

# **Integrating the Least Developed Countries into the World Trading System: The Current Impact of EU Preferences under Everything But Arms\***

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## *Abstract*

Trade preferences are a key element in industrial countries efforts to assist the integration of the least developed countries (LDCs) into the world economy. This paper provides an initial evaluation of the impact of the EU's recently introduced Everything but Arms (EBA) initiative on the products currently exported by the LDCs . It shows that the changes introduced by the EBA in 2001 are relatively minor for the currently exported products, primarily because over 99 per cent of EU imports from the LDCs are in products which the EU had already liberalised and the complete removal of barriers to the key remaining products, rice, sugar and bananas has been delayed. The paper proceeds to look at the role EU preferences to LDCs in general have been playing and could play in assisting the integration of the LDCs. It shows that there is considerable variation across countries in the potential impact that EU preferences can have given current export structures. There is a group of the LDCs for whom EU trade preferences on existing exports are not significant since these exports are mainly of products where the MFN duty is zero. Export diversification is the key issue for these countries. For other LDCs, EU preferences have the potential to provide a more substantial impact on trade. However, the paper shows that only 50 per cent of EU imports from non-ACP LDCs which are eligible actually request preferential access to the EU. The prime suspect for this low level of utilization are the rules of origin, both the restrictiveness of the requirements on sufficient processing and the costs and difficulties of providing the necessary documentation. More simple rules of origin are likely to enhance the impact of EU trade preferences both in terms of improving market access and in stimulating diversification towards a broader range of exports.

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## 1. Introduction

Trade preferences are seen by many as an essential element in integrating the developing countries, and particularly the least developed countries, into the world trading system. Trade preferences in OECD countries are expected to encourage the importation of products from developing countries, raising the export earnings of these countries, stimulating investment and growth. Initial preference schemes were introduced in the 1970s under the “Generalised System of Tariff Preferences” (GSP). Over the past 3 decades the exports of some of the developing countries, particularly those in east Asia, have grown strongly. However, export success has not been uniform and some developing countries, those at the lowest levels of income, have been left behind. In response there have been a number of recent initiatives in OECD countries to further discriminate in favour of the least developed countries (LDCs). Most notable amongst these are the EU’s Everything But Arms (EBA) initiative and the African Growth and Opportunity Act (AGOA) of the US.

This paper takes a look at the initial impact of the EBA, which came into effect in March 2001, although as we shall show the vast majority of imports from the LDCs were already entering the EU duty and quota free. The impact of the changes introduced in 2001 on the products currently exported were therefore relatively minor and as such they should be seen as the final, but small, step in a longer term process that the EU has implemented to provide complete duty and quota free access to the LDCs. The paper goes on to look more broadly at the impact of EU preferences and seeks to assess the scope, actual and potential, that the EBA, broadly defined as covering all products with duty free access to the EU, can play in integrating the least developed countries into the world economy.

The focus of the paper is on those products currently exported by the LDCs. For a group of the poorest countries it is clear that *under current trade structures* preferences are of no real value since almost all exports are concentrated in products for which the EU external tariff is zero. For these countries the key issue is to what extent the EU scheme of preferences can assist in stimulating diversification into a broader range of exports. For other countries the value of EU preferences under the current structure of exports is more

significant due to a higher export share of dutiable products and the larger magnitude of available preferences. However, it appears that improvements in market access are often constrained by the nature of the rules which govern the granting of preferences. The adoption of more simple rules of origin would be of particular benefit to many of these LDCs.

## **2. The Everything But Arms Initiative**

Figure 1 shows the evolution of the exports of the LDCs to the EU since 1988. The period from 1989 to 1993 was one of absolute decline in the value of exports to the EU. Subsequently there has been moderate but sustained growth in the value of exports, with a very substantial increase of over 35 per cent in 2000. Nevertheless, the figure shows that the relative decline of LDC exports to the EU continued throughout the 1990s with a slight recovery in 2000 and 2001. In 2001 the LDC share of the EU import market was about 25 per cent lower than in 1988. It is against this background that we now consider the possible impact of the changes introduced in 2001 by the EBA initiative and then consider more broadly the importance of EU preferences to the LDCs.

The EBA regulation grants duty-free access to imports of all products from the least developed countries, with the exception of arms and munitions, and without any quantitative restrictions. The EU has argued that “this *significantly* enhances export opportunities and hence potential income and growth for these countries” (CEC(2002) emphasis added). Liberalisation was immediate except for three products fresh bananas, rice and sugar where tariffs will be gradually reduced to zero (in 2006 for bananas and 2009 for rice and sugar). There are duty-free tariff quotas for rice and sugar which will be increased annually. It is important to note that the majority of products from these countries already received duty free treatment under the GSP or Cotonou Agreement. The EBA proposal extended tariff and quota free access to the EU market to the remaining 919 (of these 44 tariff lines were products with full liberalization delayed) of the 10200 tariff

lines.<sup>1</sup> The vast majority of these 919 products are agricultural products, including certain meat products, vegetables, fruits, wines and prepared foodstuffs, such as biscuits and jams.

An important feature of the EBA is that it is embedded in the EU's GSP scheme and access to the EU market is governed by the rules of that scheme. At present the African and Caribbean countries (ACP) can, if they wish, continue to export to the EU under the Cotonou Agreement, the rules of which governing preferential access are in important aspects different to those of the GSP. This is an issue that we will return to in more detail below. It is important to note that the non-ACP countries can only gain zero duty access to the EU market under the EBA.

A key difference between the EBA and other unilateral preferences granted by the EU is that preferences for the least developed countries are granted for an unlimited period and are not subject to periodic review. This contrasts with the current GSP scheme which will cease at the end of 2004. As such the EBA should provide exporters and investors with greater certainty of market access to the EU and therefore stimulate greater capacity in the production of existing products and an environment conducive to the export of a wider range of products. This is a crucial aspect of the EBA. However, this may be undermined to an extent by the inclusion of a new reason for the temporary suspension of preferences: "massive increases in imports of products originating in the LDCs in relation to their usual levels of production and export capacity". This could act as a constraint upon large-scale investment that transforms production capacities in a particular country and may limit diversification into new products.<sup>2</sup>

Of the 919 product lines liberalised under the EBA, imports from the LDCs<sup>3</sup> were recorded in just 80 of the tariff lines in 2000, with 13 of these lines being products where full liberalisation is delayed, bananas, sugar and rice. Imports of these 80 product lines

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<sup>1</sup> For some product categories liberalisation had already been implemented for the ACP countries whilst for other categories zero duty access was already available for the non-ACP LDCs.

<sup>2</sup> This clause was initially discussed in the context of combating fraud, however, this is not made clear in the legislation and it would appear that it could be invoked in more general circumstances.

<sup>3</sup> Myanmar is currently excluded from preferences for political reasons. Senegal also became eligible for EBA preferences from the start of 2002 but is not included here.

amounted to 73.6 million euro in 2000, equivalent to around one half of one per cent of total LDC exports to the EU, but 63 million euro of these imports were in products with delayed liberalization (Table 1).<sup>4</sup> In 2001 the LDCs exported to the EU again in 80 of the categories liberalised by the EBA, with 11 of these being products with delayed liberalization. Exports to the EU of products liberalized in 2001 amounted to 3.7 million euro, a substantial decline from the exports of 10.7 million euro of such products in 2000. However, driving these figures was a decline from 7.2 million euro in 2000 to 0.8 million euro in 2001 of imports of grain sorghum from Sudan. Excluding this exceptional item trade in products liberalised under the EBA in 2001 fell from 3.5 million euro to 2.9 million euro. The value of exports of products with delayed liberalization fell slightly from 62.9 to 60.7 million euro. Table 1 also shows that the vast majority of exports of products liberalized under the EBA emanate from the ACP countries. Very small flows of these products currently come from the non-ACP countries.<sup>5</sup>

Total exports to the EU of the LDCs, on the other hand, increased by 9.6 per cent in 2001. Thus, it is difficult to postulate that liberalisation under the EBA has stimulated this increase in total trade. Indeed within this overall total there is wide variation in the growth of exports to the EU amongst the LDC countries. For 12 of the LDCs, exports to the EU fell by more than 30 per cent between 2000 and 2001. For another 16 countries exports fell but by less than 30 per cent. Exports to the EU increased for 19 LDCs, with 9 of these experiencing growth of more than 30 per cent. Thus, for the majority of the LDCs exports to the EU declined in 2001. This demonstrates that market access is just one of a range of factors, which include price volatility for primary products and domestic supply constraints, that are influencing the value of LDC exports to the EU.

The direct impact of the liberalisation provided by the EBA in 2001 is shown in more detail in Table 2, which shows for each of the LDCs the value of exports to the EU in products for which there was liberalisation of EU trade barriers in 2001. In general the amount of trade in products liberalized in 2001 is very small reaching at most one per cent

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<sup>4</sup> The key product here is sugar, exports of which to the EU amounted to 47.9 million euros in 2000.

of total exports to the EU for Haiti and amounting to three one-hundredths of one per cent of total LDC exports to the EU in 2001. The table also shows the amount of exports to the EU which were eligible for these improved preferences and which requested preferential access to the EU under the EBA initiative. None of the eligible imports from the ACP countries actually requested and therefore were not granted preferential access under the EBA. It would appear that the EBA has had no immediate impact on EU imports from the ACP countries. This is in contrast to the non-ACP countries where three-quarters of the exports of products for which tariffs were removed in 2001 were actually granted duty-free access under the EBA. We assume that for various reasons to be discussed in more detail below imports from the ACP countries are still entering the EU under the Cotonou Agreement rather than under the EBA.

The table also shows the value of exports to the EU in 2001 of bananas, rice and sugar, products which will be fully liberalised under the EBA but with some delay. Here the potential impact of the EBA is more significant for particular countries. For example, due to the importance of sugar, almost 12 per cent of the value of Malawi's exports to the EU in 2001 was from products which will be subject to future liberalisation. Significant shares of the exports of Bhutan, Sudan and Zambia are also in products where market access *may* improve in the future. Overall, bananas, rice and sugar comprised almost one half of one per cent of total LDC exports to the EU in 2001. These products are much more important in the exports of the ACP countries than in the exports of the non-ACP countries. Thus, of the products which had not been fully liberalized under the GSP or the Cotonou Agreement it is precisely those products which are of more importance to the LDCs where full liberalisation has been delayed. However, it is worth noting that on the basis of current exports to the EU most of the LDC will be unaffected by future liberalisation under the EBA. Thirty two of the LDCs did not export any bananas, rice or sugar to the EU in 2001.

Thus we conclude from an analysis of the exports of LDCs of products liberalized in 2001 that the direct impact of the EBA has not so far been significant: very small amounts of

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<sup>5</sup> However, UNCTAD (2001) suggests some export potential in these products for countries such as Bangladesh.

exports are concerned and for all the ACP countries exports of products which have been liberalized have not entered the EU market under the EBA. It may be that adjustment to the new regime will take some time as different documentation is required than under the Cotonou Agreement. It could also be that substantial investment is required for these new preferences to be exploited, for example, if the products concerned are subject to demanding technical regulations or private standards. Thus, the reduction of barriers and the greater certainty of the EBA could stimulate new trade from the LDCs in the future. However, even a substantial increase in the volume of exports of products liberalized in 2002 will have little impact on overall exports. The impact of the future liberalization of bananas, rice and sugar could have a more profound impact on particular countries, but not the ACPs in general, since the majority do not export these products. This impact will be determined by the extent to which current tariff quotas are binding on trade.

The small impact of the EBA in 2001 reflects that the vast majority of EU imports from the LDCs (99.5 per cent in 2001) were already eligible for tariff and quota free access. Hence, we now proceed to look at trade in all products covered by EU preferences, including those previously liberalized under the GSP and the Cotonou Agreement to try and assess what role EU trade preferences in general have been playing and could play in assisting the integration of the LDCs into international markets. We start by looking at two broad measures of the potential impact of the EBA, now defined more broadly as EU trade preferences in general, on the exports of the least developing countries: first, the coverage of the EBA for each country, that is, the importance of exports which are subject to preferences in relation to total exports to the EU and second, the extent to which the available preferences are actually utilised. On the first point, if a country mainly exports to the EU products that are already subject to zero or low MFN tariffs then the preference scheme will have little direct short-term impact on exports. The key contribution that may arise is if the scheme encourages a degree of export diversification into products where preferential margins remain. As noted above, the EBA is potentially an important step forward in this respect due its unlimited duration. On the second point preferences are only valuable from an economic point of view to the extent that they are actually granted. A

scheme which offers preferential access but which contains rules that constrain or prevent delivery of improved access will be of little importance.

### **3. The Potential Impact of EU Trade Preferences with Current Trade Structures**

Table 3 classifies each of the LDCs along these two dimensions on the basis of data on exports to the EU in 2001. We look first at the importance of products for which preferences, whatever their magnitude, are available and allocate countries according to whether such products comprise less than 5 per cent of total exports, for which we deem the initiative to be having no direct impact given the current structure of exports, when such products comprise between 5 and 30 per cent of total exports to the EU we take the initiative to be of low relevance, and when products subject to preferences amount to more than 30 per cent of exports we take the initiative to be of high relevance given current exports. These dimensions are shown in the rows of Table 3. For seven countries, Angola, Central African Republic, Chad, Congo, Liberia, Niger and Vanautu, products eligible for preferential access to the EU under the EBA comprised less than 5 per cent of total exports to the EU in 2001. It is worth noting that none of these countries currently export bananas, rice or sugar and so further liberalisation under the EBA is likely to have no immediate impact. For these countries exports are dominated by products where the MFN duty is already zero. Specifically, for each country in 2001 the key products were: Angola (oil/diamonds), Central African Republic (diamonds/wood), Chad (cotton), Congo (diamonds), Liberia (sea-going vessels/wood), Niger (uranium) and Vanautu (sea-going vessels).

For these countries the key issue is export diversification. The extent to which preference schemes such as the EBA assist in the process of export diversification is worthy of further study. For this particular group of countries, for whom extensive trade preferences have been available under the Cotonou Agreement, there has been little apparent export diversification, although diversification may have been stymied by the weak contractual nature of the preferences. Preferences under the EBA provide for greater certainty. This is a crucial issue and one where it would be useful if there were to be monitoring of the impact of the EBA on export diversification and careful analysis of constraints upon the

export of a broader range of products. Such constraints are likely to include technical regulations and standards in overseas markets and the costs of transport and other trade-related infrastructure.

A further fifteen countries are classified as those where EU trade preferences are of low relevance given current exports since the share of exports of products where preferences are available comprises a significant but not substantial share of total exports to the EU, that is, between 5 and 30 per cent. With the exceptions of Afghanistan and Bhutan, all of these countries are from the ACP region. Finally, the majority of LDCs, 25 countries, comprise the group for which products subject to preferences account for more than 30 per cent of current exports. The remaining non-ACP countries all fall into this category.

Hence this classification gives a crude first indication of the potential importance of trade preferences for the various ACP countries with current export structures. However, it is important to go further and look at the magnitude of the preferences that are being granted. This is provided in Figures 2 to 4 which show the average margin of preference in the EU market *if all available preferences were fully utilized* (as will be discussed later, this cannot be stressed enough). This was computed as the implicit transfer (the sum across all products of the MFN tariff<sup>6</sup> multiplied by the value of exports) divided by the value of total exports to the EU in 2001.<sup>7</sup> This is equivalent to the trade weighted average tariff that would arise if MFN duties were applied. The three figures group countries according to a perceived insignificant current value of preferences, a potential transfer of less than 1 per cent of the value of exports to the EU, countries for whom the potential value of preferences is currently low, of the order of between 1 and 5 per cent of exports, and

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<sup>6</sup> Throughout we use the post-Uruguay Round ad valorem tariffs and the ad valorem equivalents of specific duties. For some products, such as confectionary, the duty is complex being based upon an ad valorem tariff and specific rates according to sugar and milk contents. For these products, without further information, the ad valorem equivalents of the specific duties for average sugar and milk contents were applied.

<sup>7</sup> This does not include the value preferences for the delayed liberalisation products of bananas, rice and sugar. For these products the value of preferences depends upon the extent to which exports exceed the tariff-free quota. Thus, for those countries which are significant exporters of these products, Malawi, Sudan, Madagascar, Zambia and Tanzania, the potential transfer could be higher than shown here. Nevertheless, since three of these five countries are classified as having a high potential transfer under the EBA the omission of sugar, rice and bananas will not distort the overall picture given by Figures 2 to 4.

countries for whom the current value EU preferences is potentially substantial, that is, equivalent to more than 5 per cent of the value of current exports to the EU.

Figure 2 shows the countries where EU preferences are currently insignificant and comprises all 7 countries identified above as having a share of preferential exports in total exports of less than 5 per cent. These countries are joined in this figure by 6 other ACP countries and Bhutan. Whilst these countries exports are characterized by a higher proportion of products which are subject to preferences, the MFN tariffs on these preferences are low. For example, the majority of preferential exports by Mali are hides and skins where the average EU tariff is only 2 per cent. In general, EU preferences for this group of countries are unlikely to be having any substantial impact on exports under current trade structures.

Figure 3 shows the group of countries for whom the potential value of EU preferences with the current structure of exports lies between 1 and 5 per cent of the value of exports in 2001. The figure also shows that the average for the ACP countries lies at just over 2 per cent. If fully exploited EU preferences to ACP countries amounted to a transfer equivalent to approximately 1.92 Billion Euros in 2001. To reiterate, the actual transfer would have been less than this due to the fact that only a proportion of exports from the ACP countries to the EU would have been granted preferential access to the EU. Some exports would have paid the MFN tariff.

Figure 4 shows the group of countries for whom EU trade preferences are of greater significance under current trade structures, which in our very crude breakdown is defined as when the value of the potential transfer exceeds 5 per cent of the value of exports in 2001. The Figure highlights the substantial impact that EU trade preferences *could* be having on the non-ACP LDCs. For these countries, the current potential transfer on average is equivalent to 11.26 per cent of the value of exports in 2001. In general, this reflects the high share of clothing products in the exports of these countries to the EU, for which the EU tariff is typically 12 per cent. The very high value of the potential transfer for the Maldives reflects the importance of clothing exports but also exports of prepared

Tuna, for which the EU tariff is 24 per cent. The Maldives also highlight the importance of taking account of the amount of exports which are actually granted preferences, since for this country, the value of the actual transfer in 2001 was no more than 5.5 per cent of the value of exports in 2001. For Nepal, Laos, Cambodia and Bangladesh, the potential transfer under EU preferences is also substantial. There are a number of ACP countries in the group for whom the potential value of EU trade preferences with current trade structures is high. They include Malawi, primarily due to exports of tobacco, Madagascar (fish and clothing), Mozambique (unwrought aluminium), Uganda (fish and tobacco).

Thus, this analysis shows the vastly different impact that EU trade preferences can potentially make for the various LDCs which are eligible for duty and quota free access to the EU market under the current structures of exports of these countries. For a group of the ACP countries EU preferences are not significant with the products currently exported. For countries such as Chad and Liberia the potential value of EU preferences currently amounts to less than one tenth of one per cent of the value of exports to the EU, reflecting that the structure of exports is dominated by products for which the MFN duty is zero. However, there are also a number of countries for whom the potential value of EU preferences is currently substantial. The analysis shows a clear distinction between the non-ACP countries on average, for whom preferences are potentially of high significance and the average for the ACP countries, where EU trade preferences are typically much less important under current trade structures. This analysis has been based on the importance of EU preferences if all exports from the LDCs were granted preferential access to the EU market. We now proceed to look at the available information on the actual take-up of preferences under the EBA.

#### **4. The Utilisation of Preferences**

The take-up of preferences is the other key factor which defines the impact of trade schemes such as the EBA. The columns of Table 3 show the allocation of the LDCs according to the share of exports which requested<sup>8</sup> preferential access to the EU market

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<sup>8</sup> Thus, the amount actually granted preferential access could be less than this figure. We suspect that the main reason why traders forego the financial incentives that are available and do not request preferences is

under the EBA in the value of exports which were eligible for preferential access, the later being the value of exports for which the MFN duty is non-zero (with the exception of bananas, rice and sugar). Again we present a crude breakdown according to whether there is no take-up of preferences (exports requesting preferences were less than 5 per cent of the value of exports eligible for preferences), low take-up of preferences (the ratio of requesting zero duty access over eligible between 5 and 30 per cent), and high utilization of preferences (more than 30 per cent of exports eligible for preferences requested to enter the EU market duty free).

It is striking from Table 3 that for almost all of the ACP countries there is no-take up of preferences under the EBA. Lesotho, is a notable exception. In contrast, for the majority of the non-ACP countries there is a high-take up of preferences. We suspect that the very low utilization of preferences under the EBA by the ACP countries reflects that most of the exports from these countries entered the EU under the Cotonou Agreement rather than under the EBA in 2001. This begs the question of why these countries are still using the Cotonou Agreement rather than the EBA to access the EU market. On the one hand this may just reflect the delay in adjusting to the new scheme and also, as we have discussed above, the majority of exports from ACP countries were already entering the EU duty free under Cotonou and at present there is no incentive to change to EBA, particularly given that different documentation is required to use the EBA (Form A) and the Cotonou (EUR1). Although, we noted above, see Table 2, that even for products where the EBA offers better access than Cotonou there has been no take-up of preferences under EBA.

On the other hand, the lack of use of EBA may reflect some important differences between the two schemes. Most notable amongst these are differences in the rules of origin. Although, the required degree of processing tends to be the same for each product category, a number of the general rules vary substantially:

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that the costs of attaining them exceed their value. The key factors raising the costs of obtaining preferences are the rules of origin and the administrative costs of proving conformity with those rules. There is some suspicion regarding the data provided by the Netherlands which may understate (to an unknown extent) requests for preferences. This will not distort the key findings that are presented.

- *Cumulation*: Cumulation allows inputs from specified countries to be treated as originating materials. The EBA is contained within the EU's GSP scheme and therefore is governed by the rules of origin specified in the GSP. Under the GSP *diagonal* cumulation can take place *within* four regional groupings: ASEAN, CACM, the Andean Community and SAARC. Diagonal cumulation allows *originating* materials (those which satisfy the EU rules of origin for that product) from regional partners to be further processed in another country in the group and treated as if the materials were originating in the country where the processing is undertaken. However, this flexibility in sourcing is constrained by the requirement that the value-added in the final stage of production exceeds the highest customs value of any of the inputs used from countries in the regional grouping.

Cumulation under the EBA is not available to the ACP countries. Such cumulation is a possibility for Cambodia and Laos within ASEAN and for Bangladesh, Bhutan, Maldives and Nepal within SAARC. Thus, for example, the standard rule of origin states that clothing products must be made from yarn. In other words, the fabric from which the clothes are cut and made-up must be woven in the beneficiary country or the EU. With diagonal cumulation clothing producers in Cambodia can use fabrics from Indonesia (providing they are originating, that is produced from the stage of fibres) and still receive duty free access to the EU. Similarly, producers in Nepal can import originating fabric from India. This provides for slightly more freedom in sourcing decisions than is available under the basic rule of origin.<sup>9</sup>

However, UNCTAD (2001) shows how the value added requirement can render regional cumulation of little value. For example, value-added in the making up of clothing in Bangladesh ranges from between 25 and 35 per cent of the value of exports. However, value-added in the production of fabrics in India is around 65 to 75 per cent. Regional cumulation allows clothing produced in Bangladesh from

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<sup>9</sup> For certain textile and clothing products, but subject to quantitative limits, Cambodia, Laos and Nepal have requested and been granted a derogation from the rules for certain textiles and clothing products such that originating inputs from any countries belonging to the SAARC, ASEAN or the ACP can count as originating materials.

Indian fabrics preferential access to the EU but not at the zero rate (for which Bangladesh is eligible) but at the rate for which India is eligible, which is only a 20 per cent reduction from the MFN rate, that is a tariff of 9.6 per cent.

Under the Cotonou Agreement *full* cumulation<sup>10</sup> (Inama (2002)) can occur with any of the ACP countries and there is no requirement concerning value-added in the final stage relative to the customs value of inputs used. There is also the possibility for cumulation with South Africa, provided that the value added exceeds the value of materials from South Africa, and with neighbouring non-ACP developing countries, although highly constrained for textile and clothing products. Hence it is possible that ACP countries using materials from other ACP countries qualify for duty free access to the EU market under the Cotonou Agreement but not under the EBA.

- *Tolerance Rule/Minimum Processing*: Under the EBA non-originating materials which according to the specific rules of origin cannot be used in the manufacture of a product may nevertheless be used provided that their value does not exceed 10 per cent of the ex-works price of the product. Under Cotonou non-originating materials up to a total value of 15 per cent of the ex-works prices can be used.<sup>11</sup>
- *Fish*: For a number of the ACP countries (Angola, Benin, Eritrea, Gambia, Guinea, Guinea Bissau, Madagascar, Mauritania, Mozambique, Sao Tome, Togo, Tanzania, Uganda) fish are a major export. Although the basic processing rule is the same under the EBA and Cotonou, all products used must be wholly obtained, the

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<sup>10</sup> The most advanced form of cumulation, *full* cumulation, allows for any working or processing (even if it does not confer origin) undertaken in one country to be carried forward to another country and counted as if it were undertaken in the country of final processing. For example, a clothing product made in one country from fabric produced in a regional partner which in turn was made from non-originating yarn would be eligible for duty free access to the EU under full cumulation but not under diagonal cumulation since the fabric would not be deemed to be originating (the rule of origin for the fabric requires manufacture from fibres).

<sup>11</sup> In both cases this is predicated on specific rules on maximum values of non-originating materials not being violated. For example, the rule of origin for preparations of vegetables, fruits etc preserved by sugar (HS 2006) requires that materials of Chapter 17 (sugar) do not exceed 30 per cent of the ex-works price.

conditions pertaining to the vessels which catch the fish are more liberal under Cotonou (see Annex 1).

Hence there are a number of reasons why the ACP countries may not be utilizing the duty free preferences under the EBA and are still using the Cotonou Agreement to access the EU market.

For the non-ACP LDCs we can analyse the issue of the take-up of preferences in more detail since exports from these countries can only achieve duty-free access to the EU market under the EBA. Given our data on the amount of exports eligible for preferences which actually requested duty free access we can derive (the lower bound on) the amount of exports which actually pays the MFN duty rate.

Table 4 shows that on average 50 per cent of exports from the non-ACP countries requested duty free access to the EU market in 2001. This implies that at least half of exports from these countries to the EU did not receive preferential access and paid the MFN tariff rate. The take-up of preferences varies from less than 10 per cent for Afghanistan and Bhutan to 36 per cent for Cambodia, 50 per cent for Bangladesh and over 70 per cent for Nepal and Yemen. The next column of the table shows the value of the implied transfer for the exports that may have entered duty free, that is, the value of exports which requested duty free access multiplied by the MFN tariff. On the basis of exports in 2001 this amounted to a transfer of 2.3 Billion Euros.<sup>12</sup> The table shows that, given the size of overall exports, most of this transfer went to Bangladesh, which received 1.9 Billion Euros.

The next column of the Table shows the value of the transfer that was foregone, that is, the additional transfer that would have arisen if all exports from these countries had entered the EU market with zero duties. Thus, if the EBA had delivered duty free access to all of the exports recorded as having come from Bangladesh then there would have been an

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<sup>12</sup> This is assuming that all of the transfer goes to the exporter. Olarreaga and Ozden (2003) suggest that a substantial part of this transfer could be going to the importers.

additional transfer of 1.93 Billion Euros. The table then shows the delivery ratio, the value of preferences that requested duty free access compared to the total available transfer if all preferences were utilized. This will be lower than the ratio of exports requesting access to exports eligible for preferences if the take-up of preferences tends to be lower for higher tariff products. With the exception of Afghanistan and Bangladesh this is not the case, although the weight of Bangladesh entails that the delivery ratio for the group as a whole is lower.

The penultimate column of the table shows the value of the total potential transfer (the actual transfer plus the transfer foregone) as a proportion of exports to the EU in 2001. These are the data that were presented in Figures 3 and 4. Thus, on average the EBA could deliver a transfer equivalent to 11 per cent of the exports of the non-ACP LDCs in 2001. The final column shows the transfer foregone as a proportion of exports to the EU which is equivalent to the trade weighted average tariff that the exports of these countries actually faced. The difference between the two columns shows that value of the transfer actually made as a proportion of exports to the EU. For Bangladesh, the EBA led to a transfer (or a margin of preference) equivalent to 5.65 per cent. However, the lack of full utilization of the available preferences entails that Bangladesh faced a trade-weighted average tariff of 5.8 per cent, which is far in excess of the trade-weighted average tariffs paid by many non-preferential exporters to the EU! Cambodia, Laos and the Maldives all faced relatively high average tariffs when exporting to the EU after taking into account that only a proportion of exports could have entered the EU duty free.

If we assume that the same factors which constrain the take-up of preferences by non ACP countries also afflict the ACP countries and that the utilization of preferences by the ACP countries was on average similar to that of the non-ACP countries then the value of EU preferences under current export structures becomes even less for these countries with an implicit transfer of around 1 per cent of the value of exports to the EU in 2001.

## **5. Reasons for the Under-Utilisation of Preferences**

Brenton and Manchin (2003) argue that the prime suspects for the lack of utilization of EU trade preferences are the rules of origin, both in terms of the nature of the rules defining specific processing requirements, with the constraints that this entails for international sourcing from the lowest cost locations, and the costs of providing the necessary documentation to prove conformity with the rules. The costs of documentation related to the rules of origin are compounded by the requirement that goods for which preferences are requested are shipped directly to the EU and that if they are in transit through another country, which will be the case for most of the LDCs, then documentary evidence must be provided to show that the goods remained under the supervision of the customs authorities of the country of transit, did not enter the domestic market there and did not undergo operations other than unloading and reloading. In practice it may be very difficult to obtain the necessary documentation.

Rules of origin are required to prevent trade deflection, whereby products from non-beneficiary countries are re-directed through LDCs to exploit the preferences that are available. This is indeed necessary but the rules of origin should be no stricter than is required to fulfill this function. Rules of origin which are more strict than is necessary will act to protect producers in the preference granting country and undermine the value of the preference scheme for the LDCs. Unfortunately there appears to be no analytical work that assesses the optimal rule of origin from a practical point of view that would prevent trade deflection. One suspects that in most cases a simple change of tariff heading would suffice, compared to the complex rules in most preferential trade schemes.

The fact that only a proportion of exports which are eligible for preferences are requesting preferences suggests that much more than trade deflection is at hand. Deflected trade would request preferences. This in turn suggests that on average 50 per cent of recorded exports from the non-ACP LDCs which are eligible for zero duty access to the EU market and which are not deflected trade from non-eligible countries are not getting that preferential access. If the reason for this lack of take-up of preferences is inability to satisfy

the rules of origin or the high costs of proving origin, which are the prime suspects, then clearly the rules are restrictive relative to the objective of preventing trade deflection.

A reason which has been used to justify strict rules of origin is that they encourage the development of integrated production structures within developing countries to maximize the impact on employment and to ensure that it is not just low value-added activities which are undertaken in the LDCs. This is not a reasonable justification for the strict rules of origin that are applied by the EU and the other OECD countries. First, such rules discriminate against small countries where the possibilities for local sourcing are limited or non-existent (Hewitt et al (1995)). Since most LDCs are small countries they are particularly disadvantaged by restrictive rules of origin relative to larger developing countries. Regional cumulation provisions have been introduced to reduce the constraining effect of the current rules of origin. Nevertheless, they still hamper the choice of sourcing, the ACP countries can source materials from each other but not from low-cost locations in Asia, for example, and as noted earlier there are further restrictions, in terms of value-added requirements on the extent to which cumulation can be used.

Second, there is no evidence that strict rules of origin over the past 20 years have done anything to stimulate the development of integrated production structures in developing countries. Third, this argument would be much more convincing if the rules of origin were defined by a process of discussion with the developing countries to identify what would be appropriate. They are not. They are defined and imposed by the EU, the US and so on. It seems very difficult to argue that the double or triple processing requirements (yarn or fibre forward rules) that dominate both EU and US preference schemes were introduced for the benefit of textile producers in developing countries as opposed to the benefit of textile producers in the EU and US. Finally, globalisation and the splitting up of the production chain does not allow the luxury of being able to establish integrated production structures within countries. Strict rules of origin act to constrain the ability of firms in LDCs to integrate into these global production networks and in effect act to dampen the location of any value-added activities in these countries.

## 6. Conclusions

The EBA initiative is an important step forward in the treatment of products from LDCs in the EU market. It sends a clear signal that all products from LDCs will be eligible for duty and quota free access to the EU market and that such access will be maintained indefinitely.<sup>13</sup> This is where the main impact of the changes introduced by the EBA will be felt in the future, that is, in the extent to which they provide for the diversification of the exports of LDCs, which has been so lacking in the past. Such a policy should be more broadly adopted by all OECD countries, preferably bound under the auspices of the WTO and with a common and more liberal approach to rules of origin.

The direct impact of the EBA in 2001 was negligible since a very small proportion of exports from the LDCs was involved and for the least developed ACP countries even those products which were eligible for improved access did not enter the EU market under the EBA. The principle impact of the changes introduced by the EU in 2001 on products currently exported will arise for products for which full liberalization was delayed: bananas, sugar and rice. However, these products are important only for a minority of the LDCs and accounted for just a half of one percent of the exports to the EU of the LDCs as a group in 2001.

For a number of the least developed ACP countries, *under current export structures* EU tariff preferences in general can play nothing more than a minor role in integrating these countries into the world economy. The average tariff that these countries would pay if preferences were removed, the average margin of preference, is less than 1 per cent. Thus, for these countries the paramount trade policy issue is that of trade diversification rather than that of market access for the bundle of products currently exported. For trade preferences in the EU to be of real value they must facilitate the export of a broader range of goods.

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<sup>13</sup> There are, however, the concerns over the provisions for the suspension of preferences in the agreement and the uncertainty that these may introduce.

The lack of trade diversification of many LDCs despite duty free access to the EU for more than a decade for the vast majority of tariff lines under the Lome Convention and the GSP is not encouraging in this respect. However, the EBA is different since the preferences are not time limited, providing greater certainty for investors and traders. It is important that the impact of the EBA on diversification be monitored and constraints on the export of a broader range of products identified and alleviated. In many cases supply constraints are drastic and it is these which should be the focus of trade-related technical assistance.

Nevertheless, with the preference scheme attention needs to focus on the rules of origin and the extent to which these limit the possibilities for export diversification. The rules of origin are particularly restrictive for simple manufactured products, such as clothing, and for processed food products, precisely those manufactured products where export diversification maybe feasible for these LDCs. This group of countries stands out as a case for the current complex rules of origin to be replaced with a more simple requirement to confer origin for all products, such as change of tariff heading. For other LDCs, EU preferences are of more significance under current export structures by providing a more substantial margin of preference. However, the available evidence from the non-ACP countries suggests that there are constraints upon the ability of these LDCs to fully exploit the available preferences in the EU market.

So, although EU trade preferences do entail a significant margin of preferences for many of the LDCs the full potential of the scheme is not being realized. The under utilization of preferences, which we believe is due to difficulties in satisfying the rules of origin, entails that a substantial proportion of exports of LDCs to the EU pay the full MFN tariff. Since the products exported by many of the LDCs are subject to relatively high MFN tariffs, such as those applied to clothing, exports from the LDCs can still face substantial tariff barriers to access the EU market. This has a number of implications for the modeling of the impact of trade liberalization. Models which assume the full take-up of preferences under trade schemes such as the EBA will overstate the economic benefits of such schemes to the LDCs due to the under utilization of preferences in practice. It then follows that estimates of the impact of preference erosion following multilateral liberalization in a successful

WTO round will overstate the negative impact on LDCs. Modelling exercises which show the impact of more liberal rules of origin would be particularly useful.

The ACP countries are now in the process of negotiating changes to their trade relationships with the EU. Under current EU proposals the least developed ACP countries must contemplate the end of the Cotonou Agreement and either establish economic partnership agreements with the EU and regional partners or revert to the preferences that are available under the EBA. The analysis presented here shows that for a number of the least developed ACP countries EU preferences are currently of little value given the existing structure of trade since the majority of their exports are concentrated in products with a zero MFN duty. Hence for these countries the end of the Cotonou Agreement will only be of relevance to their access to the EU market to the extent that the more favourable rules of origin under Cotonou compared to the EBA provides a stimulus to future trade diversification. The possibilities for cumulation between ACP countries under Cotonou but not under the EBA may be of particular importance in this context.

For other ACP LDCs the information on the utilization of the EBA in 2001 suggests that for the vast majority of trade the Cotonou Agreement was the preferred vehicle for accessing the EU market. This may reflect some inertia and lack of knowledge of the new scheme. However, it may also reflect the more liberal rules of origin under the Cotonou Agreement. Further studies on this issue would be very useful, for if the rules of origin are encouraging the use of Cotonou rather than EBA then there may be significant costs in shifting to the EBA. At this point, it would appear that the EBA is not a substitute for the Cotonou Agreement. This also highlights that rules of origin should be a key issue for countries which decide to enter into negotiations to establish economic partnership agreements with the EU.

Finally, the EU has provided an important lead to other developed countries in opening up its market to all the products exported by the LDCs. The United States has recently implemented the Africa Growth and Opportunity Act which offers improved access to certain African, but not Asian, LDCs. However, the US scheme is less than fully

comprehensive, is time limited and its impact is also constrained by restrictive rules of origin.<sup>14</sup> Canada has recently proposed its own scheme of duty free access for LDCs, but again certain agricultural products are excluded. The proposed Canadian scheme does appear to have more flexible rules of origin. For example, for textiles and clothing the scheme allows cumulation amongst all developing countries (including China and India) with a 25 per cent value added requirement. What would be of immense value would be for the developed countries to come together at the WTO and coordinate their positions on market access for developing countries and in particular to address the issue of the under-utilisation of trade preferences. The prime suspects for this are the rules of origin, at the very least it is time they were brought in for questioning!

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<sup>14</sup> See Mattoo et al (2001).

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Annex 1: Simple Comparison of the Rules of Origin Regarding Vessels under the EBA and Cotonou Agreement.

- Under the EBA the vessel must be registered in the beneficiary country or the EU. Under Cotonou the vessel must be registered in the EU or any ACP state.
- Under the EBA the vessel must sail under the flag of the beneficiary country or the EU. Under Cotonou the vessel must sail under the flag of any ACP country or the EU.
- Under the EBA the vessels must be at least 50 per cent owned by nationals of the beneficiary country or the EU or by companies with a head office in either the beneficiary or an EU state of which the chairman and the majority of the board members are nationals of those countries. Under Cotonou these provisions are extended to cover all ACP states. Under certain conditions the EU will accept vessels chartered or leased by the ACP state under the Cotonou Agreement.
- Under the EBA the master and officers must be nationals of the beneficiary country or an EU member and at least 75 per cent of the crew must be nationals of the beneficiary country or the EU. Under Cotonou 50 per cent of the crew, and the master and officers must be nationals of any ACP state or the EU.

Figure 1: LDC Exports to the EU, 1988 - 2001

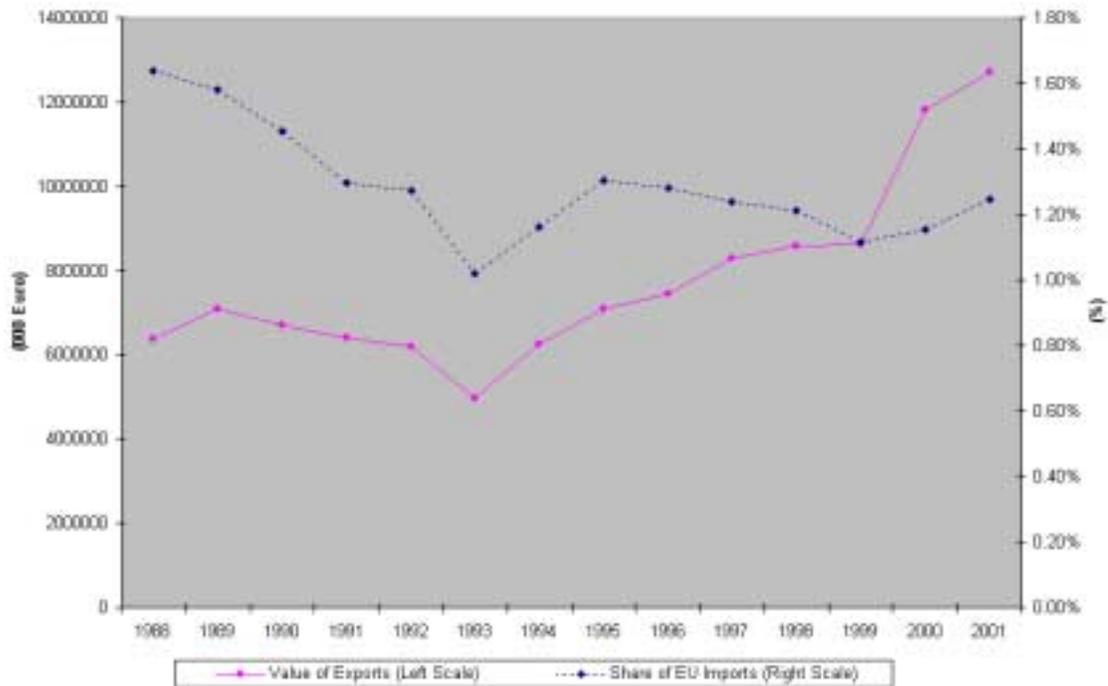


Table 1: The Overall Impact of the EBA in 2001.

	Exports of Products liberalized under the EBA in 2001	Exports of Products under the EBA with Delayed Liberalisation (Bananas, Rice Sugar)	Exports of All products covered by the EBA	Total Exports of All Products
Exports to the EU of all LDCs (000 Euro)				
2000	10657	62963	73620	11733712
2001	3658	60670	64328	12858993
Exports to the EU of ACP Countries				
2000	10505	62904	73409	7764664
2001	3344	60596	63940	8634365
Exports to the EU of Non-ACP Countries				
2000	152	59	214	3969048
2001	313	74	387	4225518

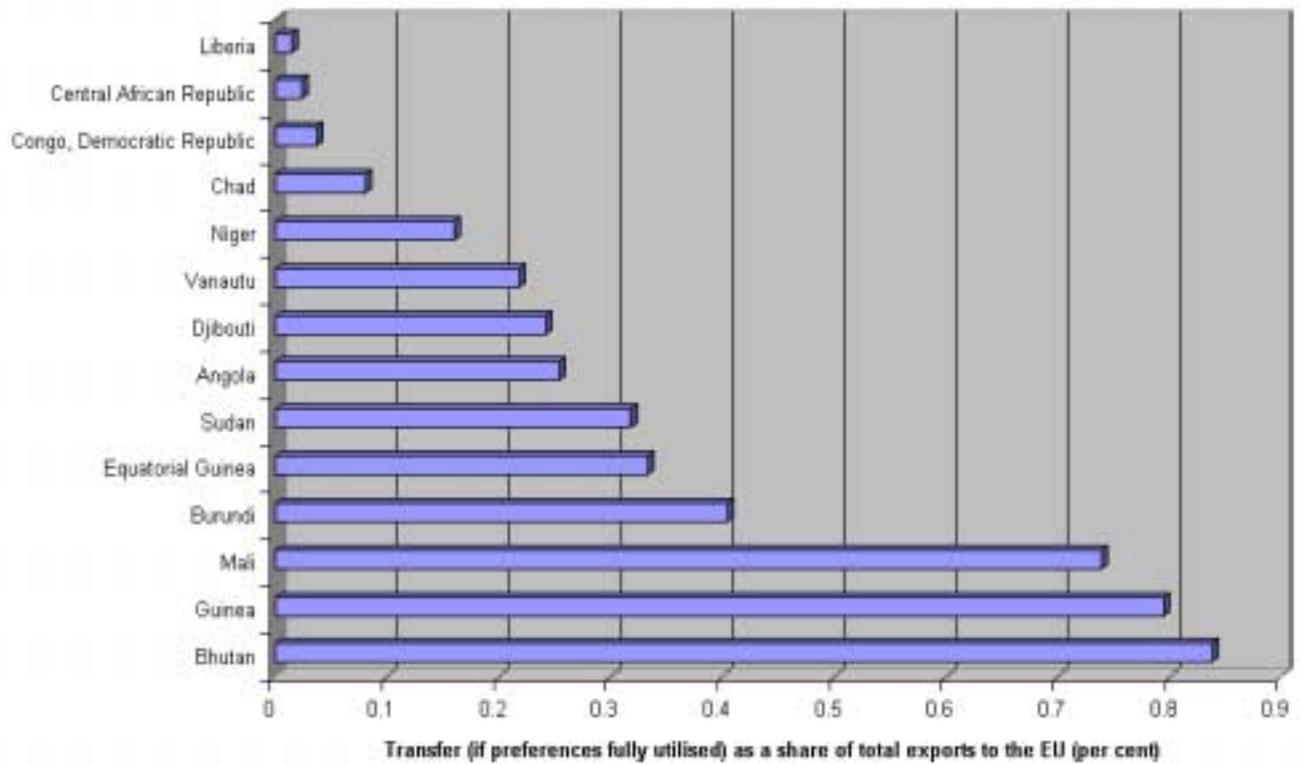
Table 2: The Importance of Products Liberalised in 2001 under the EBA (000 Euro)

	Total Exports to EU	Eligible Exports of Products Liberalised in 2001	Exports of products liberalised in 2001 requesting access under EBA	exports of rice, sugar, bananas	Share of exports liberalised in 2001 in total exports to EU %	Export Share of items with delayed liberalization %
ACP						
Angola	1944630	91 (91)*	0	0	0.00	0.00
Congo	941784	7 (7)	0	50	0.00	0.01
Equatorial Guinea	754865	0	0	0	0.00	0.00
Liberia	736973	10 (10)	0	0	0.00	0.00
Madagascar	600912	72 (42)	0	8500	0.01	1.41
Guinea	579518	41 (28)	0	0	0.01	0.00
Mozambique	530174	248.5 (2)	0	991	0.05	0.19
Tanzania	395283	35 (35)	0	6648	0.01	1.68
Sudan	303550	778 (778)	0	13982	0.26	4.61
Mauritania	258568	6	0	6	0.00	0.00
Uganda	242524	116.3 (49)	0	55	0.05	0.02
Malawi	194903	0	0	22617	0.00	11.60
Ethiopia	159389	12(11)	0	968	0.01	0.61
Zambia	158375	1359 (1359)	0	6675	0.86	4.21
Central African Republic	152804	0	0	0	0.00	0.00
Niger	119613	6	0	0	0.00	0.00
Benin	63698	69 (69)	0	0	0.11	0.00
Burkina Faso	63052	52 (44)	0	0	0.08	0.00
Djibouti	61494	38 (22)	0	0	0.06	0.00
Togo	58591	26 (26)	0	26	0.04	0.02
Chad	57638	1 (1)	0	0	0.00	0.00
Mali	45726	67 (60)	0	0	0.13	0.00
Sierra Leone	38420	72 (2)	0	0	0.19	0.00
Rwanda	21782	5.5 (4)	0	78	0.03	0.36
Comoros	20770	3	0	0	0.00	0.00
Gambia	20679	41 (41)	0	0	0.00	0.00
Burundi	19474	19 (19)	0	0	0.10	0.00
Lesotho	12797	0	0	0	0.00	0.00
Haiti	16356	158 (158)	0	0	0.97	0.00
Vanuatu	13653	0	0	0	0.00	0.00
Cape Verde	11803	10 (10)	0	0	0.11	0.00
Sao Tome	8009	0	0	0	0.00	0.00
Eritrea	6737	1 (1)	0	0	0.01	0.00
Solomon Islands	4975	0	0	0	0.00	0.00
Guinea Bissau	4542	0	0	0	0.00	0.00
Somalia	3047	0	0	0	0.00	0.00
Samoa	2206	0	0	0	0.00	0.00
Kiribati	728	0	0	0	0.00	0.00
Tuvalu	390	0	0	0	0.00	0.00

	Total Exports to EU	Eligible Exports of Products Liberalised in 2001	Exports of products liberalised in 2001 requesting access under EBA	exports of rice, sugar, bananas	Share of exports liberalised in 2001 in total exports to EU	Export Share of items with delayed liberalisation
Non-ACP						
Bangladesh	3318865	69	68	5	0.00	0.00
Cambodia	482480	0	0	0	0.00	0.00
Laos	143716	74	74	42	0.05	0.03
Nepal	135119	0	0	0	0.00	0.00
Yemen	83596	169	91	0	0.20	0.00
Maldives	37377	1 (1)	0	0	0.00	0.00
Afganistan	23813	0	0	0	0.00	0.00
Bhutan	552	0	0	27	0.00	4.89
Total	12859883	3658 (2870)	234	60670	0.03	0.47
Total - ACP	8634365	3344 (2869)	0	60596	0.04	0.70
Total Non-ACP	4225518	313 (1)	234	74	0.01	0.00

\* The number in brackets is the value of exports in products liberalized under the EBA but which were not recorded as being eligible for EBA preferences in EU customs statistics. One possibility is that imports entered the EU in the first two months of the year prior to the implementation of the EBA. However, cursory investigation for some of these products suggests that imports occurred throughout the year. Mis-recording of the data is also possible but maybe worth investigating whether imports of these products were denied preferences to which they were eligible.

**Figure 2: Countries for Whom the Potential Value of EU Preferences is Insignificant**



**Figure 3: Countries for Whom the Potential Value of EU Preferences is Low**

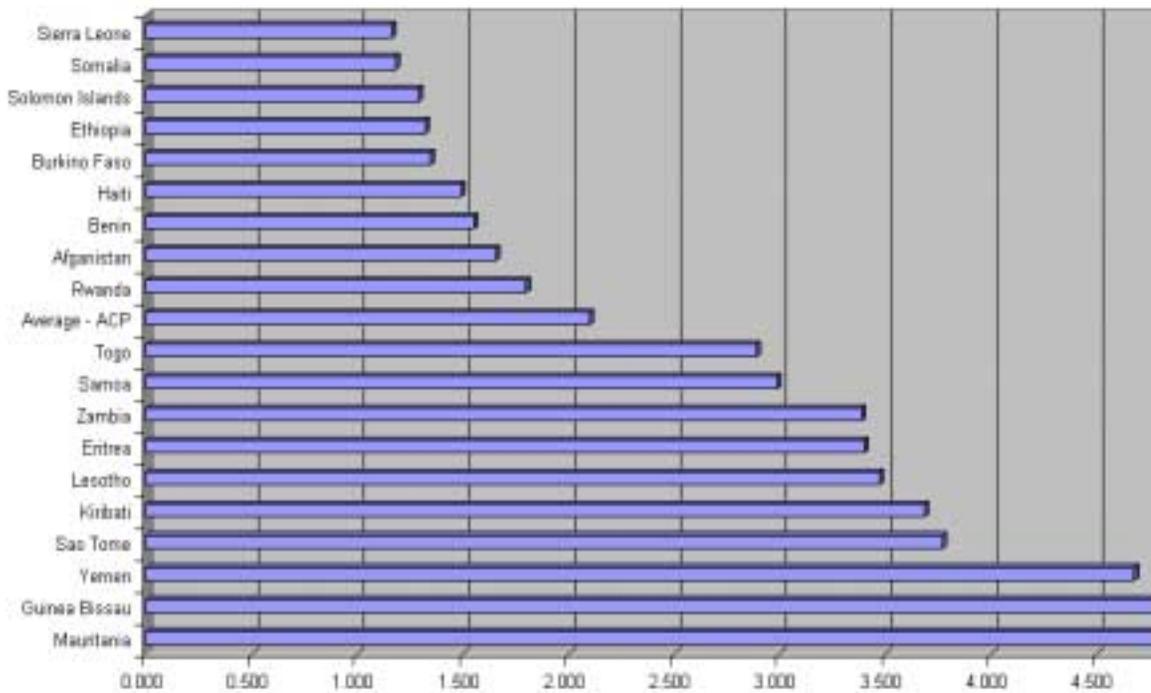


Figure 4: Countries for Whom the Potential Value of EU Preferences is High

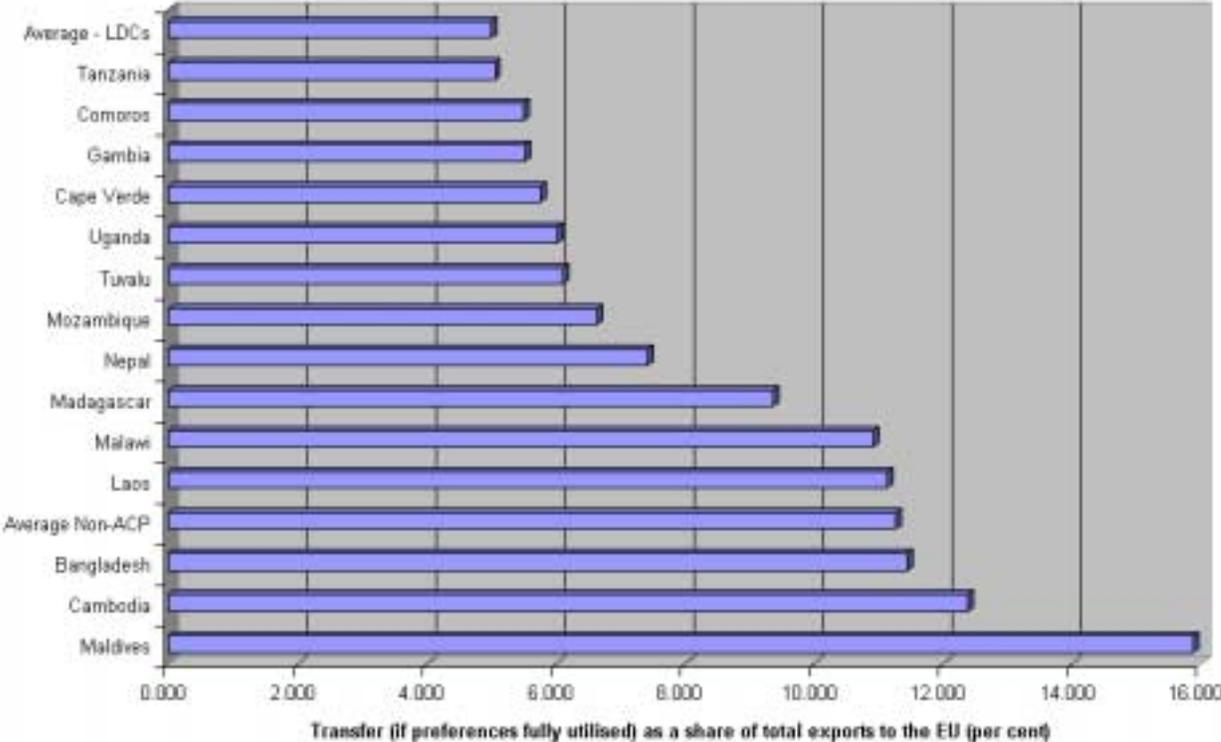


Table 3: The Relevance of EBA and the Delivery of Preferential Access to the EU Market in 2001

	Extent of Preferential Access		
	No take-up of preferences	Low Take-up of Preferences	High Take-up of Preferences
No Relevance of EBA	Angola, Central African Republic, Chad, Democratic Republic of Congo, Liberia, Niger, Vanautu		
Low Relevance of EBA	<b>Bhutan</b> , Burundi, Djibouti, Equatorial Guinea, Guinea, Kiribati, Mali Rwanda, Solomon Islands, Sudan	<b>Afganistan</b> , Sierra Leone	Haiti, Samoa, Lesotho
High Relevance of EBA	Benin, Burkino Faso, Cape Verde, Comoros, Eritrea, Gambia Guinea Bissau, Madagascar Malawi, Mauritania, Mozambique Sao Tome, Somalia, Tanzania, Togo, Tuvalu, Uganda, Zambia	Ethiopia, <b>Maldives</b>	<b>Bangladesh</b> , <b>Cambodia</b> <b>Laos</b> , <b>Nepal</b> <b>Yemen</b>

No Relevance of EBA – Exports eligible for preferences < 5% of total exports to the EU

Low Relevance of EBA – 5% < Exports eligible for preferences < 30% of total exports to the EU

High Relevance of EBA - Exports eligible for preferences >30% of total exports to the EU

No take-up of preferences – exports requesting preferences < 5% of exports eligible for preferences

Low take-up of preferences – 5% < exports requesting preferences < 30% of export eligible for preferences

High take-up of preferences - exports requesting preferences >30% of exports eligible for preferences

The non-ACP LDCs are shaded in yellow.

Table 4: Exports to the EU Under the EBA from Non-ACP Countries

	Total Exports to EU (Eur 000)	Exports to EU eligible under EBA (Eur 000)	Exports to EU requesting duty free access (Eur 000)	Exports requesting duty free access as a proportion of total eligible exports (%)	Maximum value of preferences granted (Eur 000)	Transfer foregone (Eur 000)*	Delivery Ratio	Total Potential Transfer as a proportion of exports to the EU	Transfer foregone as a proportion of exports to the EU
Afganistan	23813	5705	307	5.38	15.76	378.38	4.00	1.66	1.59
Bangladesh	3318865	3265831	1637514	50.14	187426.55	192610.83	49.32	11.45	5.80
Bhutan	552	109	2	1.65	0.12	4.51	2.51	0.84	0.82
Cambodia	482480	477700	171865	35.98	22830.63	36980.56	38.17	12.40	7.66
Laos	143716	133872	78878	58.92	9536.50	6491.26	59.50	11.15	4.52
Maldives	37377	37152	9732	26.20	2064.14	3876.08	34.75	15.89	10.37
Nepal	135119	123406	88130	71.42	7237.67	2807.27	72.05	7.43	2.08
Yemen	83596	38262	29213	76.35	3280.23	635.11	83.78	4.68	0.76
Total Non-ACP LDCs	4225518	4082037	2015641	49.38	232391.59	243784.01	48.80	11.27	5.77