because the CET rates on those types of goods are assumed to have been already at 0 per cent prior to the EU-ESA FTA at stage one of this analytical scenario¹³.

In the alternative upper limit FTA scenario - based on the upper limit of the CET ranges - the overall trade outlook only has negligible differences with the lower limit scenario in terms of relative magnitudes. The overall trade revenue loss from establishing an FTA with the EU pursuant to the COMESA Customs Union (applying the upper CET harmonisation rates) would potentially be marginally higher at 21.7 per cent of total tariff revenue collected in 2003, on an ESA regional average basis. This implies a differential of 0.6 percentage points between the tariff revenue losses estimated by the lower and upper limits scenarios.

When considered on a country-by-country basis, the potential customs revenue losses on overall country trade would be virtually the same in the two scenarios of tariff phase-down sequencing¹⁴. As before, Zimbabwe and Zambia maintain the potentially modest overall tariff revenue losses while DR Congo and Rwanda also retain their positions with significant potential losses.

¹²Djibouti is now included in the analysis because in both cases of moving from a Customs Union to an EU-ESA FTA (i.e., both upper- and lower limit scenarios) it is possible to talk about percentage changes for Djibouti.

¹³The study also estimates the potential tariff revenue impacts of the Customs Union lower and upper limit based FTAs at the industry level, for all ESA countries. The results on this part of the assessment are, however, not reported here.

¹⁴The results for the industry and country level analysis are not graphically presented here due to only marginal qualitative differences - of about 0.1 percentage points on average for the country level analysis - between the lower and upper limits scenarios.



Fig. 8.5: Model Estimates

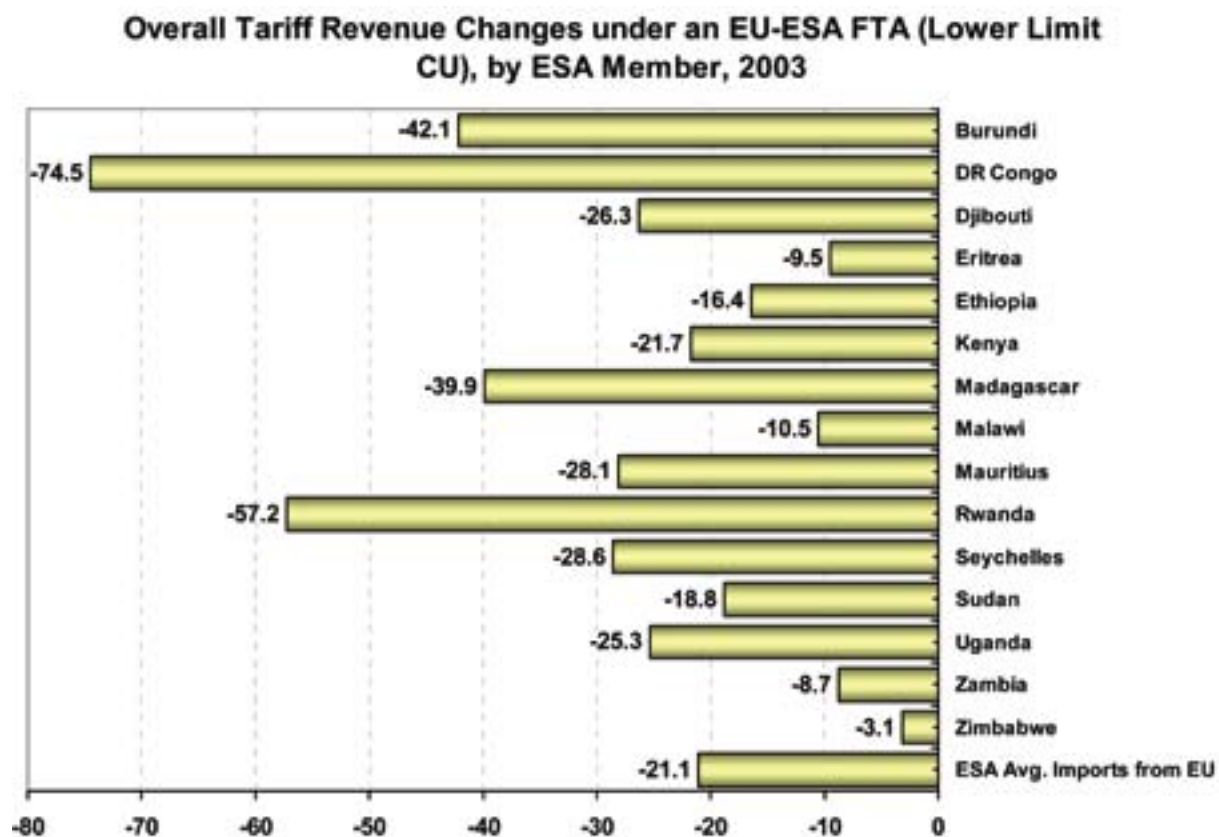
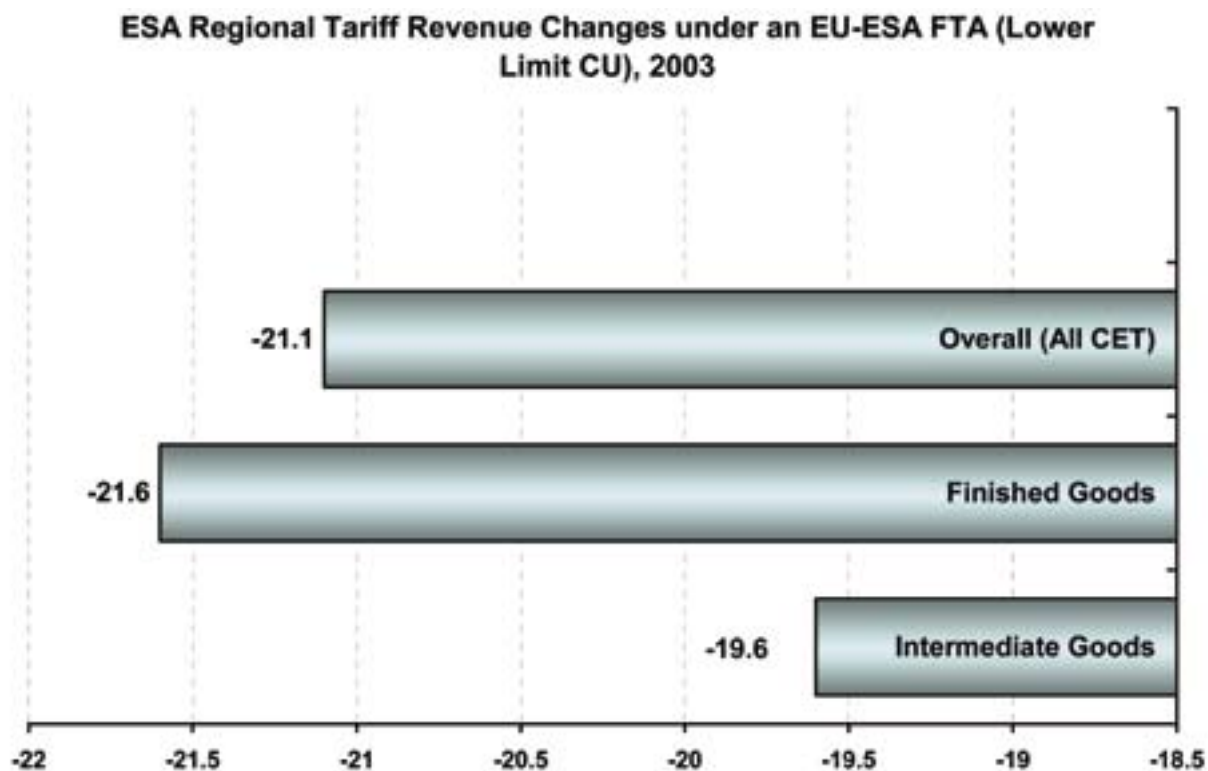


Fig. 8.6: Source: Model Estimates





Similarly, at the industry level, the potential percentage losses in tariff revenue in the four CET categories are virtually the same, differing by only 0.1 and 0.8 percentage points for intermediate and finished goods respectively. Obviously, there is qualitatively no major difference in the end line scenarios of establishing the EU-ESA FTA. However, the interim sequencing of tariff phase-down towards forming the FTA has important implications, which are discussed after the following summary of results so far.

In summary, the three separate scenarios estimating the potential tariff revenue impacts of tariff revisions for establishing free trade between the ESA and EU were captured as follows:

- * In the first instance, it was assumed that there is a “big bang” approach to establishing an FTA between the EU and ESA. In this instance, the only trade arrangements existing prior to the FTA are the COMESA FTA among the ESA countries and the EBA arrangement between the EU and some ESA countries.
- * In the second instance, it was assumed that an EU-ESA FTA is established subsequent to the formation of the COMESA Customs Union, with the CU being based on the COMESA CU Roadmap. The lower limits of the CET harmonisation rates indicated in the Roadmap were applied, which generated what the study terms the “lower limit baseline” scenario.
- * Finally, it was assumed that the EU-ESA FTA is established after the establishment of the Customs Union, but with alternative (upper limit) CET harmonisation rates being applied to intermediate and finished products. This scenario was obtained from the second baseline scenario.

In this regard, at the industry (CTN category) level, the ESA regional average tariff revenue changes that would potentially be obtained in each of the above scenarios were estimated, among other things. The results are summarised in **Table 8.1** and **Figure 8.7** below:

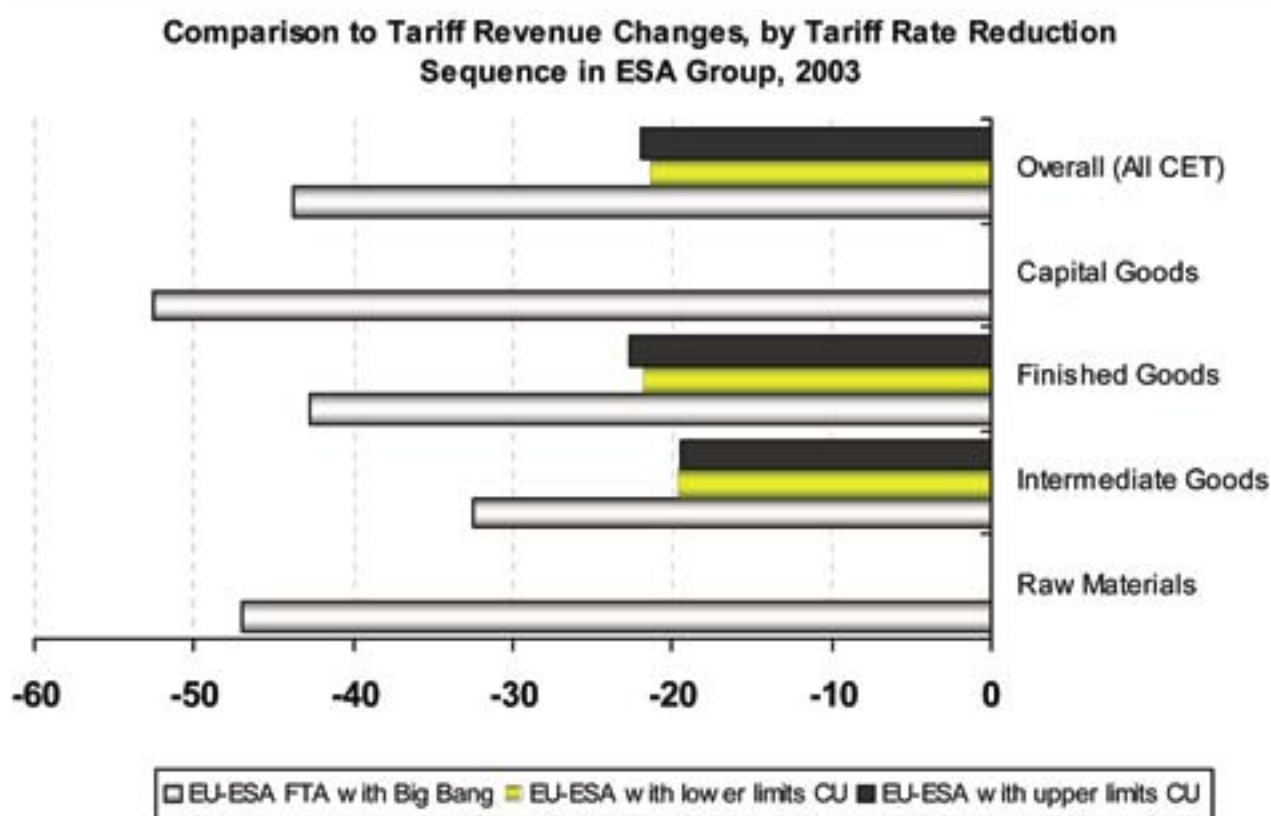
Table 8.1: Comparison of Tariff Revenue Changes, by CET Rate Reduction Sequencing and Type of Trade Arrangement: 2003

Anticipated Trade Arrangement	Percentage Tariff Changes by CTN Category				
	Raw Materials	Intermediate Goods	Finished Goods	Capital Goods	Overall (All CTN)
(a) EU-ESA FTA with Big Bang Approach	-54.2	-33.5	-41.6	-52.2	-44.1
(b1) Lower limits Customs Union only	-100.0	73.8	85.1	-100.0	18.4
(b2) Upper limits Customs Union only	-100.0	144.5	168.6	-100.0	70.4
(c1) EU-ESA FTA within Lower limits Customs Union	0.0	-19.6	-21.6	0.0	-21.1
(c2) EU-ESA FTA within Upper limits Customs Union	0.0	-19.5	-22.4	0.0	-21.7



Of importance in **Table 8.1** and **Figure 8.7**, the “big bang” approach would potentially impose the highest adjustment costs in terms of customs duty losses. This is consistently true for all CTN categories without exception.

Fig. 8.7: Source: Model Outputs



Specifically, for all the CTN categories, it is clear that the revenue implications of the “big bang” approach are considerably more deleterious than the two cases where the ESA first moves into a Customs Union prior to establishment of an FTA with the EU. With the establishment of the FTA under the EU-ESA EPA, the upper limits scenario implies negligibly lower potential revenue losses than the lower limits scenario for both intermediate and finished goods. For both goods categories, although the end line estimates of the potential revenue losses are virtually the same; the disproportionately higher potential revenue gain from moving into a Customs Union under the upper limits scenario makes the upper limits scenario more preferable for the ESA group.

Overall therefore, initiating a COMESA Customs Union with raw materials and capital goods both set at zero per cent tariff rates, and intermediate and finished goods set at 15 and 40 per cent, respectively, and then moving into an FTA under the EU-ESA EPA, would possibly be the most favourable sequence to follow in establishing the FTA, from the perspective of minimising revenue losses while maximising intermediate gains during the Customs Union stage of trade arrangements.



8.4 Towards an Exceptions List

As reciprocity is an important element of the EU's EPA negotiation, revenue considerations are among the issues that are raised as concerns for ESA countries. Loss of revenue is non-trivial given the levels of dependence on customs revenue in overall government revenue for many ESA countries.

As a possible initial negotiating position, criteria for an exceptions list would need to be defined. This is a list of products that should not be liberalised at the onset of the EPA but would be liberalised gradually. Stevens (2005) highlights possible assumptions for building scenarios for such an exceptions list. The simplest scenario would be to make two assumptions namely; use of an agreed proportion to be excluded from liberalisation, which further assumes that "substantially all trade" is understood as a set percentage. Below we make a range of assumptions about what "substantially all trade" implies, starting with 80 per cent (as in Stevens, *op. cit*) and then 90 per cent and 70 per cent. The share of liberalised items in total theoretical trade is indicated for each country under each assumption.

The data suggests a concentration in trade value among a few top products for most ESA countries. In fact, Seychelles has over 50 per cent of its theoretical revenue among its top three products in its 2003 trade. For each scenario we obtained the share of the exceptions list in total theoretical revenue and this is presented in **Table 8.2** below. Utilising the 90 per cent as "substantially all trade" scenario, it is evident that for countries such as Sudan and Burundi, these products have a significant share (above 20 per cent) of theoretical revenue. Assuming 80 per cent trade as "substantially all trade", the share of the exceptions list in theoretical revenue increases, with Eritrea, Sudan and Burundi all registering shares of above 40 per cent, while DR Congo and Kenya register shares of between 29 and 40 per cent. The 70 per cent as "substantially all trade" assumption indicates a similar picture for the mentioned countries, but with the emergence of Mauritius, Malawi, Ethiopia and Madagascar into double digit shares for the exceptions list in total theoretical revenue¹⁵.

The above scenario-building exercises demonstrate the work to be undertaken at the country level. There would be a need to then build a regional consensus after country positions are established. It is worth noting that this sort of sequencing from country position to regional position was followed in obtaining goods of economic importance that would be considered for exclusion from the COMESA CU proposals (See COMESA 2004).

Lastly, a critical consideration is the sequencing of the EPA *viz a viz* the COMESA CU. Any work towards an exceptions list implies such a list for products from all importers, not just the EU. Subsequent to the implementation of the COMESA CU, another exclusions list relating to trade with the EU would then need to be defined for gradual liberalisation under the EPA. This would obviously consist mainly of finished and intermediate products.

¹⁵Note that the blanks in Table 8.2 above imply that the top products account for more than 10 per cent, 20 per cent or 30 per cent of trade depending on the assumption.



Table 8.2: Share of Exceptions List of Products in Total Theoretical

Country	Assumption		
	90% Liberalisation	80% Liberalisation	70% Liberalisation
Burundi	23.83	42.16	52.5
DRC	16.8	31.6	48
Ethiopia	3.87	9.65	21.39
Eritrea	34.9	51.3	65.9
Kenya	12.55	29.24	42.41
Madagascar	0	4.62	20.19
Malawi	0	0	17.62
Mauritius	5.43	6.52	16.51
Seychelles			
Sudan	24.92	49.44	62.15
Rwanda	0	5.66	13.67
Uganda		0	18.79
Zambia		12.11	17.21
Zimbabwe	3.14	17.55	40.33
Source:	Authors calculations. Trade data from country CSOs, tariff data from country revenue authorities. Data for Eritrea and DRC obtained from EUROSTAT Mirror Data.		



9.0 Conclusion

In conclusion, the results of this assessment suggest that the impact of the EU-ESA FTA on revenue would be largely negative, irrespective of the sequencing of tariff revision towards forming the EPA. However, the magnitudes of impact would be to varying degrees dependent on the extent and sequencing of tariff reduction.

In this regard, a “big bang” sort of approach, where the ESA moves straight into free trade with the EU, would potentially impose the highest short term adjustment cost. The more cost effective way for the ESA groups to move towards an FTA with the EU under an EPA would therefore be to first establish the anticipated COMESA Customs Union and then establish the EPA¹⁶. The most advantageous tariff rate revision sequence from the proposals, which minimises tariff revenue losses, would be one establishing a CU that sets harmonised CET rates on both raw materials and capital goods at zero per cent, and on intermediate and finished goods at 15 and 40 per cent respectively, and then to move from that CU into an EU-ESA FTA. Tariff revenue losses during FTA formation in this scenario would potentially be lowest, and perhaps more importantly, the losses would be more than compensated for by the potential revenue gains from moving into an upper limits CET prior to forming the FTA with the EU.

Of course the above conclusion assumes away the effects of trade distortions and domestic absorption in influencing actual outcomes among the trading blocs. It also does not capture the wider revenue implications of country-specific internal tax structures. These and several other aspects are important areas for further research that could strengthen understanding of the implications of the EPAs and other trade arrangements.

Nevertheless, the results and discussions of this study are quintessential in forging a basic understanding of the potential customs revenue implications of the envisaged FTA under the EU-ESA EPA, and in proposing possible mitigating measures for some of the foreseeable revenue challenges of the FTA.

As a final note, it is important to realise that in the main, this study has limited the discussion to a regional level. Country level impact has been examined but not discussed extensively. Partially this was motivated by the need to keep at the core the “integration spirit” via the ESA configuration when analysing the impact of the EPA. Hence a regional approach was preferred.

¹⁶“Cost effective” from the revenue loss perspective.