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EU Preferential Market Access Conditions for the Least Developed Countries

The EU has opened up its market to duty and quota free imports from the least developed countries. This article outlines the key elements of this initiative and the factors determining its likely effects and argues that the EU must also liberalise and reform its preferential rules of origin if the initiative is to be effective in achieving its objectives.

The EU is the largest single market for the merchandise exports of the least developed countries (LDCs), accounting for just over one-third of their total exports. Of the 49 LDCs, 40 countries have received legally binding preferential access to the EU market under the Lomé Convention (1975-2000) and Cotonou Partnership Agreement (2000), while the remaining 9 LDCs have, until recently, received less generous (but still more favourable than other GSP-dependent developing countries) preferences under the EU's Generalised System of Preferences (GSP). Following the WTO Singapore Ministerial Conference of December 1996, the EU Council announced in June 1997 that it would move towards offering Lomé equivalent preferences to all LDCs and in March 1998 amended the GSP offer[1] to give Lomé equivalent preferences for all industrial products and agricultural products not subject to tariff quotas. Further liberalisation of LDC access to the EU market was envisaged in Article 37 of the Cotonou Agreement which stated that "the Community will start by the year 2000, a process which by the end of multilateral trade negotiations and at the latest 2005 will allow duty free access for essentially all products from all LDCs building on the level of the existing trade provisions of the Fourth ACP-EC Convention" (para.9). The "multilateral trade negotiations" referred to in the Cotonou Agreement were not, however, launched, as expected, at the Seattle meeting of the WTO. To try and avoid a similar outcome at the WTO meeting at Doha, Qatar in November 2001 and gain the support of the developing countries for a new round of multilateral trade negotiations, the General Affairs Council of the EU brought forward the implementation of Article 37(9) of the Cotonou Agreement and amended the GSP offer[2] so that, as from 5 March 2001, imports of "Everything But Arms" (EBA) originating in the LDCs would have access to the EU market free of customs duties and quotas. Free access would apply immediately to all products except fresh bananas, rice and sugar, where a full liberalisation was phased in according to a stated timetable. These special arrangements would also be maintained by the EU "for an unlimited period of time and not subject to the periodic renewal of the Community's scheme of generalised preferences" (para.11). EBA was subsequently incorporated into the European Commission's proposed GSP for 2002-4.[3]

Both the short time-scale over which EBA has been introduced and its potential impact on producers in the EU and non-LDC developing countries, have proved controversial. The ACP-EU Joint Parliamentary Assembly meeting in Gabon on 19-22 March 2001, for example, whilst welcoming the EBA initiative, deplored the lack of consultation with the ACP and European Parliament on the proposal and called on the Commission to urgently compile impact studies on the likely effects of the EBA[4] and to ensure that ACP exports are not adversely affected and that

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[1] Council Regulation (EC) No. 602/98 of 9.3.1998.

[2] Council Regulation (EC) No. 416/2001 of 28.2.2001.

[3] COM (2001) 293 final, Brussels 12.6.2001.

[4] ACP-EU 3171/01/fin Resolution.

their competitive position in the market is maintained. Behind this declaration lies the concern that a number of non-LDC ACP countries will suffer from a serious erosion of their preferences, the value of which has already suffered from other EU trade initiatives, multilateral trade negotiations and the implementation of WTO rules. EU producers of "sensitive" products may be adversely affected by the EBA but, it is argued, most of the cost of improving the incomes of the poorest countries are likely to be borne by only slightly less poor producers in other developing countries.

This article sets out the details of the EBA initiatives and analyses the margin of preference now available to the LDCs and the potential impact of these preferences on different groups of developing countries. An often neglected aspect of these preferences is that they are subject to rules of origin and it is argued that the EU's rules substantially limit the potential value of the offer to the LDCs. The article concludes with an analysis of the impact of these special preferences for the LDCs on the negotiation of Economic Partnership Agreements (free trade agreements) which are scheduled to replace the current Cotonou Agreement between the EU and the ACP countries on 1 January 2008 at the latest.

Everything But Arms (EBA) Preferences

The LDCs already received duty and quota free access to the EU market for all manufactured and agricultural goods not subject to tariff quotas under the EU's GSP offer of 1998. The EBA improvement to the GSP in March 2001 extended this duty and quota free access to all products falling within Chapters 1 to 97 originating within the LDCs, except Ch.93 (arms and ammunition). This regulation applied with immediate effect except for three "sensitive" products: fresh bananas, rice and sugar, where free access is phased in over a period of time. Also, to provide greater certainty to importers and producers and to provide greater symmetry with the Cotonou Agreement, these preferences are of unlimited duration and not subject to the Community's periodic review of the GSP.[5] Under the 1998 offer, where (agricultural) products were subject to both an *ad valorem* and a *specific* duty, only the ad valorem duty was subject to reduction, the specific duty still applied. EBA abolishes *both* duties.[6]

The liberalisation schedule for bananas reduces duties by 20% annually starting on 1 January 2002, with free entry from 1 January 2006.[7] The schedule for rice and sugar cane sets a timetable for the reduction in duties over the period 2006-2008 with free entry from 2009, and free entry for an initial tariff quota set for the marketing year 2001-2 and increasing by 15% in each subsequent marketing year up to 2008-9. Details are set out in Table 1.

The Commission's original proposal envisaged a three year transition to free trade in these products and the extended period was agreed as a result of strong objections from EU and Caribbean producers and representatives. Objections to the proposal also resulted in a strengthening of the GSP safeguard provisions to cover "massive increases in imports into the Community of products originating in (the LDCs) in relation to their usual levels of production and export capacity".[8] The Commission subsequently clarified the phrase "massive increase" in the context of rice, sugar and bananas to mean a situation where in any given marketing year, imports into the Community from the least developed countries of rice, sugar and bananas exceed, or are likely to exceed, imports in the previous marketing year by more than 25%.[9]

Finally, the Commission has to submit a report to the Council in 2005 which examines the extent to which LDCs are benefiting from EBA and the adequacy of available instruments to address any substantial disturbances to Community markets and their regulatory mechanisms, notably as regards rice, sugar and bananas.

The Margin of Preferences Available to LDCs

Multilateral trade negotiations have substantially reduced tariffs on manufactured goods to a low average level but they are still significant in "sensitive" manufactured goods such as textiles and clothing, where LDCs have an actual or potential comparative advantage, and in other goods such as electronic goods where LDCs could have a comparative advantage in the labour intensive stages of production. Agricultural, horticultural and fisheries sectors, where imports compete with EU production,

[5] Council Regulation (EC) No. 416/2001, para.11.

[6] 9bid., Article 1(6).

[7] Aligning these preferences with the move from a quota to a tariff only system of protection from 1 January 2006.

[8] 416/2001 Part 1(4) amending Regulation EC No. 2820/98, Art.22(1)(d).

[9] General Secretariat of the Council Doc. No. 8/01 SPG 2.3.01.

Table 1

Tariff Reductions and Quotas for Rice and Sugar Cane Imports from the LDCs

		2001/2	2002/3	2003/4	2004/5	2005/6	2006/7	2007/8	2008/9
Rice[1]	tariff reduction	0	0	0	0	0	20%	50%	80%
(CN1006)	tariff quota (tonnes)	2,517	2,895	3,329	3,829	4,403	5,063	5,823	6,696
Sugar[2]	tariff reduction	0	0	0	0		20%	50%	80%
(CN1701)	tariff quota (tonnes)	74,185	85,313	98,110	112,827	129,751	149,213	171,595	197,335

[1] Marketing years September 2001 - September 2009.

[2] Marketing years July 2001 - July 2009.

Source: Council Regulation (EC) No. 416/2001 Article 1(3), (4), (5).

are very often subject to high levels of protection, while other products, although subject to zero tariffs on the raw material, can be subject to significant tariff escalation on further stages of processing, resulting in high effective tariff rates.

The margin of preferences available to the LDCs must, of course, be assessed *relative* to the tariffs levied on competing third country suppliers. Unfortunately, there is no simple way of evaluating this as the EU has a complex and elaborate system of regional trade agreements. Developing countries are generally covered by the GSP and in addition to offering substantially more generous treatment in the GSP for LDCs under the EBA initiative, the EU offers significantly superior preferences to the Andean Pact and Central American countries to assist them in drug control measures. The ACP countries are covered by the Cotonou Partnership Agreement while the EU aims to establish a Euro-Med Free Trade Area by 2010 and currently has concluded FTAs with nine Mediterranean countries (in addition to the customs union agreements with Cyprus, Malta and Turkey). Free trade agreements have also been concluded with South Africa and Mexico and the EU is currently negotiating further FTAs in Latin America (Mercosur and Chile) and with the Gulf Corporation Council States. The Europe Agreements cover ten Central and East European countries whilst the European Economic Area covers Iceland, Norway, Switzerland and the Faroe Islands. This system of preferential trade agreements can be likened to a "pyramid of privilege"[10] with the top tier occupied by the most preferred countries and the bottom occupied by those countries obtaining only WTO based "most favoured nation" (MFN) treatment. While this concept conveys the general structure of EU preferences, the reality is even more complex because each set of agreements differs in the details of product coverage, depth of tariff cut, coverage and size of tariff quotas and access determining administrative rules and procedures.

Table 2 illustrates some of the elements of the complexity of the EU's preferential trading regime and the relative margin of preferences obtained by LDCs. The most sensitive agricultural, horticultural and fisheries products and processed products are either excluded from the GSP or only made available to the Latin American countries benefiting from the EU's special regime for the control of drugs and are protected by ad valorem tariffs, specific duties or both. The protective effect of specific tariffs is difficult to evaluate without detailed information on import prices, but recent evidence suggests a substantial price raising effect in the EU market relative to world prices (1999/2000)[11] for sugar (160%), beef (57%), milled rice (100%), cheese (62%) and bananas (83%). All of these products are exported by at least some of the LDCs to the EU.[12] Free access for these products therefore potentially conveys a significant competitive advantage to the LDCs over most third countries, though the change in the margin of preference brought about by recent EU initiatives in favour of LDCs varies according to the initial position of the LDC in question. Non-ACP LDCs which have been excluded from preferences on these products potentially gain the most.

[10] For a recent discussion of this see C. Stevens, M. McQueen: Regional Trade Agreements, Department of International Development (DFID), Trade and Investment Background Briefing No.2, 2000, www.dfid.gov.uk.

[11] Commission: EU Trade Concessions to Least Developed Countries (revised version), Brussels 2001, www.europa.eu.int/trade.

[12] C. Stevens, J. Kennan: The Impact of the EU's Everything but Arms Proposal: A Report to Oxfam, IDS, Sussex, January 2001; M. McQueen et al.: ACP-EU Trade and Aid Co-operation post Lomé IV, London, Commonwealth Secretariat, 1998, Ch.2.

Table 2

Variations in EU Preferences

CN	Product	MFN	ACP	Other Preferences
02023090	Frozen bovine boned beef	12.8% + €304.1/100kg	0% + €304.1/100kg 0% + €24.3/100kg, TQ	GSP - No Poland 0% Bulgaria 2.5% + €60.8/100kg Turkey - as ACP
10063098	Wholly milled long grain rice	€416/1000kg	€133.21/1000kg	GSP - No Egypt €312/1000kg
04069021	Cheddar cheese	€167.1/100kg €21.0/100kg, TQ	€58.4/100kg, TQ	GSP - No Poland, Bulgaria 0%, TQ
17011110	Cane sugar for refining	€33.9/100kg	0%, TQ	No
17011190	Cane sugar, other	€41.9/100kg	0%, TQ	No
08030019	Bananas	€680/1000kg €300/1000kg, TQ €75/1000kg, TQ	0%, TQ €380/1000kg, TQ	No
060310	Fresh cut flowers	12%	0%	GSP - No SPGE. Turkey,Croatia, Bulgaria 0%
08111109010	Strawberries	14.4%	0%	GSP - No SPGE. Morocco, Poland 0% Bulgaria 5.1%
030613 10 40 50 80 30	Shrimps and prawns, fresh, chilled, etc.	12.0% 12.0% 12.0% 12.0% 18.0%	0%	GSP - No SPGE. 3.6% Turkey 0%
6205200090	Men's, boys' cotton shorts	12%	0%	GSP 10.2% Egypt, Poland, Bulgaria 0%

Notes: "Other Preferences" (Col.5) is illustrative only. – SPGE = special GSP preferences for Andean Pact and Central American countries combating drugs. – TQ = reduced duty within a tariff quota.

Source: TARIC, August 2001.

All ACP and LDCs which were sugar exporters to the UK and France prior to 1975 have received preferential access to the EU under the sugar protocol attached to the Lomé Convention and will only gain by the EBA to the extent that country specific tariff quotas have been binding or discouraged investment to expand production in the industry. Access to the EU market, however, has never been offered to other ACP-LDCs such as Uganda and Sudan or to non-ACP LDCs and EBA may induce exports to this profitable market. Rice producers in the EU have also received substantial protection and prior to the EU's initiatives in favour of the LDCs, the only preferences granted were a reduced specific tariff for the ACP countries. Bananas have also been subject to high import duties and a complex system of import licensing to protect high cost ACP producers in the Caribbean. Successful action in the WTO against this regime by the US and Latin American producers has forced the EU to revise this regime and move to tariff only protection by 1 January 2006, but this should still produce a substantial margin of preference for the LDCs, including ACP-LDCs. The other products listed are either excluded from the EU standard GSP for all developing countries or are classified as "sensitive" products and subject to only small tariff reductions.

The changes to the GSP proposed by the Commission in June 2001 for the period 2002-2004 will, if anything, enhance the relative level of preferences for the LDCs.[13] These proposals simplify the structure of preferences, maintaining duty-free access for all non-sensitive products and replacing the previous three categories of sensitive products (with different tariff levels) with one category which will be subject to an absolute reduction of 3.5%. "Graduation" out of preferences on a country and sector basis will take place annually if countries meet one of the three criteria calculated over the three previous years, although graduation could be subsequently reversed where the criteria are no longer fulfilled. On the basis of the most recent statistics, implementing this new scheme could remove GSP coverage from

[13] Commission proposal for a Council Regulation applying a share of generalised tariff preference for the period 1 January 2002 to 31 December 2004, Brussels, 12.6. 2001, Com (2001) 293 final.

half the volume of trade covered by the GSP, compared to the current level of one-third of eligible trade.

The trend in EU initiatives for regional preferential trade agreements means, however, that the value of preference for the LDCs will be substantially eroded over the next ten to fifteen years. The EU's free trade agreements have to comply with Article XXIV of the GATT and the Understanding on the Interpretation of Article XXIV (1994). In practice this has meant that the EU FTAs with developing countries have been implemented over a maximum period of 12 years, with the EU liberalising its market access over a shorter period of time and that "substantially all trade" (Art. XXIV) has been interpreted as covering 90% of bilateral trade. The EU has interpreted this to cover *existing* trade flows but it should be noted that these are reduced and distorted by pre-FTA border restrictions, especially for agricultural goods. The preamble to the "Understanding" states that the contribution of FTAs to the expansion of world trade is increased if the elimination of "duties and other restrictive regulations of commerce extends to all trade, and diminished if any major sector of trade is excluded". Too narrow an interpretation of "substantially all trade" which excluded important sectors of agriculture would therefore make the EU liable to successful challenge in the WTO. The prospects for the LDCs are therefore for duty-free access in "everything but arms" to be simply part of a wider structure of EU free trade agreements covering essentially all trade with countries in Europe, the Mediterranean, Latin America, Africa, the Caribbean and Pacific.[14]

In addition, the agreed timetable of eastward enlargement of the EU with potentially large implications for Community expenditure on agriculture, combined with WTO agreements, will, as envisaged in Agenda 2000, result in a large shift in EU agricultural protection away from border protection and high guaranteed prices and export subsidies, to more competitive markets (with CAP prices moving close to world prices) and targeted producer subsidies. This will result in a fall in EU market prices and a rise in the world prices of temperate (and close substitute tropical) food and animal feedstuffs, further eroding the value of LDC preferences.

Preferences for the LDCs should therefore be seen as a potential windfall gain, the value of which is already being eroded by EU bilateral and multilateral trade liberalisation measures. If this initiative is to assist the LDCs better to integrate into the international economy, then time is of the essence in enabling them to benefit from special preferences. Equally, it is important that investment decisions are not based on a false comparative advantage created solely by the margin of preferences, but on actual or potential long-run comparative advantage based on natural resource endowments and the relative costs of factors of production. Preferences for the LDCs should be considered as a relatively short-term subsidy to local or foreign investors which helps overcome some of the initial costs of increasing existing production or establishing new areas of production for export.

The Impact of EBA

The impact of EBA on the LDCs, non-LDC developing countries, other beneficiaries of EU preferences (who will be subject to preference erosion), countries subject only to MFN treatment, and EU producers, is not easy to predict. It might be assumed that the additional effect of the EBA is likely to be small. First, most of the LDCs are ACP countries which have had generous access to the EU market since at least 1975, including substantial concessions on sensitive agricultural products. Second, EBA builds on previous initiatives in favour of the LDCs and so the additional effect is confined to primary products in Chapters 1 to 24 which were subject to tariff quotas and where non-ACP-LDCs were more affected than ACP-LDCs. Third, the LDCs as a whole are marginal suppliers and net importers of these commodities and so it might be assumed that the EBA would therefore have little or no effect.

Whilst the impact of EBA will probably be small at a global level, the complexities of the EU's trade and agricultural policies mean that there could still be product-specific marginal changes which could have significant distributional effects. On the supply side, the substantial price wedge between EU and world prices created by the protective regime of the CAP produces an incentive for producers in the LDCs to substitute the EU market for other export markets. In addition, if domestic prices are less than EU prices then the LDCs may engage in "triangular trade", switching production for domestic consumption towards exports to the EU and replacing this with imports purchased at world prices (both from third countries and subsidised exports from the EU). In the long run, the profitability of the EU market may

[14] Negotiations to replace the Cotonou Agreement with Regional Free trade (economic partnership) agreements will take place over the period 2002-2006/8.

stimulate investment, particularly foreign direct investment, to increase export capacity. On the demand side, the impact of the EBA will depend on the balance between production and consumption in the EU and the characteristics of the EU's import regime. Introducing unrestricted imports from the LDCs for a product where the EU's import regime strongly discriminates between sources of supply, could produce substantial distributional effects from relatively small changes in imports. For example, relatively small increases in imports from the LDCs in a market where the EU is already self-sufficient may produce potentially significant adverse effects on non-LDC exporters to the EU and EU producers (or the EU budget).

The potential interaction between these supply and demand factors appears to be most acute in the case of sugar. EU sugar beet producers have been heavily protected under the CAP and as a result there is a large annual excess supply of sugar. In addition, there are complex preferential import arrangements for raw cane sugar. The arrangements for "preferential sugar" consist of a zero duty on country specific tariff quotas for traditional ACP suppliers (guaranteed under the Sugar Protocol attached to the Cotonou Agreement), and a separate agreement on imports of sugar from India. In addition, there are arrangements for imports of "special preferential sugar" (SPS) from these countries which are subject to a substantially reduced rate of duty on a variable quantity. Imports of SPS are determined by the difference between the presumed maximum supply needs of sugar cane refineries in Finland, metropolitan France, mainland Portugal and the UK,[15] and EU imports of preferential sugar. Excess supplies of sugar from domestic production and imports are put into store or exported. Prior to 1994 the EU was free to dump as much sugar on to world markets as it wanted to, using export subsidies, but the volume of subsidised sugar exports is now limited by the WTO Agreement on Agriculture to 2.8 million tonnes and all of this is already fully utilised. Any increase in imports in excess of the growth in demand for sugar (currently around 2.5% p.a.) will therefore have to be balanced by a reduction in EU production of beet sugar and imports of SPS. ACP producers in particular feel threatened by this situation, not only because they consider that the EU will reduce imports of SPS rather than cut production quotas for EU producers, but also because EU refiners of cane sugar would be able to switch from "preferential sugar" which they have to purchase at the intervention price, to LDC sugar which they could purchase at a substantially lower price. In principle, the EU is obliged to purchase any excess supply of preferential sugar at the intervention price, but in practice the EU has already questioned whether the sugar protocol is of indefinite duration and the cost to the EU budget of intervention purchases would increase the pressure to re-negotiate or even terminate the sugar protocol. Further pressure on EU sugar producers and therefore on the continuation of the Sugar Protocol could arise if the EU's capacity to refine cane sugar were expanded through the utilisation of existing excess capacity in cane sugar refineries and minor adjustments were made to enable beet sugar refineries to process cane sugar.

The capacity of the LDCs to respond to free access is therefore critical to its effects on the EU market and therefore on ACP producers, particularly those in the Caribbean, Mauritius and Fiji. Given the range of variables determining the supply response and the large degree of uncertainty over the responsiveness of the variables to this profitable market opportunity, it is not surprising that estimates of potential LDC exports vary widely from a maximum increase of 100,000 tonnes[16] to a "potential (full and planned) capacity to export" of 4.3 million tonnes, with the Commission producing "scenarios" of between 900,000 tonnes and 2.7 million tonnes (1.4 million tonnes from market substitution and 1.3 million tonnes from increased production).[17] Critical to these outcomes is the supply response of Sudan, Mozambique, Zambia, Malawi and Ethiopia and the willingness of foreign investors to increase substantially the level of production and export capacity of these countries. As a result of this uncertainty, free imports of sugar from LDCs are being phased in over the period up to 2009.

Rice is another commodity where EU supplies (domestic production plus imports) are greater than consumption and where a substantial price wedge could induce substantial market substitution effects among Asian LDCs, potentially crowding out non-LDCs' Asian exports as well as EU producers. Non-LDC ACP producers, particularly in the Caribbean, would also be adversely affected by increased supplies of bananas from LDCs causing the

[15] Set in a country specific basis at a total of 1,776,000 tonnes per marketing year for the period 2001-2 to 2005/6, OJL178/28, 30.6.2001.

[16] FAO estimate quoted by C. Stevens, J. Kennan, op. cit.

[17] EBA – An Impact Assessment for the Sugar Sector, ASSUC, 25 January 2001; Commission: EU Trade Concessions to Least Developed Countries, pp. 15-16.

protection distorted EU price to fall below the high production costs of the producers.

Estimates of the production response by LDCs to free access to the EU must also be set in the context of the increasing marginalisation of these countries in world trade. For example, an important conclusion of a recent study is that "the trend in the value of EU imports from LDC and non-LDC suppliers of the 11 most likely affected commodities is pretty bleak".[18] The EU's initiative should therefore be primarily seen as an attempt to reverse this process, but abolishing duties on imports from the LDCs needs to be part of a more general and ambitious process of trade liberalisation and financial and technical assistance to enable them not only to increase production and diversify exports, but also to meet the exacting requirements of the EU market. A key element in this is the ability to attract the financial and technical involvement of multinational companies. Duty and quota free access to the EU market should help in inducing these companies to become involved in LDCs but this has to be complemented by other initiatives taken by the EU, in particular changes to the rules governing the definition of products "originating" in the LDCs.

Rules of Origin

In order to be able to discriminate in favour of the LDCs, the EU must also ensure that third countries do not circumvent the EU's tariffs by deflecting exports to the EU via the LDCs. In this respect the EU and the LDCs have a mutual interest in ensuring that only exports "originating" in the LDCs benefit from preference, and goods which use "non-originating" (third country) inputs in their production need to have undergone sufficient working or processing to qualify as originating goods for preferential treatment. Beyond this, however, policy objectives may diverge. The LDCs will wish to use preferences to increase and diversify their exports to the EU and to attract foreign direct investment. The EU, while also seeking these development objectives, may have additional policy objectives such as creating conditions favourable for EU exports and investment in the LDCs and protecting the interests of powerful producer groups.

For some years now, the EU's rules of origin[19] have been criticised for going beyond the level necessary to present trade deflection.[20] Operations such as "simple assembly" and "simple mixing of products" are classified as insufficient working or processing, while processed foodstuffs must generally be manufactured from products wholly obtained in the LDC. Manufactured goods which use non-originating inputs must satisfy the "tariff jump" criterion, that is imported inputs must be classified under a different four-digit HS heading from that of the exported product. This basic criterion is often supplemented by additional domestic value added criteria (typically 50% or 60%) or, in the case of textiles and clothing, process criteria (for example, clothing using non-originating imports of cloth would not qualify for preferences, manufacturers would have to start with imported yarn.) The problem with these criteria is that the LDCs have, according to the agreed UN definition of an LDC, a small share of manufacturing in GDP.[21] As a result, they very often lack the vertical chains of production necessary to fulfil the high value added and process criteria. Secondly, the concept of vertically integrated industries (for example, in the case of clothing, starting from the weaving of imported yarn through to the finished garment) does not correspond to modern techniques of production and the global production strategies of multinational corporations (MNCs) emphasising different geographical locations for different production processes (global sourcing) rather than the production of finished products for export. This disincentive effect of rules of origin is a crucial weakness in the EU's preferences for developing countries in general and the least developed countries in particular. Access to the EU market, for both manufactured and non-manufactured goods does not simply depend on exemption from tariffs. Access also requires precise knowledge about the characteristics of the market, designs, production processes, the maintenance of high standards of quality and cost control, transportation and distribution, and fulfilling the exacting standards both of the regulatory authorities of the importing country and of the retail chains who dominate the market. In many cases, the only effective source of this knowledge is through foreign direct investment or contractual relationships with MNCs. Preferences for the LDCs provide a financial incentive for MNCs to become involved with these countries, but the rules of origin

[18] C. Stevens, J. Kennan, op. cit., p.10.

[19] The EU's GSP rules of origin are set out in Regulation (EC) No. 2454/93 as amended by Regulation (EC) No. 1602/2000, OJ L188 of 26.7.2000.

[20] See, for example, M. McQueen: Lomé and the Protective Rules of Origin, in: Journal of World Trade Law, Vol. 16, No. 2, March/April 1982, pp. 119-132.

[21] An average of 8%, ranging from 15% for Bangladesh to less than 4% for countries such as Angola and Mali (World Bank, World Development Indicators, 2001).

largely limit this effect to the export of agricultural and horticultural goods which are produced within the LDC.

The EU has sought to reduce the adverse effects of the rules of origin by permitting cumulation of origin beyond the customs territory of any beneficiary country (not just LDCs) and "derogations" (exemptions) from the rules of origin in special cases. Neither of these measures is a satisfactory substitute for a reform of the system.

Bilateral cumulation allows imports from the EU to count as originating products provided working or processing goes beyond "insufficient" levels.[22] This is only of assistance to the LDC, however, if the EU is the most efficient world source of supply of the required intermediate products, or the cost disadvantage of importing from the EU is outweighed by the margin of preference on the final export to the EU. Even in the latter case, it should be noted that this implies welfare reducing trade diversion. The second form of cumulation allowed under the GSP is partial regional cumulation which permits beneficiaries (in this case LDCs) to obtain preferential access to the EU market for goods which incorporate materials imported from other countries of the same regional grouping provided that the value-added in the LDC exceeds the value of the materials originating in any one of the other countries of the regional group (100% value added). In the case of the LDCs, this allows cumulation of origin with the ASEAN[23] and SAARC[24] countries. As with bilateral cumulation, this is only of use to the LDC if a regional partner is able to provide the required intermediate products and at a price and quality which enables the LDC to compete in the EU market. Also, a number of constraints in this system of cumulation should be noted. First, only the materials which acquire origin in one of the member countries of the regional group are counted as "domestic content" in the LDC for the purposes of satisfying the rules of origin. This can be contrasted with the regional cumulation rules of the USA and Japan which treat the regional group as effectively one customs territory within which origin can be accumulated. Second, the materials imported from the regional partner must have acquired the status of originating products by an application of rules of origin identical to those of the EU's GSP. Third, if the 100% value added rule is not fulfilled by the LDC then origin (and therefore conditions of market access) is determined by the supplier of the intermediate products. If this country is not a recipient of EU preferences or the same margin of preferences as the LDC then the LDC will not obtain EBA preferences.

A further area of difficulty with the rules of origin concerns fisheries products, where EU rules define the country of origin as the country where the vessel was registered and, in addition, stipulate the nationality of the captain and crew. The result of this is to exclude vessels chartered from third countries (usually the only practicable method) even though the fish are caught in the territorial waters of the LDC.

The EU response to these criticisms is that it allows exemptions or "derogations" from the rules of origin in particular cases. This is, however, not an adequate response to the basic problem of excessively restrictive rules of origin. In any case, derogations are only permitted after a costly and time-consuming investigation for a limited period of time to allow beneficiaries to adjust and conform to the rules of origin and are not granted on a permanent basis.

Implications for Future ACP-EU Economic Relations

The Cotonou Agreement specifies that the current non-reciprocal preferential agreement will be replaced by new WTO-compatible Economic Partnership Agreements (EPAs) between regional groups of ACP countries and the EU,[25] with negotiations beginning in September 2002 and the new trading arrangements coming into force by 1st January 2008 at the latest. Article 35(2) of the Cotonou Agreement provides that "economic and trade co-operation shall build on regional integration initiatives of ACP states bearing in mind that regional integration is a key instrument for the integration of ACP countries into the world economy". Also, EPAs are seen by the EU as a means of deepening and consolidating current regional integration initiatives, as well as acting as an "agency of restraint" in preventing a reversal of policies of trade and market liberalisation and assisting conflict prevention. Equally, the EU has indicated that it would not be prepared to negotiate EPAs with individual

[22] In the case of agricultural products subject to export refunds, there has to be "substantial, economically justified processing or working in an undertaking equipped for the purpose and resulting in the manufacture of a new product or representing an important stage of manufacture" (Act 24, Regulation (EC) No. 2913/92), otherwise export refunds are denied.

[23] Cambodia, Thailand, Laos*, Vietnam, Indonesia, Malaysia, Brunei, Singapore, Philippines, Myanmar* (LDC = *).

[24] Pakistan, India, Bangladesh*, Maldives*, Sri Lanka, Nepal*, Bhutan* (LDC = *).

[25] See M. McQueen: After Lomé IV: ACP-EU Trade Preferences in the 21st Century, in: INTERECONOMICS, Vol. 35, No.5, September/October 1999, pp. 223-232.

ACP countries which are members of regional groups which are eligible for negotiating EPAs.[26]

The EU special preferences for the LDCs create a potential obstacle for the negotiation of EPAs since practically all of the ACP sub-groups which could negotiate EPAs include LDCs. The LDCs have now been given the same duty and quota free access to the EU market as they could obtain under an EPA, while if they participate in an EPA they will have to offer the EU free access to their domestic markets. This may produce some trade creation and dynamic gains but it will also cause trade diversion and adjustment costs for the LDCs. If, however, they decide not to participate in the EPA and retain their own border restrictions against the EU, then this will undermine the process of regional integration.

The LDCs in SADC (comprises South Africa and thirteen developing countries) which are not part of the Southern African Customs Union (SACU) are, perhaps, faced with the most difficult situation.[27] South Africa has concluded a free trade agreement with the EU and if SADC concluded an EPA on behalf of its non-LDC members then regional and foreign investors operating within the EPA could freely trade between the EU and themselves, but not with the LDC members of SADC, since these countries would have retained their tariffs against imports of intermediate goods from the EU. Even if this cost disadvantage is offset by an export rebate scheme in the LDCs, they would only be able to claim EBA preferences on goods using inputs from South Africa if they could satisfy the EU's partial cumulation rules of origin, in particular the 100% value added rule.

More generally, if EPAs do fulfil their objective of accelerating regional growth then opting out of EPAs will essentially mean that LDCs will only benefit indirectly from this process (in the sense that the region as a whole grows more rapidly) and this may not be in their long-term interest. As an additional inducement, the EU has indicated that it would be prepared to consider a delayed start or slower pace of tariff reductions by the LDCs (although whether this added complication would be in the interests of the LDCs is an open question) and provide additional aid for adjustment to an EPA.

If the EU were, however, to change the GSP rules of origin to allow full cumulation of origin with all countries (including developed countries) with which the LDCs had WTO-compatible trade agreements (or alternatively Article XXIV compliant agreements), then the ACP-LDCs would have the opportunity of making an unbiased choice between the GSP and EPAs in terms of their own development objectives. As it is, the GSP rules of origin (and those of the Cotonou Agreement in relation to ACP trade with South Africa) bias the decision against the GSP and in favour of concluding a free trade agreement with the EU.

Concluding Remarks

The EU has taken what appears to be a bold initiative in allowing imports of "everything but arms" into the EU free of duties and quotas. As is invariably the case with trade policy measures, however, "the devil is in the detail". Preferences for the LDCs must be evaluated in the context of the EU's mercantilist trade strategy of concluding bilateral preferential trade agreements with an increasingly wide range of countries. This not only reduces the effective margin of preferences available to the LDCs, but also ensures that, through "hub and spoke" effects, the EU (as the common denominator in these different agreements) obtains a disproportionate share of the gains from this form of trade liberalisation. This effect is compounded by restrictive rules of origin which are combined with allowing cumulation of origin using imports from the EU. The main objective of reversing the declining volume of exports of the LDCs will significantly depend on their ability to attract the participation of MNCs, both through foreign direct investment and contractual relations. These enterprises are a crucial source of knowledge, enabling the LDCs to increase production and engage in vertical and horizontal export diversification, but the rules of origin will limit MNC involvement. Liberalising the EU's preferential rules of origin for LDCs to accord with their structure of production and level of economic development, as well as with global methods of international sourcing and production, is a further essential step in maximising the gain to the LDCs from EBA. Discriminating in favour of the LDCs will inevitably lead to a further erosion of preferences for non-LDC developing countries, particularly sugar and banana producers in the Caribbean. The answer to this, however, is not protection through the quotas and surge mechanisms of the EBA, but concerted action by the EU, in combination with other key WTO players, to liberalise world markets so as to decrease the dependence of those countries on preferential access to the EU market for commodities in which they do not have a comparative advantage.

[26] Commission Orientations on the Qualifications of ACP Regions for the Negotiation of Economic Partnership Agreements, 4/7/01, europa.eu.int/comm/trade/pdf/acpl.pdf

[27] Angola, Malawi, Mozambique, Tanzania, DR of Congo and Zambia.